

# Private Equity Transactions After the Tax Cuts and Jobs Act (TCJA)

**David R. Sicular, Esq.**

Paul, Weiss, Rifkind, Wharton & Garrison LLP, New York, NY

**Erik H. Corwin, Esq.**

KPMG LLP, Washington, DC

**Daniel M. McCall, Esq.**

International Revenue Service, Washington, DC

**David J. Sreter, Esq.**

Warburg Pincus LLC, New York, NY

**Sara B. Zablottney, Esq.**

Kirkland & Ellis LLP, New York, NY



# Private Equity Transactions After the Tax Cuts and Jobs Act (TCJA)

This panel will discuss the impact of the TCJA and recent guidance on private equity transactions, with a focus on cross-border transactions. Topics will include the change in the CFC rules and implications including GILTI and Section 956, pass-through transactions and blocker structures, and other implications of the interest deduction limitations of Section 163(j).

**Panel Chair:**            **David R. Sicular, Esq.**  
Paul, Weiss, Rifkind, Wharton & Garrison LLP  
New York City

**Panelists:**            **Erik H. Corwin, Esq.**  
KPMG LLP  
Washington, D.C.

**David J. Sreter, Esq.**  
Warburg Pincus LLC  
New York City

**Sara B. Zablottney, Esq.**  
Kirkland & Ellis LLP  
New York City

## Representative Authorities

1. GILTI
  - a. NYSBA Report No. 1406, Report on Proposed GILTI Regulations (11/6/2018) (Links: [Tax Section Letter and Report](#))
  - b. NYSBA Report No. 1394, Report on GILTI Provisions of the Code (5/4/2018) (Links: [Tax Section Letter](#) and [Report](#))
  - c. GILTI Proposed Regulations, Federal Register Vol. 83, No. 196, October 10, 2018, at 51072-51111 (Link: [REG-104390-18](#))

2. Section 163(j)
  - a. NYSBA Report No. 1393, Report on Section 163(j) (3/28/2018) (Links: [Tax Section Letter](#) and [Report](#))
  - b. 163(j) Proposed Regulations, Not yet published in the Federal Register (Link: [REG-106089-18](#))



# 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

### KAREN GILBREATH SOWELL

Chair  
Ernst & Young LLP  
1101 New York Ave, N.W.  
Washington, DC 20005  
202/327-8747

### DEBORAH L. PAUL

First Vice-Chair  
212/403-1300

### ANDREW H. BRAITERMAN

Second Vice-Chair  
212/837-6315

### GORDON E. WARNKE

Secretary  
212/997-0500

### COMMITTEE CHAIRS:

#### Bankruptcy and Operating Losses

Stuart J. Goldring  
David W. Mayo

#### Compliance, Practice & Procedure

Elliot Pisem  
Bryan C. Skarlatos

#### Consolidated Returns

William Alexander  
Richard Nugent

#### Corporations

Michael T. Mollerus  
Linda Z. Swartz

#### Cross-Border Capital Markets

David M. Schizer  
Andrew R. Walker

#### Cross-Border M&A

Yaron Z. Reich  
Ansgar A. Simon

#### Employee Benefits

Robert C. Fleder  
Andrea K. Wahlquist

#### Estates and Trusts

Alan S. Halperin  
Joseph Septimus

#### Financial Instruments

Lucy W. Farr  
Jeffrey Maddrey

#### "Inbound" U.S. Activities of Foreign

Taxpayers  
Peter J. Connors  
Peter F. G. Schuur

#### Individuals

Megan L. Brackney  
Steven A. Dean

#### Investment Funds

John C. Hart  
Amanda H. Nussbaum

#### Multistate Taxation

Arthur R. Rosen  
Jack Trachtenberg

#### New York City Taxes

Sherry S. Kraus  
Irwin M. Slomka

#### New York State Taxes

Paul R. Comeau  
Joshua E. Gewolb

#### "Outbound" Foreign Activities of

U.S. Taxpayers  
Andrew P. Solomon  
Philip R. Wagman

#### Partnerships

Phillip J. Gall  
Eric B. Sloan

#### Pass-Through Entities

James R. Brown  
Edward E. Gonzalez

#### Real Property

Robert Cassanos  
Marcy Geller

#### Reorganizations

Neil J. Barr  
Peter A. Furci

#### Securitized and Structured

Finance  
Daniel M. Dunn  
John T. Lutz

#### Spin Offs

Lawrence M. Garrett  
Joshua M. Holmes

#### Tax Exempt Entities

Stuart Rosow  
Richard R. Upton

#### Treaties and Intergovernmental

Agreements  
Lee E. Allison  
David R. Hardy

## MEMBERS-AT-LARGE OF EXECUTIVE COMMITTEE:

Daniel Z. Altman  
William A. Curran  
Tijana J. Dvornic  
Pamela L. Endreny  
Jason R. Factor

Kathleen L. Ferrell  
Elizabeth T. Kessenides  
Shane J. Kiggen  
Stuart E. Leblang  
William L. McRae

Kara L. Mungovan  
Joel Scharfstein  
Stephen E. Shay  
Michael B. Shulman  
Eric Solomon

Jonathan R. Talansky  
Dana L. Trier  
Eric Wang  
Sara B. Zablotney

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  
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





**NEW YORK STATE BAR ASSOCIATION TAX SECTION**

**REPORT ON PROPOSED GILTI REGULATIONS**

**November 26, 2018**

## Table of Contents

I.	Introduction.....	1
II.	Summary of Principal Recommendations and Comments .....	2
	Part III: Non-Basis Issues .....	2
A.	Proposed Regulation Section 1.951-1: Amounts Included in Gross Income of U.S. Shareholders .....	2
B.	Proposed Regulation Section 1.951A-1: General Provisions .....	3
C.	Proposed Regulation Section 1.951A-2: Tested Income and Tested Loss .....	4
D.	Proposed Regulation Section 1.951A-3: QBAI.....	4
E.	Proposed Regulation Section 1.951A-4: Tested Interest Income and Expense .....	5
F.	Proposed Regulation Section 1.951A-5: Partnerships.....	5
G.	Proposed Regulation Section 1.1502-51: Consolidated Section 951A.....	6
	Part IV: Basis Issues .....	6
A.	Introduction.....	6
B.	Proposed Regulation Section 1.951A-6: The CFC Basis Reduction Rule.....	7
C.	Proposed Regulation Section 1.1502-51: Basis Reduction for CFC Stock Held in a Group.....	8
D.	Proposed Regulation Section 1.1502-32: Upper Tier Basis Adjustments .....	8
E.	Basis Issues in Intra-Group Reorganizations.....	10
F.	General Basis Issues Under the Proposed Regulations.....	10
G.	Our Preferred Approaches to Avoid Loss Duplication.....	11
III.	General Discussion and Recommendations.....	11
A.	Proposed Regulation Section 1.951-1: Amounts Included in Gross Income of U.S. Shareholders .....	11
	1. Background.....	11
	2. Comments .....	12
	(a) The Anti-Avoidance Rule.....	12
	(b) Hypothetical Redeeming Distributions.....	16
	(c) Preferred Stock with Low Dividend Rate.....	17
	(d) Allocations of Subpart F Income and Tested Loss .....	18
B.	Proposed Regulation Section 1.951A-1: General Provisions .....	19

1.	Background .....	19
2.	Comments .....	19
	(a) Interest Expense and Interest Income .....	19
	(b) Taxable Year of GILTI Inclusion .....	22
	(c) Allocations of QBAI and Tested Loss .....	24
C.	Proposed Regulation Section 1.951A-2: Tested Income and Tested Loss .....	26
1.	Background .....	26
2.	Comments .....	27
	(a) Application of Treasury Regulation Section 1.952-2 .....	27
	(b) Disqualified Basis from Transition Period Transfers .....	29
	(c) Application of Section 952(c) .....	32
	(d) Deemed Royalties under Section 367(d) .....	34
D.	Proposed Regulation Section 1.951A-3: QBAI .....	35
1.	Background .....	35
2.	Comments .....	35
	(a) Application of Alternative Depreciation System .....	35
	(b) Anti-Abuse Rules .....	36
E.	Proposed Regulation Section 1.951A-4: Tested Interest Income and Expense .....	40
F.	Proposed Regulation Section 1.951A-5: Partnerships .....	41
1.	Alternative Approaches to CFCs Held by Partnerships .....	41
	(a) The Pure Entity Approach .....	41
	(b) The Proposed Regulations Hybrid Approach .....	41
	(c) The Prior Report Hybrid Approach .....	42
	(d) The Pure Aggregate Approach .....	43
	(e) Summary of Approaches .....	43
2.	Discussion of Alternative Approaches .....	44
	(a) Pure Aggregate Approach .....	44
	(b) Proposed Regulations Hybrid Approach .....	47
	(i) Lack of Ability to Offset at the Partner Level .....	47
	(ii) Procedural Complexity .....	48
	(iii) Computational Complexity .....	48
	(iv) Allocation Issues .....	49

	(v)	Interaction with Partnership Audit Rules.....	50
	(vi)	Incentive for Foreign Partnerships.....	51
	(vii)	Tax Basis.....	51
	(c)	Prior Report Hybrid Approach.....	56
	(d)	Pure Entity Approach.....	57
	(e)	Conclusions.....	57
G.		Proposed Regulation Section 1.1502-51: Consolidated Section 951A.....	58
	1.	Background.....	58
	2.	Comments .....	59
	(a)	Foreign Tax Credits and Section 250.....	59
	(b)	Allocation of Tested Losses.....	59
IV.		Adjustments to Tax Basis .....	61
A.		Introduction.....	61
B.		Proposed Regulation Section 1.951A-6: The CFC basis reduction rule .....	63
	1.	Summary of Proposed Regulation .....	63
	2.	Policy Issues.....	65
	(a)	Not Always a Double Tax Benefit.....	65
	(b)	Authority for the CFC Basis Reduction Rule .....	69
	(c)	Proposed Modification of the Rule .....	72
	3.	Technical Issues .....	76
	(a)	The Netting Rule for Basis Reductions .....	76
	(b)	Basis Reduction Upon the Sale of a U.S. Shareholder .....	76
	(c)	Collateral Effects of Stock Basis .....	77
	(i)	Allocation of Interest Expense.....	77
	(ii)	NUBIG and NUBIL.....	78
	(iii)	Exempt COD income.....	78
	(d)	Noncorporate U.S. Shareholders.....	79
	(e)	Definition of “Disposition”.....	79
	(f)	Tax Free Dispositions of CFC Stock .....	82
	(g)	Section 381 Transactions .....	84
	(h)	Special Allocation of Subpart F Income.....	85
	(i)	CFCs Held by Partnerships.....	86
	(j)	Retroactivity of Basis Reduction Rule.....	87

C.	Proposed Regulation Section 1.1502-51: Basis Reduction for CFC Stock Held in a Group.....	87
1.	Summary of Proposed Regulations.....	87
2.	Comments .....	88
	(a) Single Entity Principles.....	88
	(b) Effects of Sale of Member Stock .....	88
	(c) Taxable Intra-Group Dispositions of a CFC.....	91
	(d) Special Allocation of Subpart F income .....	91
D.	Proposed Regulation Section 1.1502-32: Upper Tier Basis Adjustments .....	94
1.	Summary of Proposed Regulations.....	94
2.	Comments .....	96
	(a) Rule 1 and the Timing for Basis Reduction.....	96
	(b) Rule 1 Conformity to Basis Reduction Rule.....	98
	(c) Rule 2 and Section 245A Dividend Payments .....	98
	(d) Rule 2 and the “Same CFC” Limitation .....	99
	(e) Rule 3 Following a Sale of M Stock.....	101
	(f) Sale of M Stock in Middle of Year .....	102
	(g) Rule 3: Creating a Tax Loss on M Stock.....	104
	(h) Avoiding the Loss Disallowance Rule.....	104
	(i) Rule 3 and Second Tier CFCs.....	105
	(j) Rule 3 and PTI .....	105
	(k) Tiering Up of CFC Basis Reductions .....	106
	(l) E&P Adjustments.....	106
	(m) Predecessor/Successor Rule.....	106
	(n) Loss Duplication under -36(d) .....	106
	(o) Loss Disallowance under -36(c) .....	109
	(p) Intra-group Sales of a CFC .....	110
	(q) Rule 1 and Internal Spin-offs.....	111
	(r) Rule 1 and External Spin-offs.....	113
E.	Basis Issues in Intra-Group Reorganizations .....	115
1.	The Proposed Regulations .....	115
2.	Comments on Proposed Regulation Section 1.1502-51 .....	115
3.	Comments on Proposed Regulation Section 1.1502-13(f)(7).....	116
F.	General Basis Issues Under the Proposed Regulations.....	117
1.	Aggregation of Shares.....	117
2.	Complexity.....	121
3.	The Broader Problem Concerning -32, Section 245A, and Section 961(d).....	123

G.	Our Preferred Approaches to Avoid Loss Duplication.....	124
1.	The Primary Proposal .....	125
2.	Discussion of Primary Proposal.....	125
3.	Authority for Primary Proposal .....	129
4.	The Secondary Proposal .....	130

## I. Introduction

This Report<sup>1</sup> comments on proposed regulations (the “**Proposed Regulations**”)<sup>2</sup> 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**”).<sup>3</sup> The Proposed Regulations were issued under Sections 951, 951A, 1502 and 6038.<sup>4</sup>

This Report supplements our prior report (the “**Prior Report**”)<sup>5</sup> 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

---

<sup>1</sup> 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.

<sup>2</sup> REG-104390-18, Federal Register Vol. 83, No. 196, October 10, 2018 (the “**Federal Register GILTI**”) at 51072-51111.

<sup>3</sup> 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.

<sup>4</sup> Unless otherwise stated, all “Code” and “Section” references are to the Internal Revenue Code of 1986, as amended.

<sup>5</sup> 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**”)<sup>6</sup> of a controlled foreign corporation (“**CFC**”)<sup>7</sup> 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<sup>8</sup>**

### **Part III: Non-Basis Issues**

#### **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).

---

<sup>6</sup> 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).

<sup>7</sup> 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).

<sup>8</sup> 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.<sup>9</sup>

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**”).<sup>10</sup> 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.<sup>11</sup>

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.<sup>12</sup> 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.<sup>13</sup> 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.<sup>14</sup>

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:

---

<sup>9</sup> Prop Reg. § 1.951A-1(d)(1).

<sup>10</sup> Prop Reg. § 1.951-1(e)(1)(i).

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

<sup>12</sup> Prop Reg. § 1.951-1(e)(2)-(3).

<sup>13</sup> Prop Reg. § 1.951-1(e)(3).

<sup>14</sup> 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.<sup>15</sup>

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,<sup>16</sup> 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

---

<sup>15</sup> Prop Reg. § 1.951-1(e)(6).

<sup>16</sup> 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<sup>17</sup> 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.<sup>18</sup>

---

<sup>17</sup> See Section 7701(o).

<sup>18</sup> 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.<sup>19</sup> 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.

---

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).

<sup>19</sup> 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**").<sup>20</sup> 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**").<sup>21</sup>

"**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.<sup>22</sup>

### 2. Comments

#### (a) Interest Expense and Interest Income

---

<sup>20</sup> Prop Reg. § 1.951A-1(c)(1).

<sup>21</sup> Prop Reg. § 1.951A-1(c)(2).

<sup>22</sup> 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,<sup>23</sup> 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.<sup>24</sup> 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.<sup>25</sup>

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

---

<sup>23</sup> See Prior Report at 62.

<sup>24</sup> See Federal Register GILTI at 51078-79.

<sup>25</sup> 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.<sup>26</sup>

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.<sup>27</sup>

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.

---

<sup>26</sup> Federal Register GILTI at 51078.

<sup>27</sup> 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.<sup>28</sup> 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).<sup>29</sup> The Preamble contains no explanation for the Proposed Regulations’ divergence from the statute on this point.

---

<sup>28</sup> Prop Reg. §§ 1.951A-1(b), (e)(4).

<sup>29</sup> 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,<sup>30</sup> 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.<sup>31</sup> 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

---

<sup>30</sup> Sections 958(b), 318(a)(3)(C).

<sup>31</sup> 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.”<sup>32</sup> 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<sup>33</sup> 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.

---

<sup>32</sup> Federal Register GILTI at 51074.

<sup>33</sup> 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.<sup>34</sup>

## 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.<sup>35</sup>

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.<sup>36</sup> 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.<sup>37</sup> 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

---

<sup>34</sup> Prop. Reg. § 1.951A-2(c)(2).

<sup>35</sup> 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**”).

<sup>36</sup> Treas. Reg. § 1.952-2(a).

<sup>37</sup> 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,<sup>38</sup> 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.<sup>39</sup> 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

---

<sup>38</sup> See Prior Report at 35.

<sup>39</sup> 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.<sup>40</sup>

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)<sup>41</sup> or Section 280G.<sup>42</sup> 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

---

<sup>40</sup> 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.

<sup>41</sup> 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.

<sup>42</sup> 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<sup>43</sup> as authority.<sup>44</sup> 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.<sup>45</sup>

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.<sup>46</sup> 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

---

<sup>43</sup> H. Rep. 115-466 (2017) (the “**Conference Report**”).

<sup>44</sup> Federal Register GILTI at 51075-76. The Preamble cites this authority by cross reference to the analogous QBAI rules.

<sup>45</sup> Conference Report at 645.

<sup>46</sup> 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.<sup>47</sup>

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

---

<sup>47</sup> 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 it 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 into 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.<sup>48</sup> "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").<sup>49</sup> 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.

---

<sup>48</sup> Prop. Reg. § 1.951A-3(c)(1).

<sup>49</sup> 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,<sup>50</sup> 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.<sup>51</sup>

#### (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.”

---

<sup>50</sup> Federal Register GILTI at 51076.

<sup>51</sup> 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.<sup>52</sup> 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

---

<sup>52</sup> 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."<sup>53</sup> "Interest income" has a comparably broad definition that picks up interest and interest equivalents.<sup>54</sup>

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

---

<sup>53</sup> Prop. Reg. § 1.951A-4(b)(1)(ii).

<sup>54</sup> Prop. Reg. § 1.951A-4(b)(2)(ii).

this purpose.<sup>55</sup> 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.<sup>56</sup>

---

<sup>55</sup> 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)).

<sup>56</sup> 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.<sup>57</sup> 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.<sup>58</sup>

---

<sup>57</sup> Prior Report at 91.

<sup>58</sup> 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.<sup>59</sup>

---

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.

<sup>59</sup> 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.<sup>60</sup> 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.<sup>61</sup>

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

---

<sup>60</sup> NYSBA Tax Section Report No. 1124, *Report on Differences between Domestic and Foreign Partnerships* (January 3, 2007), at 11 (the “**2007 Report**”).

<sup>61</sup> 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.”<sup>62</sup>

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.<sup>63</sup> 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

---

<sup>62</sup> 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.

<sup>63</sup> “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.<sup>64</sup>

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.<sup>65</sup> The Preamble states that this rule is based on Notice 2010-41,<sup>66</sup> which as noted above is itself based on Section 7701(a)(4).<sup>67</sup>

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

---

<sup>64</sup> 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).

<sup>65</sup> Prop. Reg. § 1.951-1(h).

<sup>66</sup> Federal Register GILTI at 51082.

<sup>67</sup> 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.<sup>68</sup>

(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.

---

<sup>68</sup> 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.<sup>69</sup> 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

---

<sup>69</sup> 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,<sup>70</sup> 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.<sup>71</sup>

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.<sup>72</sup> 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

---

<sup>70</sup> 2007 Report at 8.

<sup>71</sup> 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.

<sup>72</sup> 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.<sup>73</sup> 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

---

<sup>73</sup> 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.<sup>74</sup>

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

---

<sup>74</sup> 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.”<sup>75</sup> 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%).

---

<sup>75</sup> 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,<sup>76</sup> 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.”<sup>77</sup> 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.

---

<sup>76</sup> Federal Register GILTI at 51079.

<sup>77</sup> *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.<sup>78</sup> 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.<sup>79</sup>

**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.

---

<sup>78</sup> Prior Report at 17-27.

<sup>79</sup> 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.<sup>80</sup> 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.<sup>81</sup> 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

---

<sup>80</sup> Prop. Reg. § 1.1502-51(c)(1).

<sup>81</sup> 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.<sup>82</sup> 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

---

<sup>82</sup> 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).<sup>83</sup> 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

---

<sup>83</sup> 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.<sup>84</sup> 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

---

<sup>84</sup> 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.<sup>85</sup>

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.<sup>86</sup>

**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

---

<sup>85</sup> Prop. Reg. §§ 1.951A-6(e)(2), (e)(3).

<sup>86</sup> 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.<sup>87</sup> 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

---

<sup>87</sup> 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.<sup>88</sup>

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

---

<sup>88</sup> 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,<sup>89</sup> 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

---

<sup>89</sup> 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 *Ifeld* 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.<sup>90</sup>

*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*

---

<sup>90</sup> 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.<sup>91</sup> 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.<sup>92</sup> 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*,<sup>93</sup> 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

---

<sup>91</sup> *Charles Ilfeld Co. v Hernandez*, 292 U.S. 62 (1934); *U.S. v Skelly Oil Co.*, 394 U.S. 678 (1969).

<sup>92</sup> *Duquesne Light Holdings, Inc. v Comm’r*, 861 F.3d 396 (3d Cir. 2017), *cert denied* (138 S. Ct. 2651).

<sup>93</sup> *Gitlitz v Comm’r*, 531 U.S. 206 (2001).

address this policy concern.”<sup>94</sup> Even in the consolidated return context, courts reject reliance on *Ifeld* when the regulations are clear and specific.<sup>95</sup> Arguably the existence of Section 961, dealing specifically with tax basis, is enough to satisfy this requirement.

Third, the *Ifeld* 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.<sup>96</sup> The Code and regulations clearly make this distinction in various rules.<sup>97</sup> We are not aware of *Ifeld* 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 *Ifeld* in broader terms).<sup>98</sup> Therefore, it is possible that *Ifeld* 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 *Ifeld* 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<sup>99</sup> and this principle was recently applied by the Federal Circuit.<sup>100</sup> Moreover, notwithstanding Section 961, it can be argued that Congress was not purporting to

---

<sup>94</sup> 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).

<sup>95</sup> See, e.g., *Woods Investment Co. v Comm’r*, 85 T.C. 274 (1985).

<sup>96</sup> 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.

<sup>97</sup> 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).

<sup>98</sup> 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)).

<sup>99</sup> 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.”).

<sup>100</sup> 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.<sup>101</sup> 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

---

<sup>101</sup> 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.<sup>102</sup> 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.<sup>103</sup>

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

---

<sup>102</sup> 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.

<sup>103</sup> 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.<sup>104</sup> 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.<sup>105</sup>

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

---

<sup>104</sup> 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.

<sup>105</sup> 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.<sup>106</sup> 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.

---

<sup>106</sup> 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.<sup>107</sup> 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.<sup>108</sup> This would increase NUBIG, and reduce NUBIL to the extent of the potential basis reduction.

In fact, Notice 2003-65<sup>109</sup> 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.<sup>110</sup>

(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

---

<sup>107</sup> NUBIG and NUBIL are also relevant for Section 384 and the "separate return limitation year" rules relevant to consolidated groups.

<sup>108</sup> 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.

<sup>109</sup> 2003-2 C.B. 747.

<sup>110</sup> 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,<sup>111</sup> 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

---

<sup>111</sup> 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.<sup>112</sup>

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.<sup>113</sup> 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

---

<sup>112</sup> 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.

<sup>113</sup> *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,<sup>114</sup> 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.<sup>115</sup>
- 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.<sup>116</sup>

---

<sup>114</sup> Prop. Reg. § 1.951A-6(e)(1)(i).

<sup>115</sup> Prop. Reg. § 1.951A-6(e)(7).

<sup>116</sup> 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.<sup>117</sup>

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.<sup>118</sup> 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.

---

<sup>117</sup> 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.*

<sup>118</sup> 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<sup>119</sup> 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.<sup>120</sup> 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

---

<sup>119</sup> Prop. Reg. § 1.951A-6(e)(5).

<sup>120</sup> 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.<sup>121</sup>

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

---

<sup>121</sup> 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 from 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.<sup>122</sup> 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.<sup>123</sup> 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.

---

<sup>122</sup> Prop. Reg. § 1.1502-51(c)(1).

<sup>123</sup> 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.<sup>124</sup> 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

---

<sup>124</sup> 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.<sup>125</sup> 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.<sup>126</sup>

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*

---

<sup>125</sup> 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.

<sup>126</sup> 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**”).<sup>127</sup>

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

---

<sup>127</sup> 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.<sup>128</sup> 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.<sup>129</sup> 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

<sup>128</sup> Prop. Reg. § 1.1502-32(b)(3)(iii)(C).

<sup>129</sup> 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).<sup>130</sup> 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.<sup>131</sup>

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

---

<sup>130</sup> Prop. Reg. § 1.1502-32(b)(3)(ii)(F).

<sup>131</sup> 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.<sup>132</sup> 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.

---

<sup>132</sup> 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 owns 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 be 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.<sup>133</sup>

**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

---

<sup>133</sup> 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).<sup>134</sup>

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

---

<sup>134</sup> 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.<sup>135</sup>

---

<sup>135</sup> 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)*<sup>136</sup>

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 offset 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.

<sup>136</sup> 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.<sup>137</sup> 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

---

<sup>137</sup> 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.<sup>138</sup>

Yet under the alternative approach, P has an excess loss account of \$80 in New M1 and a basis of \$180 in M2.<sup>139</sup> 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

---

<sup>138</sup> P's \$100 basis in M is allocated 10% to New M1 (\$10) and 90% to M2 (\$90).

<sup>139</sup> 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.<sup>140</sup>

(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

---

<sup>140</sup> 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.<sup>141</sup> 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

---

<sup>141</sup> 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.<sup>142</sup> 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.<sup>143</sup> 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.<sup>144</sup>

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

---

<sup>142</sup> 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.

<sup>143</sup> Prop. Reg. §§ 1.951-1(e), 1.951A-1(d).

<sup>144</sup> 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,<sup>145</sup> 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

---

<sup>145</sup> 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.<sup>146</sup> 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

---

<sup>146</sup> 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.<sup>147</sup> 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

---

<sup>147</sup> 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.<sup>148</sup>

#### **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.<sup>149</sup>

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

---

<sup>148</sup> See Section 245A Report, at 43.

<sup>149</sup> 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**”),<sup>150</sup> 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.<sup>151</sup>

### 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.<sup>152</sup>

---

<sup>150</sup> 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.

<sup>151</sup> Further consideration needs to be given to whether corresponding e&p adjustments should be made at the member level.

<sup>152</sup> 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.<sup>153</sup>

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

---

<sup>153</sup> 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**

**NEW YORK STATE BAR ASSOCIATION TAX SECTION**

**REPORT ON THE GILTI PROVISIONS OF THE CODE**

**May 4, 2018**

## Table of Contents

I. Introduction .....	1
II. Summary of Principal Recommendations.....	2
A. Purpose of the GILTI Regime.....	2
B. Aggregation of Members of a Consolidated Group.....	2
C. Deductions Allowed in Calculating Tested Income .....	2
D. Other Computational Issues for GILTI Inclusions .....	3
E. Foreign Tax Credit Issues .....	4
F. U.S. Partnership as a U.S. Shareholder in a CFC .....	5
G. Other Issues.....	5
III. Summary of GILTI Rules .....	6
A. Income Inclusion.....	6
1. Net CFC Tested Income.....	7
2. NDTIR .....	8
B. Section 250 Deduction.....	9
1. Initial Calculation.....	9
2. Carve-Back to Deduction.....	10
C. Foreign Tax Credits .....	11
1. Calculation of the FTC.....	11
2. GILTI Basket .....	12
3. Section 78 Amount .....	12
D. Limitations on Use of FTCs.....	13
IV. Discussion and Recommendations .....	15
A. Purpose of the GILTI Regime.....	15
B. Aggregation of Members of a Consolidated Group.....	17
1. In General.....	17
2. The Section 250(a) Deduction .....	17
3. Section 904 Limit on the Deemed Paid Foreign Tax Credit.....	19
4. The Amount of the GILTI Inclusion.....	20
(a) Why it matters.....	20
(b) Discussion.....	24
C. Deductions Allowed in Calculating Tested Income .....	27

1.	The Issue .....	27
2.	Choice of Method .....	29
	(a) The modified taxable income method.....	29
	(b) The Subpart F method.....	31
	(c) The modified Subpart F method .....	32
	(d) Conclusion .....	33
3.	Loss and Interest Carryovers .....	33
	(a) Carryover of operating losses .....	33
	(b) Section 163(j) carryovers .....	44
D.	Other Computational Issues for GILTI Inclusions .....	47
1.	Order of GILTI versus Section 956 Inclusions.....	47
2.	GILTI and Subpart F Inclusions in a Year When CFC Stock is Sold .....	48
	(a) Background.....	49
	(b) Fact patterns and results.....	50
	(c) Discussion.....	56
3.	Relationship between Section 163(j) and Section 250 .....	58
4.	Limit on Section 250 Deduction .....	58
5.	Allocation to Preferred Stock.....	60
6.	Interest Expense of CFC with Tested Loss.....	61
7.	Tax Basis and E&P Issues .....	63
E.	Foreign Tax Credit Issues .....	65
1.	Determination of Allowed FTC .....	65
	(a) Tracing versus proration .....	65
	(b) Timing differences .....	66
	(c) Withholding tax on distribution of PTI.....	68
2.	Section 904 Issues.....	69
	(a) Expense allocation .....	69
	(b) Section 904(b)(4) .....	74
	(c) The Section 250 deduction.....	79
	(d) Section 78 gross-up.....	79
	(e) Interest, rent and royalty payments from a CFC to its U.S. shareholder .....	81
	(f) Basket for base differences .....	83
	(g) Basket for withholding tax on PTI.....	84
	(h) 2017 overall foreign or domestic loss.....	85

(i)	FTC transition issues.....	85
F.	U.S. Partnership as a U.S. Shareholder in a CFC .....	86
1.	Possible Approaches for Applying GILTI.....	86
2.	Discussion.....	87
3.	Conclusions.....	91
4.	Related Issues.....	93
G.	Other Issues.....	95
1.	Section 962 Election .....	95
2.	Fiscal Transition Year 2017-2018 .....	97
3.	Effect of Section 958(b)(4) Repeal .....	98
4.	Overlap Between Section 250(a)(2) and Section 172(d)(9) .....	100
5.	Medicare Tax (Section 1411).....	100
6.	REIT Income.....	100
7.	RIC Income.....	101
8.	UBTI .....	101
H.	Proposed Aggregation of CFCs held by a U.S. Shareholder .....	101
	APPENDIX 1.....	106

## I. Introduction

This Report<sup>1</sup> discusses the so-called “GILTI” provisions of the Code added by the legislation informally known as the Tax Cuts and Jobs Act (the “Act”).<sup>2</sup> 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.<sup>3</sup> In general, the GILTI provisions require a U.S. shareholder (a “**U.S. shareholder**”)<sup>4</sup> of a controlled foreign corporation (“**CFC**”)<sup>5</sup> 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.

---

<sup>1</sup> 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.

<sup>2</sup> 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.

<sup>3</sup> Unless otherwise stated, all “Code” and “Section” references are to the Internal Revenue Code of 1986, as amended.

<sup>4</sup> 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.

<sup>5</sup> 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.<sup>6</sup> *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.<sup>7</sup>

---

<sup>6</sup> 2018-16 IRB (April 2, 2018).

<sup>7</sup> 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.<sup>8</sup> 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.<sup>9</sup> 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)”.<sup>10</sup> 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),<sup>11</sup>

---

<sup>8</sup> Section 951A(b)(1).

<sup>9</sup> Section 951A(c)(1).

<sup>10</sup> Section 951(c)(2)(A).

<sup>11</sup> 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)).<sup>12</sup>

Tested loss is the excess (if any) of the deductions described above over the income, calculated as described above.<sup>13</sup> 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,<sup>14</sup> 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.<sup>15</sup> 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.<sup>16</sup> 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.<sup>17</sup> 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.<sup>18</sup> Note that gross interest expense of a CFC (unless paid to a Related

---

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).

<sup>12</sup> Section 951A(c)(2)(A).

<sup>13</sup> Section 951A(c)(2)(B)(i).

<sup>14</sup> 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).

<sup>15</sup> Section 951A(d)(1). The adjusted tax basis is determined at the end of each quarter of the taxable year and then averaged.

<sup>16</sup> Section 951A(b)(2)(A).

<sup>17</sup> Section 951A(b)(2)(B).

<sup>18</sup> 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**").<sup>19</sup>

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

---

<sup>19</sup> 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**”).<sup>20</sup> In addition, the Section 250 deduction is disallowed in calculating a net operating loss.<sup>21</sup>

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.

Example 2(a). 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.

Example 2(b). 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.

---

<sup>20</sup> 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.

<sup>21</sup> 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.<sup>22</sup>

## 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”.<sup>23</sup>

“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.<sup>24</sup> 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.<sup>25</sup>

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.<sup>26</sup>

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

---

<sup>22</sup> 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.

<sup>23</sup> Section 960(d)(1).

<sup>24</sup> Section 960(d)(3).

<sup>25</sup> 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).”)

<sup>26</sup> 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.<sup>27</sup> Any income that is GILTI is not general category income.<sup>28</sup>

## 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”.<sup>29</sup> The Section 250 deduction is allowed against the full grossed-up amount.<sup>30</sup>

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.<sup>31</sup> We assume hereafter that the gross-up goes in the GILTI FTC basket.<sup>32</sup>

---

<sup>27</sup> Section 904(c) and (d)(1)(A).

<sup>28</sup> Section 904(d)(1)(A) and (2)(A)(ii).

<sup>29</sup> Section 78.

<sup>30</sup> Section 250(a)(1)(B)(ii).

<sup>31</sup> 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.

<sup>32</sup> 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.<sup>33</sup> This determination is made separately for each FTC basket, including the GILTI basket.<sup>34</sup> 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.<sup>35</sup>

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.<sup>36</sup> 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.<sup>37</sup>

---

<sup>33</sup> 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.

<sup>34</sup> Section 904(d).

<sup>35</sup> Various re-sourcing rules under Section 904 must be taken into account but are beyond the scope of this discussion.

<sup>36</sup> *See generally*, Sections 861(b), 862(b), 863(a) and Treasury Regulations thereunder.

<sup>37</sup> 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.<sup>38</sup> 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.<sup>39</sup> For affiliated groups filing a consolidated return, all foreign taxes

---

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).

<sup>38</sup> 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).

<sup>39</sup> 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.<sup>40</sup>

## 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.<sup>41</sup>

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<sup>42</sup> (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%,<sup>43</sup> although this may have merely been intended as an illustrative rate.<sup>44</sup> 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

---

<sup>40</sup> Treas. Reg. § 1.1502-4(d).

<sup>41</sup> 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.

<sup>42</sup> 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.

<sup>43</sup> 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.”).

<sup>44</sup> 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,<sup>45</sup> 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.<sup>46</sup> 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%.

---

<sup>45</sup> Section 250(b)(3)(A)(ii).

<sup>46</sup> 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<sup>47</sup> and the legislative history suggest similarity between Subpart F income and GILTI,<sup>48</sup> 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

---

<sup>47</sup> Section 951A(f)(1)(A) lists the Code sections for which GILTI is to be treated in the same manner as Subpart F income.

<sup>48</sup> 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.<sup>49</sup>

We note that Section 5 of Notice 2018-28<sup>50</sup> 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,<sup>51</sup> 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,<sup>52</sup> 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

---

<sup>49</sup> See Staff of the Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress*, JCS-5-05 (2005) at 415.

<sup>50</sup> 2018-16 IRB (April 2, 2018).

<sup>51</sup> Treas. Reg. § 1.1502-4(d).

<sup>52</sup> 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.

Example 6(a) (tested income and tested loss; aggregation is taxpayer-favorable). 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.<sup>53</sup>

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).

---

<sup>53</sup> 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.<sup>54</sup>

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.<sup>55</sup>

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

---

<sup>54</sup> 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%.

<sup>55</sup> 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)).

Example 9(a) (base case with aggregation; NDTIR reduces inclusion percentage). 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%.

Example 9(b) (no aggregation; lower foreign tax on QBAI return; result is taxpayer-favorable compared to aggregation). 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.

Example 9(c) (no aggregation; higher foreign tax on QBAI return; result is taxpayer-unfavorable compared to aggregation). 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.<sup>56</sup> As a result, in the absence of mandatory aggregation,

---

<sup>56</sup> 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.<sup>57</sup> 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.

---

<sup>57</sup> 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.<sup>58</sup>

### 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,<sup>59</sup> 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

---

<sup>58</sup> 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.

<sup>59</sup> Section 951A(c)(2)(A)(i).

deductions would be allocable if there were such gross income)".<sup>60</sup> 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.<sup>61</sup>

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.<sup>62</sup> This calculation incorporates by reference the rules for determining e&p of the CFC.<sup>63</sup>
- (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.

---

<sup>60</sup> Section 951A(c)(2)(A)(ii).

<sup>61</sup> 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.

<sup>62</sup> Treas. Reg. § 1.952-2(b)(1), (c)(2).

<sup>63</sup> *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.<sup>64</sup> 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,<sup>65</sup> a payment under a hybrid instrument,<sup>66</sup> a loss on a sale to a related party,<sup>67</sup> an interest deduction that exceeded the limits under Section 163(j), and a nondeductible business entertainment or meal expense<sup>68</sup> 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.<sup>69</sup>

### (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.<sup>70</sup> 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

---

<sup>64</sup> Section 951A(c)(2)(A)(ii).

<sup>65</sup> Section 162(f).

<sup>66</sup> Section 267A.

<sup>67</sup> Section 267.

<sup>68</sup> Section 274.

<sup>69</sup> 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.

<sup>70</sup> 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.<sup>71</sup>

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.<sup>72</sup> 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.<sup>73</sup> 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.

---

<sup>71</sup> Treas. Reg. § 1.952-2(b)(1), (c)(2).

<sup>72</sup> 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.

<sup>73</sup> 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,<sup>74</sup> and it would be peculiar to determine the total on a different basis than the subtraction.<sup>75</sup>

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.<sup>76</sup> 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

---

<sup>74</sup> Section 951A(c)(2)(A).

<sup>75</sup> 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.

<sup>76</sup> 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,<sup>77</sup> 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

---

<sup>77</sup> 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).<sup>78</sup> 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

---

<sup>78</sup> 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.<sup>79</sup>

The Subpart F regulations provide that net operating losses are not taken into account in calculating taxable income for Subpart F purposes.<sup>80</sup> However, Subpart F income is limited to current year e&p of the applicable CFC<sup>81</sup> and is reduced for certain prior year e&p deficits of the same CFC from Subpart F activities.<sup>82</sup> In some cases, e&p deficits of other CFCs in the same ownership chain may also be used.<sup>83</sup> 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

---

<sup>79</sup> 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.

<sup>80</sup> Treas. Reg. § 1.952-2(c)(5)(ii).

<sup>81</sup> Section 952(c)(1)(A), Treas. Reg. § 1.952-1(e).

<sup>82</sup> Section 952(c)(1)(B).

<sup>83</sup> 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,<sup>84</sup> 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.<sup>85</sup> 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

---

<sup>84</sup> 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.

<sup>85</sup> 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.<sup>86</sup> 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

---

<sup>86</sup> 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.<sup>87</sup>

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.<sup>88</sup> 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,

---

<sup>87</sup> 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.

<sup>88</sup> 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.<sup>89</sup> 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.

---

<sup>89</sup> 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.<sup>90</sup> 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

---

<sup>90</sup> 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.<sup>91</sup>

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.<sup>92</sup> 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.<sup>93</sup>

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

---

<sup>91</sup> 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.

<sup>92</sup> Section 951A(b)(1).

<sup>93</sup> 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.<sup>94</sup>

---

<sup>94</sup> 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.<sup>95</sup>

Yet another issue arises because under Notice 2003-65,<sup>96</sup> 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

---

<sup>95</sup> Section 382(b)(1).

<sup>96</sup> 2003-2 C.B. 747.

may result in a Section 951A inclusion, without any cash profit.<sup>97</sup> 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.<sup>98</sup>

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,<sup>99</sup> 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.

Example 12: Carryover of Section 163(j) deduction to year with QBAI return. 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

---

<sup>97</sup> 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.

<sup>98</sup> 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.

<sup>99</sup> 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.<sup>100</sup> 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

---

<sup>100</sup> 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).<sup>101</sup>

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.<sup>102</sup> Treasury Regulations confirm this result.<sup>103</sup> Moreover, the definition of tested income specifically excludes Subpart F income,<sup>104</sup> 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.<sup>105</sup> 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

---

<sup>101</sup> 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.

<sup>102</sup> 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.

<sup>103</sup> Treas. Reg. § 1.959-1(a).

<sup>104</sup> Section 951A(c)(2)(A)(i)(II).

<sup>105</sup> 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.<sup>106</sup> 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

---

<sup>106</sup> Sections 951A(f)(1)(A), 959 and 961(a).

results arise because of the enactment of Section 245A.<sup>107</sup> 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**”).<sup>108</sup> The same rule applies to a Subpart F inclusion.<sup>109</sup> 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.<sup>110</sup> 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”.<sup>111</sup>

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.

---

<sup>107</sup> The Tax Section is preparing a separate report on Section 245A.

<sup>108</sup> Section 951A(e)(1) and (2). This rule is also expressly stated in the Conference Report at 645.

<sup>109</sup> Section 951(a)(1).

<sup>110</sup> Section 951A(a), (b)(1)(A) and (c)(1)(A).

<sup>111</sup> 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,<sup>112</sup> the U.S. shareholder holds no other CFCs and none of the relevant CFCs has any QBAI return.

Example 14(a) (CFC with Section 958(a) U.S. shareholders throughout the year): 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.

---

<sup>112</sup> 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.<sup>113</sup>

*(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.

---

<sup>113</sup> 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.<sup>114</sup> 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.<sup>115</sup> 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.<sup>116</sup> 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

---

<sup>114</sup> 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.

<sup>115</sup> The scope of the repeal of Section 958(b)(4) is discussed in Part IV.G.3.

<sup>116</sup> 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.<sup>117</sup> 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

---

<sup>117</sup> 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,<sup>118</sup> 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.<sup>119</sup> CFC1 could pass on the dividend

---

<sup>118</sup> See Section 246(c).

<sup>119</sup> 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.<sup>120</sup> 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.<sup>121</sup>

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.

---

<sup>120</sup> Note that Section 964(e)(4) applies “notwithstanding any other provision of this title”.

<sup>121</sup> 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.<sup>122</sup> 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

---

<sup>122</sup> 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**”).<sup>123</sup> 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**”).<sup>124</sup> 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.<sup>125</sup> 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.<sup>126</sup>

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.<sup>127</sup>

---

<sup>123</sup> 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).

<sup>124</sup> *Id.*

<sup>125</sup> Treas. Reg. §§ 1.951-1(e)(3)(ii)(A); -1(e)(4)(ii).

<sup>126</sup> Treas. Reg. § 1.951-1(e)(6) Ex. 5.

<sup>127</sup> 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.<sup>128</sup> 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.<sup>129</sup> 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

---

*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).

<sup>128</sup> 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).

<sup>129</sup> 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.<sup>130</sup>

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.

---

<sup>130</sup> 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.”<sup>131</sup> If the CFC has both tested income and other income, the Conference Report<sup>132</sup> 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.<sup>133</sup>

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.

Example 15(a): Two divisions of a single CFC.  
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.

Example 15(b): Disregarded subsidiary of a CFC:  
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.

---

<sup>131</sup> Section 960(d)(3).

<sup>132</sup> Conference Report at 628 (describing House bill), 630 (stating that conference agreement follows House bill).

<sup>133</sup> 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.<sup>134</sup>

---

<sup>134</sup> 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.<sup>135</sup>

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.<sup>136</sup> 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,<sup>137</sup> 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

---

<sup>135</sup> If a foreign corporation is 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).

<sup>136</sup> Section 960(d)(1)(B).

<sup>137</sup> 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.<sup>138</sup>

## 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.<sup>139</sup>

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

---

<sup>138</sup> 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.

<sup>139</sup> 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.<sup>140</sup>

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 than 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,<sup>141</sup> 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.

---

<sup>140</sup> See, e.g., Treas. Reg. § 1.861-10T, relating to special rules for allocating interest expense.

<sup>141</sup> 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.<sup>142</sup> 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,<sup>143</sup> 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.<sup>144</sup> 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

---

<sup>142</sup> 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.

<sup>143</sup> 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.

<sup>144</sup> See Treas. Reg. § 1.861-17.

not occur without gain recognition or Section 367(d) royalty income to the U.S. parent corporation.<sup>145</sup>

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.<sup>146</sup> 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.<sup>147</sup> 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.<sup>148</sup> 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

---

<sup>145</sup> 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.

<sup>146</sup> 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.

<sup>147</sup> 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).

<sup>148</sup> 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.<sup>149</sup> 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

---

<sup>149</sup> 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.<sup>150</sup> 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.

---

<sup>150</sup> 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.<sup>151</sup>

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

---

<sup>151</sup> 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.<sup>152</sup>

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.

---

<sup>152</sup> 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.<sup>153</sup> 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,<sup>154</sup> 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.

---

<sup>153</sup> 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.

<sup>154</sup> 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.<sup>155</sup>

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.<sup>156</sup> In that case, other adjustments would logically follow.<sup>157</sup> 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

---

<sup>155</sup> 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.

<sup>156</sup> 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.

<sup>157</sup> 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.<sup>158</sup>

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.<sup>159</sup>

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.<sup>160</sup>

---

<sup>158</sup> 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%).

<sup>159</sup> 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.

<sup>160</sup> 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.

Example 17 (Royalty income and FTC baskets).

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.<sup>161</sup> 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.<sup>162</sup> This rule is the result of a technical error in the Act,<sup>163</sup> 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.<sup>164</sup> 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)).

---

<sup>161</sup> 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.

<sup>162</sup> Section 904(d)(2)(H)(i).

<sup>163</sup> 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.

<sup>164</sup> Section 904(d)(1)(B).

We acknowledge that our proposal is arguably inconsistent with language in the Conference Report<sup>165</sup> 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.<sup>166</sup> 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.

---

<sup>165</sup> 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])

<sup>166</sup> 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,<sup>167</sup> 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.<sup>168</sup> 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

---

<sup>167</sup> Treas. Reg. § 1.904(f)-7; Section 904(g)(3).

<sup>168</sup> 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.<sup>169</sup> 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.

---

<sup>169</sup> 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.<sup>170</sup> 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.<sup>171</sup>

---

<sup>170</sup> 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.

<sup>171</sup> 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

---

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.<sup>172</sup> Under the portfolio interest rules,<sup>173</sup> 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.<sup>174</sup>

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

---

<sup>172</sup> T.D. 9008, July 22, 2002.

<sup>173</sup> Sections 871(h), 881(c).

<sup>174</sup> 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.

Example 18(a): Partner directly holds CFC and has Section 163(j) limitation. 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.

Example 18(b): The business, the CFC and Section 163(j) interest are at partnership level. 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.<sup>175</sup>

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

---

<sup>175</sup> 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.<sup>176</sup>

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

---

<sup>176</sup> 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).<sup>177</sup> 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.<sup>178</sup>

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.<sup>179</sup> The fact that Congress chose to achieve a reduced tax rate on foreign earnings by means of a gross income

---

<sup>177</sup> Section 1(h)(11).

<sup>178</sup> Treas. Reg. § 1.962-1(b)(1)(i).

<sup>179</sup> *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.<sup>180</sup> We note that resolution of this issue has broader implications than GILTI.

Finally, the statute and regulation<sup>181</sup> 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.<sup>182</sup>

---

<sup>180</sup> 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.

<sup>181</sup> Treas. Reg. § 1.962-2(a).

<sup>182</sup> *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.<sup>183</sup> 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<sup>184</sup> 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<sup>185</sup> 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.

---

<sup>183</sup> Section 951A applies to taxable years of a foreign corporation beginning after December 31, 2017.

<sup>184</sup> Section 951A(d)(4).

<sup>185</sup> 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.<sup>186</sup> 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.<sup>187</sup> It further states that Treasury Regulations should interpret the provision accordingly.<sup>188</sup> The Senate Finance Committee’s explanation of the corresponding provision in the Senate Bill is to the same effect,<sup>189</sup> and there is no indication that Congress intended repeal to have broader consequences.

---

<sup>186</sup> Act § 14213.

<sup>187</sup> 163 Cong. Rec. No. 207 (Dec. 19, 2017) at p. S8110 (colloquy between Senator Hatch, Chairman of the Senate Finance Committee and Senator Perdue).

<sup>188</sup> *Id.*

<sup>189</sup> “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 situations 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.<sup>190</sup> There is clear statutory authority for such regulations.<sup>191</sup> The current Treasury/IRS Priority Guidance Plan already includes a project to determine

---

<sup>190</sup> Section 856(c).

<sup>191</sup> Section 856(c)(5)(J).

whether Subpart F income is qualifying income under Section 856(c),<sup>192</sup> 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.<sup>193</sup>

## 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.<sup>194</sup> In a prior Report, we stated our disagreement with this aspect of the proposed regulations.<sup>195</sup> 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.

---

<sup>192</sup> Department of the Treasury, 2017-2018 Priority Guidance Plan, as updated February 7, 2018.

<sup>193</sup> 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).

<sup>194</sup> REG-123600-16, Sept. 28, 2016.

<sup>195</sup> 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 property used in the production of tested income”.<sup>196</sup> 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.<sup>197</sup>

Second, foreign taxes are taken into account to the extent they are “properly attributable” to tested income.<sup>198</sup> 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.<sup>199</sup> 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

---

<sup>196</sup> Section 951A(d)(2)(A).

<sup>197</sup> 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”).

<sup>198</sup> Section 960(d)(3).

<sup>199</sup> 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,<sup>200</sup> 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

---

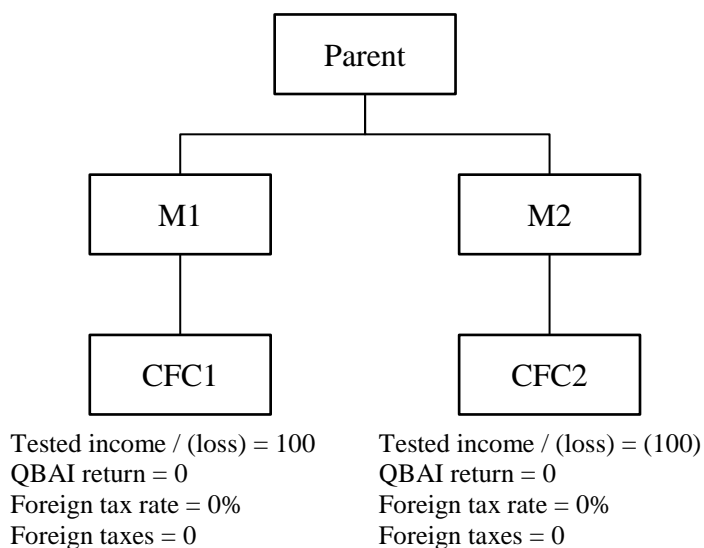
<sup>200</sup> See Part IV.B.4.

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.

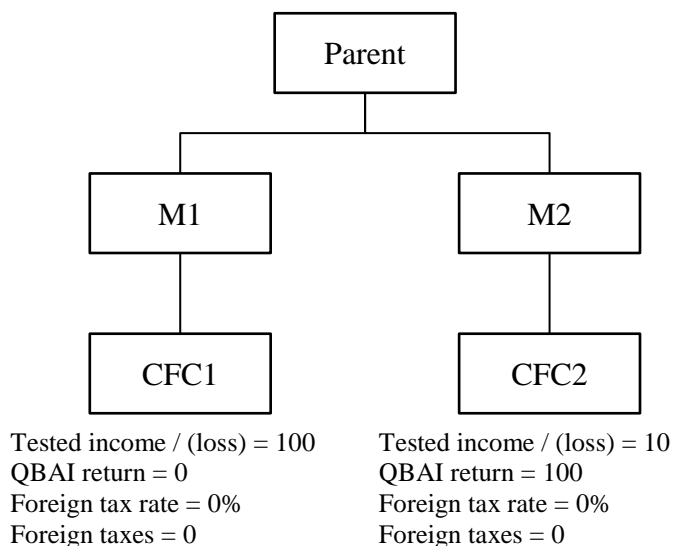


**Example 6(a)**

	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% <sup>201</sup> * 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
<b>Aggregate tax for consolidated group</b>	<b>10.50</b>		<b>0</b>

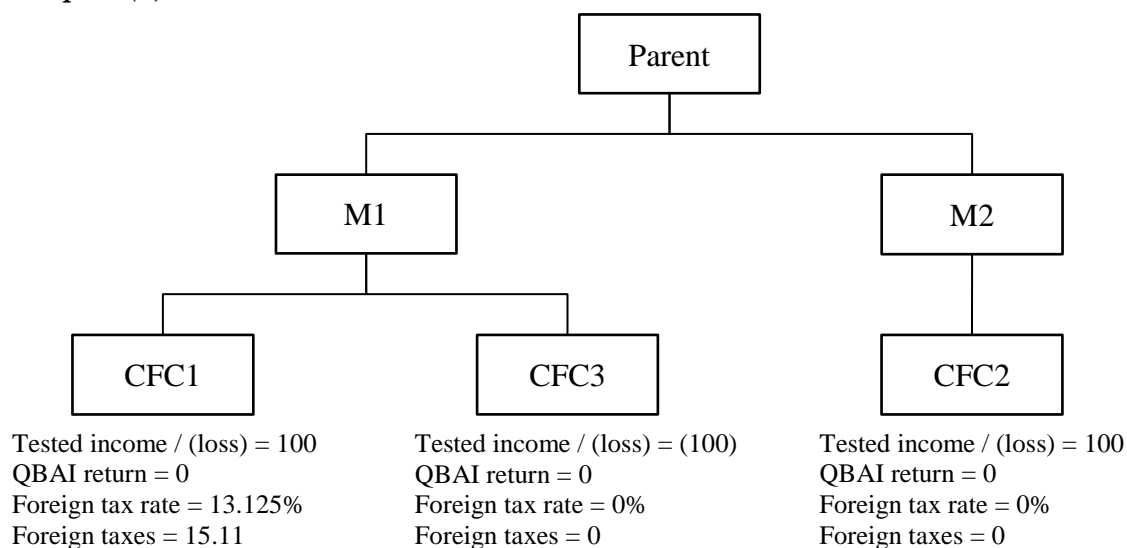
<sup>201</sup> Assumes full Section 250 deduction for GILTI is available.



**Example 7**

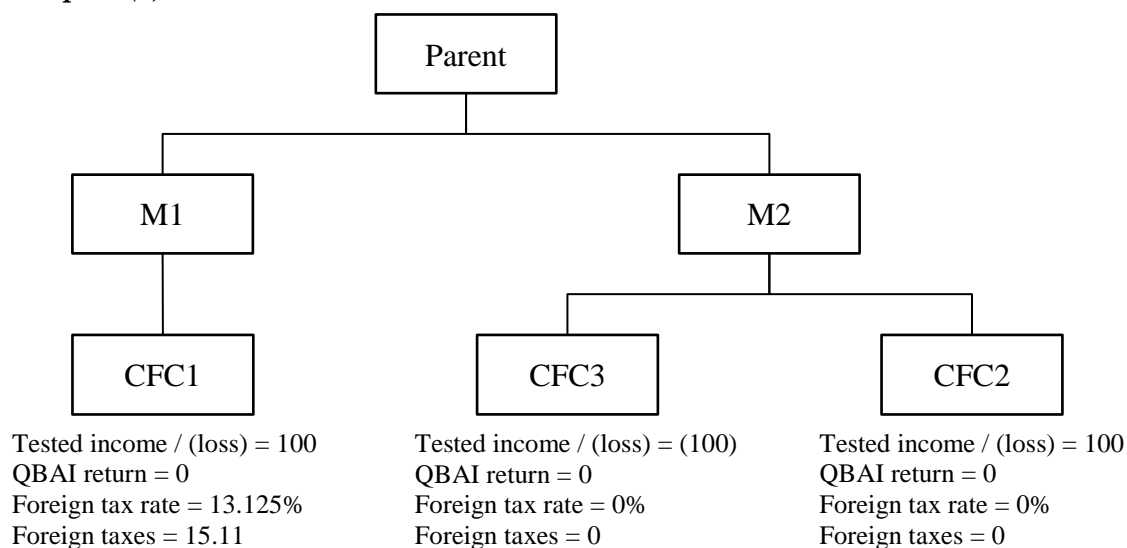
	Nonaggregation		Aggregation
	M1	M2	M
Net CFC tested income	100	10	110
NDTIR	0	100	100
Section 951A inclusion	100	0	10
Aggregate of Related CFCs' tested income	100	10	110
Inclusion percentage (Section 951A incl. / Agg. Rel. CFCs' tested income)	100%	0%	9%
Foreign tax paid by Related CFCs with tested income	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% <sup>204</sup> * 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
<b>Aggregate tax for consolidated group</b>	<b>10.50</b>		<b>1.05</b>

<sup>204</sup> Assumes full Section 250 deduction for GILTI is available.

**Example 8(b)**

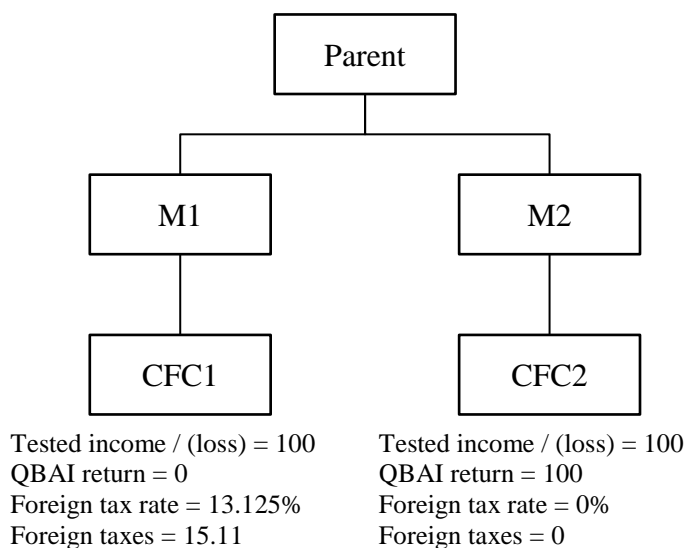
	Nonaggregation		Aggregation
	M1	M2	M
Net CFC tested income	0	100	100
NDTIR	0	0	0
Section 951A inclusion	0	100	100
Aggregate of Related CFCs' tested income	100	100	200
Inclusion percentage (Section 951A incl. / Agg. Rel. CFCs' tested income)	0%	100%	50%
Foreign tax paid by Related CFCs with tested income	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% <sup>205</sup> * 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
<b>Aggregate tax for consolidated group</b>	<b>25.61</b>		<b>20.36</b>

<sup>205</sup> Assumes full Section 250 deduction for GILTI is available.

*Example 8(c)*

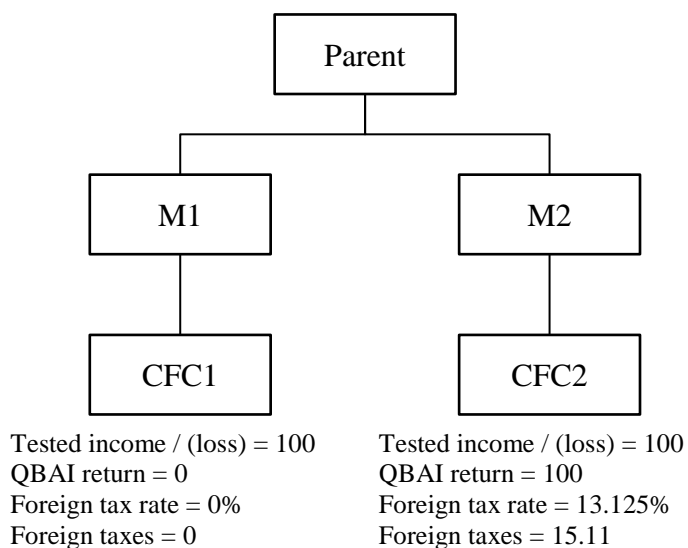
	Nonaggregation		Aggregation
	M1	M2	M
Net CFC tested income	100	0	100
NDTIR	0	0	0
Section 951A inclusion	100	0	100
Aggregate of Related CFCs' tested income	100	100	200
Inclusion percentage (Section 951A incl. / Agg. Rel. CFCs' tested income)	100%	0%	50%
Foreign tax paid by Related CFCs with tested income	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% <sup>206</sup> * 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
<b>Aggregate tax for consolidated group</b>	<b>15.11</b>		<b>20.36</b>

<sup>206</sup> Assumes full Section 250 deduction for GILTI is available.

**Example 9(b)**

	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% <sup>207</sup> * 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
<b>Aggregate tax for consolidated group</b>	<b>15.11</b>		<b>20.36</b>

<sup>207</sup> Assumes full Section 250 deduction for GILTI is available.

**Example 9(c)**

	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% <sup>208</sup> * 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
<b>Aggregate tax for consolidated group</b>	<b>25.61</b>		<b>20.36</b>

<sup>208</sup> 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
<b>Total</b>	<b>300</b>	<b>200</b>	<b>200</b>	<b>(100)</b>	<b>0</b>	<b>(100)</b>

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
<b>Total</b>	<b>400</b>	<b>200</b>	<b>200</b>	<b>0</b>	<b>0</b>	<b>0</b>

$$\text{GILTI fraction} = \frac{\text{GILTI basket income}}{\text{Worldwide income}}$$

$$\text{GILTI fraction} = \frac{200}{400} = 0.50$$



*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
<b>Total</b>	<b>300</b>	<b>60</b>	<b>240</b>	<b>(40)</b>	<b>40</b>	<b>0</b>

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
<b>Total</b>	<b>340</b>	<b>60</b>	<b>240</b>	<b>0</b>	<b>40</b>	<b>40</b>

$$\text{GILTI fraction} = \frac{\text{GILTI basket income}}{\text{Worldwide income}} = \frac{240}{340} = 0.71$$

$$\text{Foreign general basket fraction} = \frac{\text{Foreign general basket income}}{\text{Worldwide income}} = \frac{40}{340} = 0.12$$





# 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

#### KAREN GILBREATH SOWELL

Chair  
Ernst & Young LLP  
1101 New York Ave. N.W.  
Washington, DC 20005  
202/327-8747

#### DEBORAH L. PAUL

First Vice-Chair  
212/403-1300

#### ANDREW H. BRAITERMAN

Second Vice-Chair  
212/837-6315

#### GORDON E. WARNKE

Secretary  
212/997-0500

#### COMMITTEE CHAIRS:

##### Bankruptcy and Operating Losses

Stuart J. Goldring  
David W. Mayo

##### Compliance, Practice & Procedure

Elliot Pisem  
Bryan C. Skarlatos

##### Consolidated Returns

William Alexander  
Richard Nugent

##### Corporations

Michael T. Mollerus  
Linda Z. Swartz

##### Cross-Border Capital Markets

David M. Schizer  
Andrew R. Walker

##### Cross-Border M&A

Yaron Z. Reich  
Ansgar A. Simon

##### Employee Benefits

Robert C. Fleder  
Andrea K. Wahlquist

##### Estates and Trusts

Alan S. Halperin  
Joseph Septimus

##### Financial Instruments

Lucy W. Farr  
Jeffrey Maddrey

##### "Inbound" U.S. Activities of Foreign

##### Taxpayers

Peter J. Connors  
Peter F. G. Schuur

##### Individuals

Megan L. Brackney  
Steven A. Dean

##### Investment Funds

John C. Hart  
Amanda H. Nussbaum

##### Multistate Taxation

Arthur R. Rosen  
Jack Trachtenberg

##### New York City Taxes

Sherry S. Kraus  
Irwin M. Slomka

##### New York State Taxes

Paul R. Comeau  
Joshua E. Gewolb

##### "Outbound" Foreign Activities of

##### U.S. Taxpayers

Andrew P. Solomon  
Philip R. Wagman

##### Partnerships

Phillip J. Gall  
Eric B. Sloan

##### Pass-Through Entities

James R. Brown  
Edward E. Gonzalez

##### Real Property

Robert Cassanos  
Marcy Geller

##### Reorganizations

Neil J. Barr  
Peter A. Furci

##### Securitized and Structured

##### Finance

Daniel M. Dunn  
John T. Lutz

##### Spin Offs

Lawrence M. Garrett  
Joshua M. Holmes

##### Tax Exempt Entities

Stuart Rosow  
Richard R. Upton

##### Treaties and Intergovernmental

##### Agreements

Lee E. Allison  
David R. Hardy

## MEMBERS-AT-LARGE OF EXECUTIVE COMMITTEE:

Daniel Z. Altman  
William A. Curran  
Tijana J. Dvornic  
Pamela L. Endreny  
Jason R. Factor

Kathleen L. Ferrell  
Elizabeth T. Kessenides  
Shane J. Kiggen  
Stuart E. Leblang  
William L. McRae

Kara L. Mungovan  
Joel Scharfstein  
Stephen E. Shay  
Michael B. Shulman  
Eric Solomon

Jonathan R. Talansky  
Eric Wang  
Sara B. Zablotny

Report No. 1394

May 4, 2018

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

The Honorable David J. Kautter  
Acting 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. 1394 on the GILTI Provisions of the Code*

Dear Messrs. Kautter and Paul:

I am pleased to submit Report No. 1394 addressing the so-called "GILTI" provisions of the Internal Revenue Code of 1986, as amended (the "Code"). These provisions were added by P.L. 115-97 (the "Act"), enacted on December 22, 2017. 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. In general, the GILTI provisions require a 10% U.S. shareholder (a "U.S. shareholder") of a controlled foreign corporation (a "CFC") to pay, on a current basis, a minimum aggregate U.S. and foreign tax on its share of the earnings of the CFC.

## 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. Handier  
Robert H. Scarborough  
Robert A. Jacobs  
Samuel J. Dimon  
Andrew N. Berg

Lewis R. Steinberg  
David P. Hariton  
Kimberly S. Blanchard  
Patrick C. Gallagher  
Robert A. 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

The Report discusses the issues under the GILTI rules that we have identified so far and that we consider most significant. A summary of our principal recommendations is contained in Part II 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.

Part IV of the Report is a detailed analysis of certain of the GILTI provisions and discussion of our recommendations. Our recommendations include guidance concerning:

- the extent to which members of a consolidated group should be treated as a single corporation for various GILTI purposes;
- the appropriate method for calculating tested income of a CFC, including the determination of allowable deductions and the ability of a CFC to carry over tested losses and interest expense disallowed under Section 163(j);
- computational issues, including the order in which GILTI and Section 956 inclusions are determined, issues that arise when a CFC is sold mid-year, and the relationship between Section 163(j) and Section 250;
- foreign tax credit issues, including the Section 904 basket for a Section 78 gross-up of a GILTI inclusion, determination of when foreign taxes are attributable to tested income, methods for matching the timing of tested income and related foreign taxes, the allocation of expenses of a U.S. shareholder to GILTI income, and limitations on foreign tax credits under Section 904;
- the application of the GILTI rules to CFCs held through partnerships, including whether the GILTI calculations are to be made at the level of the partnership or the partner; and
- other issues, including the effect of Section 962, the consequences of repeal of the Section 958(b)(4) exception to the attribution rules, and the application of the GILTI rules to a RIC, REIT, or tax-exempt shareholder.

In connection with our recommendation in Part IV.E.2(d) of the Report that the Section 78 gross-up for a GILTI inclusion be in the GILTI foreign tax credit basket, it is particularly urgent that this issue be resolved promptly because uncertainty is affecting quarterly reporting of public companies under GAAP.

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  
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

**NEW YORK STATE BAR ASSOCIATION TAX SECTION**

**REPORT ON THE GILTI PROVISIONS OF THE CODE**

**May 4, 2018**





## Table of Contents

I. Introduction .....	1
II. Summary of Principal Recommendations.....	2
A. Purpose of the GILTI Regime.....	2
B. Aggregation of Members of a Consolidated Group.....	2
C. Deductions Allowed in Calculating Tested Income .....	2
D. Other Computational Issues for GILTI Inclusions .....	3
E. Foreign Tax Credit Issues .....	4
F. U.S. Partnership as a U.S. Shareholder in a CFC .....	5
G. Other Issues.....	6
III. Summary of GILTI Rules .....	6
A. Income Inclusion.....	6
1. Net CFC Tested Income.....	7
2. NDTIR .....	8
B. Section 250 Deduction.....	9
1. Initial Calculation.....	9
2. Carve-Back to Deduction.....	10
C. Foreign Tax Credits .....	11
1. Calculation of the FTC.....	11
2. GILTI Basket .....	12
3. Section 78 Amount .....	12
D. Limitations on Use of FTCs.....	13
IV. Discussion and Recommendations .....	15
A. Purpose of the GILTI Regime.....	15
B. Aggregation of Members of a Consolidated Group.....	17
1. In General.....	17
2. The Section 250(a) Deduction .....	18
3. Section 904 Limit on the Deemed Paid Foreign Tax Credit.....	19
4. The Amount of the GILTI Inclusion.....	20
(a) Why it matters.....	20
(b) Discussion .....	24
C. Deductions Allowed in Calculating Tested Income .....	28

1.	The Issue .....	28
2.	Choice of Method .....	29
	(a) The modified taxable income method.....	30
	(b) The Subpart F method.....	31
	(c) The modified Subpart F method .....	33
	(d) Conclusion .....	34
3.	Loss and Interest Carryovers .....	34
	(a) Carryover of operating losses .....	34
	(b) Section 163(j) carryovers .....	44
D.	Other Computational Issues for GILTI Inclusions .....	47
1.	Order of GILTI versus Section 956 Inclusions.....	47
2.	GILTI and Subpart F Inclusions in a Year When CFC Stock is Sold .....	49
	(a) Background.....	49
	(b) Fact patterns and results.....	50
	(c) Discussion.....	57
3.	Relationship between Section 163(j) and Section 250 .....	59
4.	Limit on Section 250 Deduction .....	59
5.	Allocation to Preferred Stock.....	60
6.	Interest Expense of CFC with Tested Loss.....	62
7.	Tax Basis and E&P Issues .....	63
E.	Foreign Tax Credit Issues .....	65
1.	Determination of Allowed FTC .....	65
	(a) Tracing versus proration .....	65
	(b) Timing differences .....	67
	(c) Withholding tax on distribution of PTI.....	69
2.	Section 904 Issues.....	70
	(a) Expense allocation .....	70
	(b) Section 904(b)(4) .....	75
	(c) The Section 250 deduction.....	80
	(d) Section 78 gross-up.....	80
	(e) Interest, rent and royalty payments from a CFC to its U.S. shareholder .....	82
	(f) Basket for base differences .....	84
	(g) Basket for withholding tax on PTI.....	85
	(h) 2017 overall foreign or domestic loss.....	86

(i)	FTC transition issues.....	86
F.	U.S. Partnership as a U.S. Shareholder in a CFC .....	87
1.	Possible Approaches for Applying GILTI.....	87
2.	Discussion.....	88
3.	Conclusions.....	92
4.	Related Issues.....	94
G.	Other Issues.....	96
1.	Section 962 Election .....	96
2.	Fiscal Transition Year 2017-2018 .....	98
3.	Effect of Section 958(b)(4) Repeal .....	99
4.	Overlap Between Section 250(a)(2) and Section 172(d)(9) .....	101
5.	Medicare Tax (Section 1411).....	101
6.	REIT Income.....	101
7.	RIC Income.....	102
8.	UBTI.....	102
H.	Proposed Aggregation of CFCs held by a U.S. Shareholder .....	102
	APPENDIX 1.....	106

## I. Introduction

This Report<sup>1</sup> discusses the so-called “GILTI” provisions of the Code added by the legislation informally known as the Tax Cuts and Jobs Act (the “Act”).<sup>2</sup> 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.<sup>3</sup> In general, the GILTI provisions require a U.S. shareholder (a “**U.S. shareholder**”)<sup>4</sup> of a controlled foreign corporation (“**CFC**”)<sup>5</sup> 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.

---

<sup>1</sup> 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.

<sup>2</sup> 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.

<sup>3</sup> Unless otherwise stated, all “Code” and “Section” references are to the Internal Revenue Code of 1986, as amended.

<sup>4</sup> 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.

<sup>5</sup> 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.<sup>6</sup> *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.<sup>7</sup>

---

<sup>6</sup> 2018-16 IRB (April 2, 2018).

<sup>7</sup> 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.<sup>8</sup> 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.<sup>9</sup> 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)”.<sup>10</sup> 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),<sup>11</sup>

---

<sup>8</sup> Section 951A(b)(1).

<sup>9</sup> Section 951A(c)(1).

<sup>10</sup> Section 951(c)(2)(A).

<sup>11</sup> 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

- (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)).<sup>12</sup>

Tested loss is the excess (if any) of the deductions described above over the income, calculated as described above.<sup>13</sup> 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,<sup>14</sup> 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.<sup>15</sup> 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.<sup>16</sup> 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.<sup>17</sup> The reduction applies even if the

---

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 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).

<sup>12</sup> Section 951A(c)(2)(A).

<sup>13</sup> Section 951A(c)(2)(B)(i).

<sup>14</sup> 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).

<sup>15</sup> Section 951A(d)(1). The adjusted tax basis is determined at the end of each quarter of the taxable year and then averaged.

<sup>16</sup> Section 951A(b)(2)(A).

<sup>17</sup> Section 951A(b)(2)(B).

interest expense is not in the same Related CFC as is the QBAI. The result is the U.S. shareholder's NDTIR.<sup>18</sup> Note that gross interest expense of a CFC (unless paid to a Related 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**”).<sup>19</sup>

---

<sup>18</sup> Section 951A(b)(2).

<sup>19</sup> 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.

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 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**”).<sup>20</sup> In addition, the Section 250 deduction is disallowed in calculating a net operating loss.<sup>21</sup>

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.

Example 2(a). 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.

Example 2(b). Same facts as Example 2(a), except the NOL is \$150. Now, the taxable income

---

<sup>20</sup> 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.

<sup>21</sup> Section 172(d)(9).

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. 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.<sup>22</sup>

### 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”.<sup>23</sup>

“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.<sup>24</sup> 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.<sup>25</sup>

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.<sup>26</sup>

---

<sup>22</sup> 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.

<sup>23</sup> Section 960(d)(1).

<sup>24</sup> Section 960(d)(3).

<sup>25</sup> 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).”)

<sup>26</sup> Section 960(d)(2).

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 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.<sup>27</sup> Any income that is GILTI is not general category income.<sup>28</sup>

## 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".<sup>29</sup> The Section 250 deduction is allowed against the full grossed-up amount.<sup>30</sup>

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.<sup>31</sup>

---

<sup>27</sup> Section 904(c) and (d)(1)(A).

<sup>28</sup> Section 904(d)(1)(A) and (2)(A)(ii).

<sup>29</sup> Section 78.

<sup>30</sup> Section 250(a)(1)(B)(ii).

<sup>31</sup> 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.

We assume hereafter that the gross-up goes in the GILTI FTC basket.<sup>32</sup>

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.<sup>33</sup> This determination is made separately for each FTC basket, including the GILTI basket.<sup>34</sup> 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.<sup>35</sup>

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.<sup>36</sup> Following the Act, interest deductions are

---

<sup>32</sup> *See* Part IV.E.2(d).

<sup>33</sup> 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.

<sup>34</sup> Section 904(d).

<sup>35</sup> Various re-sourcing rules under Section 904 must be taken into account but are beyond the scope of this discussion.

<sup>36</sup> *See generally*, Sections 861(b), 862(b), 863(a) and Treasury Regulations thereunder.



generally allocated and apportioned on the basis of the tax basis of assets, rather than the value of assets or income.<sup>37</sup>

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

---

<sup>37</sup> 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 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).

group were a single corporation.<sup>38</sup> 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.<sup>39</sup> For affiliated groups filing a consolidated return, all foreign taxes paid by group members are aggregated, and a single Section 904 limit is calculated for the group.<sup>40</sup>

## 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.<sup>41</sup>

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<sup>42</sup> (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%,<sup>43</sup> although this may have merely been intended as an illustrative rate.<sup>44</sup> Other

---

<sup>38</sup> 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).

<sup>39</sup> Section 864(e)(6), Temp. Treas. Reg. § 1.861-14T.

<sup>40</sup> Treas. Reg. § 1.1502-4(d).

<sup>41</sup> 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.

<sup>42</sup> 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.

<sup>43</sup> 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

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 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,<sup>45</sup> 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.<sup>46</sup> 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

---

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.”).

<sup>44</sup> The quoted language is under the heading “Illustration of effective tax rates on FDII and GILTI”. *Id.* at 626.

<sup>45</sup> Section 250(b)(3)(A)(ii).

<sup>46</sup> We propose in Part IV.C.3(a) that unused tested losses should be allowed to carry over.

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%.

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<sup>47</sup> and the legislative history suggest similarity between Subpart F income and GILTI,<sup>48</sup> and consolidation principles do not apply to calculating Subpart F inclusions. However, the GILTI rules are

---

<sup>47</sup> Section 951A(f)(1)(A) lists the Code sections for which GILTI is to be treated in the same manner as Subpart F income.

<sup>48</sup> 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”.

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 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.<sup>49</sup>

We note that Section 5 of Notice 2018-28<sup>50</sup> 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,<sup>51</sup> 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).

---

<sup>49</sup> See Staff of the Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress*, JCS-5-05 (2005) at 415.

<sup>50</sup> 2018-16 IRB (April 2, 2018).

<sup>51</sup> Treas. Reg. § 1.1502-4(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,<sup>52</sup> 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 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.

---

<sup>52</sup> Section 864(e)(6); Treas. Reg. §§ 1.861-14T and 1.861-17(a)(3)(i).

(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.

Example 6(a) (tested income and tested loss; aggregation is taxpayer-favorable). 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.<sup>53</sup>

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

---

<sup>53</sup> 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.



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). 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.<sup>54</sup>

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.<sup>55</sup>

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.

---

<sup>54</sup> 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%.

<sup>55</sup> 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.

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 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)).

Example 9(a) (base case with aggregation; NDTIR reduces inclusion percentage). 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%.

Example 9(b) (no aggregation; lower foreign tax on QBAI return; result is taxpayer-favorable compared to aggregation). 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.

Example 9(c) (no aggregation; higher foreign tax on QBAI return; result is taxpayer-unfavorable compared to aggregation). 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.<sup>56</sup> As a result, in the absence of mandatory aggregation, 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

---

<sup>56</sup> An exception might be CFCs that are regulated entities, which may be required by law to be held within or outside of specified structures.

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.<sup>57</sup> 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.

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

---

<sup>57</sup> None of this restructuring would be affected by Section 367, since the stock of the CFCs remains within the U.S. consolidated group.

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.<sup>58</sup>

### 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,<sup>59</sup> 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 deductions would be allocable if there were such gross income)”.<sup>60</sup> 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.<sup>61</sup>

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

---

<sup>58</sup> 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.

<sup>59</sup> Section 951A(c)(2)(A)(i).

<sup>60</sup> Section 951A(c)(2)(A)(ii).

<sup>61</sup> 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.

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.<sup>62</sup> This calculation incorporates by reference the rules for determining e&p of the CFC.<sup>63</sup>
- (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.

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.<sup>64</sup> 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,<sup>65</sup> a payment under a hybrid instrument,<sup>66</sup> a loss on a sale to a related party,<sup>67</sup> an interest deduction that exceeded the limits under Section 163(j), and a nondeductible business entertainment or meal expense<sup>68</sup> 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

---

<sup>62</sup> Treas. Reg. § 1.952-2(b)(1), (c)(2).

<sup>63</sup> *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.

<sup>64</sup> Section 951A(c)(2)(A)(ii).

<sup>65</sup> Section 162(f).

<sup>66</sup> Section 267A.

<sup>67</sup> Section 267.

<sup>68</sup> Section 274.



but not for U.S. tax purposes because of its riskiness might even be allowed under the same circumstances.<sup>69</sup>

(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.<sup>70</sup> 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 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.<sup>71</sup>

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.<sup>72</sup> Nevertheless, we do not believe taxpayers should have an incentive to make such shifts.

---

<sup>69</sup> 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.

<sup>70</sup> Section 951A(c)(2)(A)(i) refers to “gross income”, which is necessarily used in the tax rather than accounting sense.

<sup>71</sup> Treas. Reg. § 1.952-2(b)(1), (c)(2).

<sup>72</sup> 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.

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.<sup>73</sup> 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. 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

---

<sup>73</sup> 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.

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,<sup>74</sup> and it would be peculiar to determine the total on a different basis than the subtraction.<sup>75</sup>

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.<sup>76</sup> 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 of the stock of the CFC). Subpart F represented an exception to deferral for particular categories of income,<sup>77</sup> 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

---

<sup>74</sup> Section 951A(c)(2)(A).

<sup>75</sup> 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.

<sup>76</sup> 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.

<sup>77</sup> 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.

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 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).<sup>78</sup> 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

(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.<sup>79</sup>

---

<sup>78</sup> Sections 951A(d)(1), (d)(3)(A).

<sup>79</sup> 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.

The Subpart F regulations provide that net operating losses are not taken into account in calculating taxable income for Subpart F purposes.<sup>80</sup> However, Subpart F income is limited to current year e&p of the applicable CFC<sup>81</sup> and is reduced for certain prior year e&p deficits of the same CFC from Subpart F activities.<sup>82</sup> In some cases, e&p deficits of other CFCs in the same ownership chain may also be used.<sup>83</sup> 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 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,<sup>84</sup> but

---

<sup>80</sup> Treas. Reg. § 1.952-2(c)(5)(ii).

<sup>81</sup> Section 952(c)(1)(A), Treas. Reg. § 1.952-1(e).

<sup>82</sup> Section 952(c)(1)(B).

<sup>83</sup> Section 952(c)(1)(C).

<sup>84</sup> 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,

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.<sup>85</sup> 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 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

---

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.

<sup>85</sup> 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.

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.<sup>86</sup> 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 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.<sup>87</sup>

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.<sup>88</sup> 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.

---

<sup>86</sup> For simplicity, disregard shareholders who can use part but not all of their share of the tested loss.

<sup>87</sup> 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.

<sup>88</sup> 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.



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, 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.<sup>89</sup> 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

---

<sup>89</sup> Section 172(a).

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.

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.<sup>90</sup> 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 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

---

<sup>90</sup> 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.

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.<sup>91</sup>

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.<sup>92</sup> Net CFC tested income is the excess (if any) of the aggregate of its *pro rata* shares of its Related CFCs'

---

<sup>91</sup> 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.

<sup>92</sup> Section 951A(b)(1).

tested income over the aggregate of its *pro rata* shares of its Related CFCs' tested losses.<sup>93</sup>

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 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.

---

<sup>93</sup> Section 951A(c)(1).

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.<sup>94</sup>

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

---

<sup>94</sup> 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.

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.<sup>95</sup>

Yet another issue arises because under Notice 2003-65,<sup>96</sup> 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

---

<sup>95</sup> Section 382(b)(1).

<sup>96</sup> 2003-2 C.B. 747.

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 may result in a Section 951A inclusion, without any cash profit.<sup>97</sup> 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.<sup>98</sup>

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.

---

<sup>97</sup> 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.

<sup>98</sup> 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.



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,<sup>99</sup> 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.

Example 12: Carryover of Section 163(j) deduction to year with QBAI return. 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 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.<sup>100</sup> 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

---

<sup>99</sup> Section 382(d)(3), added by the Act.

<sup>100</sup> Section 951A(b)(2)(B).

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 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).<sup>101</sup>

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.

---

<sup>101</sup> 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.

It is clear from the Code that Subpart F income is determined before Section 956 inclusions.<sup>102</sup> Treasury Regulations confirm this result.<sup>103</sup> Moreover, the definition of tested income specifically excludes Subpart F income,<sup>104</sup> 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.<sup>105</sup> 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 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.<sup>106</sup> 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.

---

<sup>102</sup> 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.

<sup>103</sup> Treas. Reg. § 1.959-1(a).

<sup>104</sup> Section 951A(c)(2)(A)(i)(II).

<sup>105</sup> 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.

<sup>106</sup> Sections 951A(f)(1)(A), 959 and 961(a).

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 results arise because of the enactment of Section 245A.<sup>107</sup> 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**”).<sup>108</sup> The same rule applies to a Subpart F inclusion.<sup>109</sup> 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.<sup>110</sup> The U.S. shareholder’s *pro rata* share of tested income, tested loss, and QBAI is determined

---

<sup>107</sup> The Tax Section is preparing a separate report on Section 245A.

<sup>108</sup> Section 951A(e)(1) and (2). This rule is also expressly stated in the Conference Report at 645.

<sup>109</sup> Section 951(a)(1).

<sup>110</sup> Section 951A(a), (b)(1)(A) and (c)(1)(A).

“under the rules of section 951(a)(2) in the same manner as such section applies to subpart F income”.<sup>111</sup>

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.

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

---

<sup>111</sup> Section 951A(e)(1). This section is written in a rather peculiar way because it refers separately to tested income, tested loss, and QBAL, 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.

requirement,<sup>112</sup> the U.S. shareholder holds no other CFCs and none of the relevant CFCs has any QBAI return.

Example 14(a) (CFC with Section 958(a) U.S. shareholders throughout the year): 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.

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

---

<sup>112</sup> See Section 246(c).

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.<sup>113</sup>

*(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.

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

---

<sup>113</sup> 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).

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.<sup>114</sup> While the partnership would have the Subpart F inclusion as a U.S.

---

<sup>114</sup> 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



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.<sup>115</sup> 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.<sup>116</sup> 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 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.<sup>117</sup> 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.

---

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.

<sup>115</sup> The scope of the repeal of Section 958(b)(4) is discussed in Part IV.G.3.

<sup>116</sup> 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)).

<sup>117</sup> 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.

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 period for the CFC stock satisfies the Section 245A holding period requirement,<sup>118</sup> 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.

---

<sup>118</sup> See Section 246(c).

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.<sup>119</sup> CFC1 could pass on the dividend 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.<sup>120</sup> 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.<sup>121</sup>

---

<sup>119</sup> 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.

<sup>120</sup> Note that Section 964(e)(4) applies "notwithstanding any other provision of this title".

<sup>121</sup> 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.

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.

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.<sup>122</sup> 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 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

---

<sup>122</sup> TAM 9538002 (May 16, 1995).

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**”).<sup>123</sup> 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**”).<sup>124</sup> 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.<sup>125</sup> 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.<sup>126</sup>

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.<sup>127</sup> 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.

---

<sup>123</sup> 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).

<sup>124</sup> *Id.*

<sup>125</sup> Treas. Reg. §§ 1.951-1(e)(3)(ii)(A); -1(e)(4)(ii).

<sup>126</sup> Treas. Reg. § 1.951-1(e)(6) Ex. 5.

<sup>127</sup> 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 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).



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.<sup>128</sup> 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.<sup>129</sup> 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 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.<sup>130</sup>

---

<sup>128</sup> 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).

<sup>129</sup> This assumes no previous inversion transaction. *See* Treas. Reg. § 1.7701(l)-4T.

<sup>130</sup> 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

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.

## 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

---

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.

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.”<sup>131</sup> If the CFC has both tested income and other income, the Conference Report<sup>132</sup> 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.<sup>133</sup>

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.

Example 15(a): Two divisions of a single CFC.

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.

Example 15(b): Disregarded subsidiary of a CFC:

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.

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.

---

<sup>131</sup> Section 960(d)(3).

<sup>132</sup> Conference Report at 628 (describing House bill), 630 (stating that conference agreement follows House bill).

<sup>133</sup> 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.

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.<sup>134</sup>

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*.

---

<sup>134</sup> 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).

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.<sup>135</sup>

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.<sup>136</sup> 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,<sup>137</sup> 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 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

---

<sup>135</sup> If a foreign corporation is 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).

<sup>136</sup> Section 960(d)(1)(B).

<sup>137</sup> See Alan Fischl, Elizabeth Nelson, and Anisa Afshar, *Section 905(c) Mysteries*, J. Int'l Tax, July 2017 at 22.

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.<sup>138</sup>

## 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.<sup>139</sup>

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 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

---

<sup>138</sup> 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.

<sup>139</sup> See generally Section 861 and Treasury Regulations thereunder.

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.<sup>140</sup>

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 than 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,<sup>141</sup> 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.
- 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.

---

<sup>140</sup> See, e.g., Treas. Reg. § 1.861-10T, relating to special rules for allocating interest expense.

<sup>141</sup> 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.

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.<sup>142</sup> 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,<sup>143</sup> 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.<sup>144</sup> 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 not occur without gain recognition or Section 367(d) royalty income to the U.S. parent corporation.<sup>145</sup>

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

---

<sup>142</sup> 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.

<sup>143</sup> 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.

<sup>144</sup> See Treas. Reg. § 1.861-17.

<sup>145</sup> 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.

to the shareholder for the reasons stated above.<sup>146</sup> 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.<sup>147</sup> 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.<sup>148</sup> 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 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.

---

<sup>146</sup> 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.

<sup>147</sup> 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).

<sup>148</sup> See also Treas. Reg. § 1.861-8T(d)(2)(ii).

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.<sup>149</sup> 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 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.<sup>150</sup> The heading is “Treatment of Dividends for

<sup>149</sup> Section 245A(d).

<sup>150</sup> 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.

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.

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.<sup>151</sup>

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 decreases the limitations in the GILTI and Subpart F baskets. The following example illustrates these results.<sup>152</sup>

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,

<sup>151</sup> Section 904(f)(5); Treas. Reg. § 1.904-4(c)(2)(ii).

<sup>152</sup> Appendix 1 contains a table illustrating this example.



- \$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.

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.<sup>153</sup> 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,<sup>154</sup> 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.

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.<sup>155</sup>

---

<sup>153</sup> 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.

<sup>154</sup> 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...”).

<sup>155</sup> 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.

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.<sup>156</sup> In that case, other adjustments would logically follow.<sup>157</sup> 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 imposed on \$10 of general basket income, or \$0.80, would logically also be in the general basket.<sup>158</sup>

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

---

<sup>156</sup> 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.

<sup>157</sup> See discussion in Elizabeth J. Stevens and H. David Rosenbloom, GILTI Pleasures, Tax Notes Int'l, Feb. 12, 2018, at 615.

<sup>158</sup> 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%).

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.<sup>159</sup>

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.<sup>160</sup>

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.

---

<sup>159</sup> 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.

<sup>160</sup> See Section 951A(f)(1)(A).

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.

Example 17 (Royalty income and FTC baskets).

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.<sup>161</sup> The

---

<sup>161</sup> 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.

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.<sup>162</sup> This rule is the result of a technical error in the Act,<sup>163</sup> 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.<sup>164</sup> 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)).

We acknowledge that our proposal is arguably inconsistent with language in the Conference Report<sup>165</sup> 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

---

<sup>162</sup> Section 904(d)(2)(H)(i).

<sup>163</sup> 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.

<sup>164</sup> Section 904(d)(1)(B).

<sup>165</sup> 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])

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.<sup>166</sup> 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.

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

---

<sup>166</sup> Treas. Reg. § 1.904-6(a)(1)(iv).



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,<sup>167</sup> 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.<sup>168</sup> 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 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.

---

<sup>167</sup> Treas. Reg. § 1.904(f)-7; Section 904(g)(3).

<sup>168</sup> 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.

## 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.<sup>169</sup> 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. shareholder.<sup>170</sup> 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

---

<sup>169</sup> 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.

<sup>170</sup> 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.

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.<sup>171</sup>

---

<sup>171</sup> 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 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).”)

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 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.<sup>172</sup> Under the portfolio interest rules,<sup>173</sup> 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.<sup>174</sup>

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 believe the rules under that section should control the rules that will apply permanently under GILTI.

---

<sup>172</sup> T.D. 9008, July 22, 2002.

<sup>173</sup> Sections 871(h), 881(c).

<sup>174</sup> Treas. Reg. § 1.871-14(g)(3)(i).

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.

Example 18(a): Partner directly holds CFC and has Section 163(j) limitation. 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.

Example 18(b): The business, the CFC and Section 163(j) interest are at partnership level. 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.<sup>175</sup>

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 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.

---

<sup>175</sup> 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.

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.<sup>176</sup>

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 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

---

<sup>176</sup> 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.



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).<sup>177</sup> 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.<sup>178</sup>

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.<sup>179</sup> The fact that Congress chose to achieve a reduced tax rate on foreign earnings by means of a gross income inclusion and a deduction, rather than a reduced tax rate, should have no effect on

---

<sup>177</sup> Section 1(h)(11).

<sup>178</sup> Treas. Reg. § 1.962-1(b)(1)(i).

<sup>179</sup> 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.”).

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.<sup>180</sup> We note that resolution of this issue has broader implications than GILTI.

Finally, the statute and regulation<sup>181</sup> 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.<sup>182</sup>

---

<sup>180</sup> 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.

<sup>181</sup> Treas. Reg. § 1.962-2(a).

<sup>182</sup> 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.<sup>183</sup> 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<sup>184</sup> 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<sup>185</sup> 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.

---

<sup>183</sup> Section 951A applies to taxable years of a foreign corporation beginning after December 31, 2017.

<sup>184</sup> Section 951A(d)(4).

<sup>185</sup> 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.<sup>186</sup> 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.<sup>187</sup> It further states that Treasury Regulations should interpret the provision accordingly.<sup>188</sup> The Senate Finance Committee’s explanation of the corresponding provision in the Senate Bill is to the same effect,<sup>189</sup> and there is no indication that Congress intended repeal to have broader consequences.

---

<sup>186</sup> Act § 14213.

<sup>187</sup> 163 Cong. Rec. No. 207 (Dec. 19, 2017) at p. S8110 (colloquy between Senator Hatch, Chairman of the Senate Finance Committee and Senator Perdue).

<sup>188</sup> *Id.*

<sup>189</sup> “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.<sup>190</sup> There is clear statutory authority for such regulations.<sup>191</sup>

---

<sup>190</sup> Section 856(c).

<sup>191</sup> Section 856(c)(5)(J).



The current Treasury/IRS Priority Guidance Plan already includes a project to determine whether Subpart F income is qualifying income under Section 856(c),<sup>192</sup> 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.<sup>193</sup>

## 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.<sup>194</sup> In a prior Report, we stated our disagreement with this aspect of the proposed regulations.<sup>195</sup> 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.

---

<sup>192</sup> Department of the Treasury, 2017-2018 Priority Guidance Plan, as updated February 7, 2018.

<sup>193</sup> 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).

<sup>194</sup> REG-123600-16, Sept. 28, 2016.

<sup>195</sup> 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”.<sup>196</sup> 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.<sup>197</sup>

Second, foreign taxes are taken into account to the extent they are “properly attributable” to tested income.<sup>198</sup> 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.<sup>199</sup> 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 these rules since they give very arbitrary results and invite restructurings solely to minimize tax liability.

---

<sup>196</sup> Section 951A(d)(2)(A).

<sup>197</sup> 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”).

<sup>198</sup> Section 960(d)(3).

<sup>199</sup> 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)”).

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,<sup>200</sup> 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.

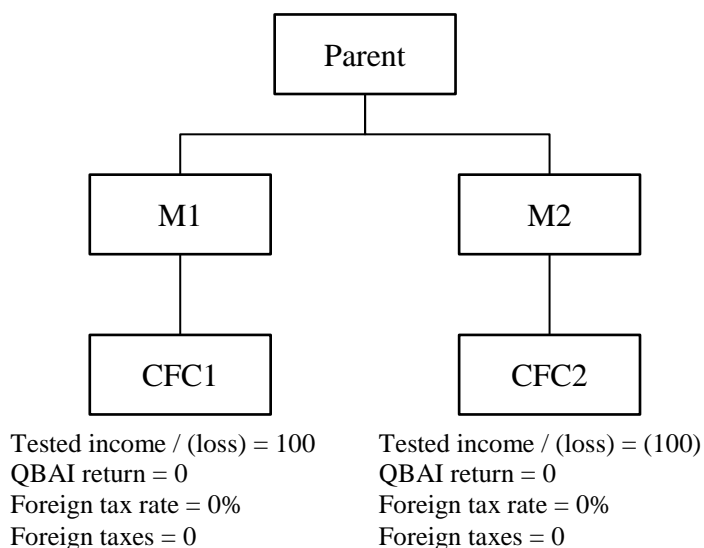
We are not suggesting, however, that all Related CFCs owned by a single U.S. shareholder (or members of a single consolidated group) should be treated as a single corporation for all purposes, so that all transactions between them should be disregarded in calculating tested income. This would, for example, eliminate tested income when one CFC sells an asset to another CFC at a gain. While elements of such a rule apply under Subpart F for transactions between CFCs, such a rule would require considerably more analysis.

---

<sup>200</sup> See Part IV.B.4.

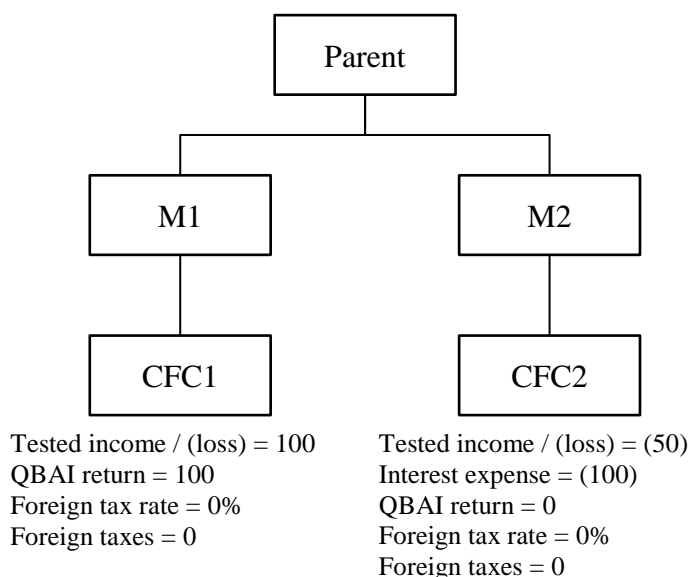
**APPENDIX 1**

The charts and calculations on the following pages illustrate certain of the examples in the Report.

**Example 6(a)**

	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% <sup>201</sup> * 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
<b>Aggregate tax for consolidated group</b>	<b>10.50</b>		<b>0</b>

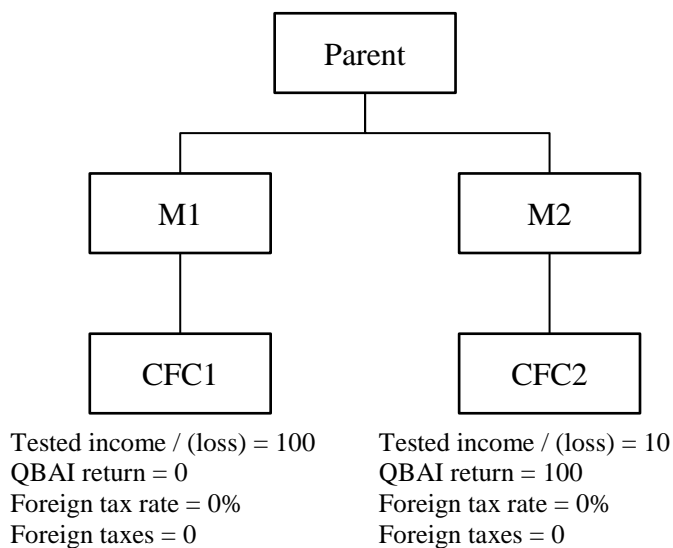
<sup>201</sup> Assumes full Section 250 deduction for GILTI is available.

**Example 6(b)**<sup>202</sup>

	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% <sup>203</sup> * 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
<b>Aggregate tax for consolidated group</b>	<b>0</b>		<b>5.25</b>

<sup>202</sup> 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.

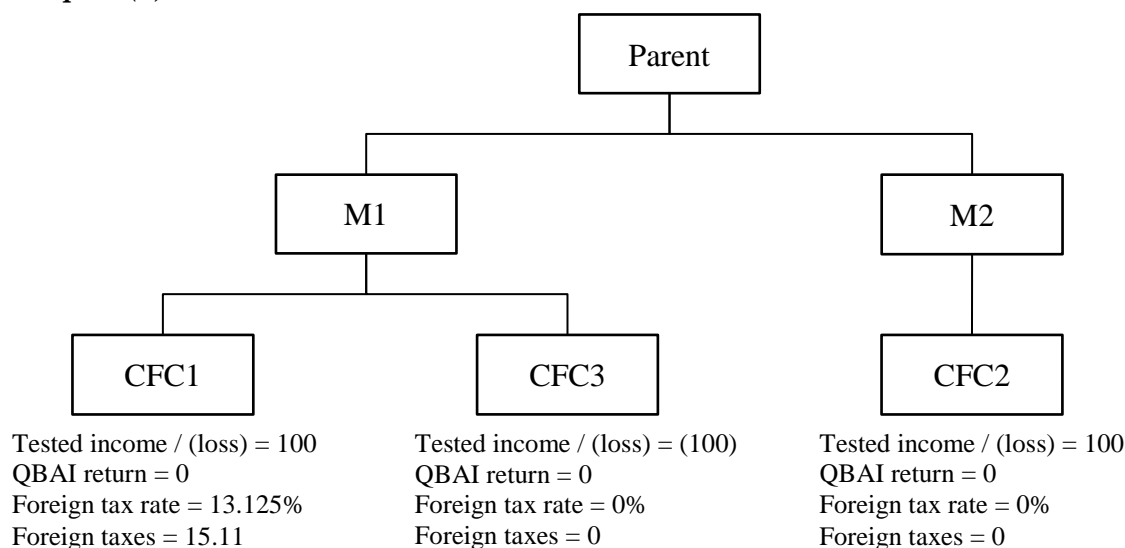
<sup>203</sup> Assumes full Section 250 deduction for GILTI is available.

**Example 7**

	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% <sup>204</sup> * 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
<b>Aggregate tax for consolidated group</b>	<b>10.50</b>		<b>1.05</b>

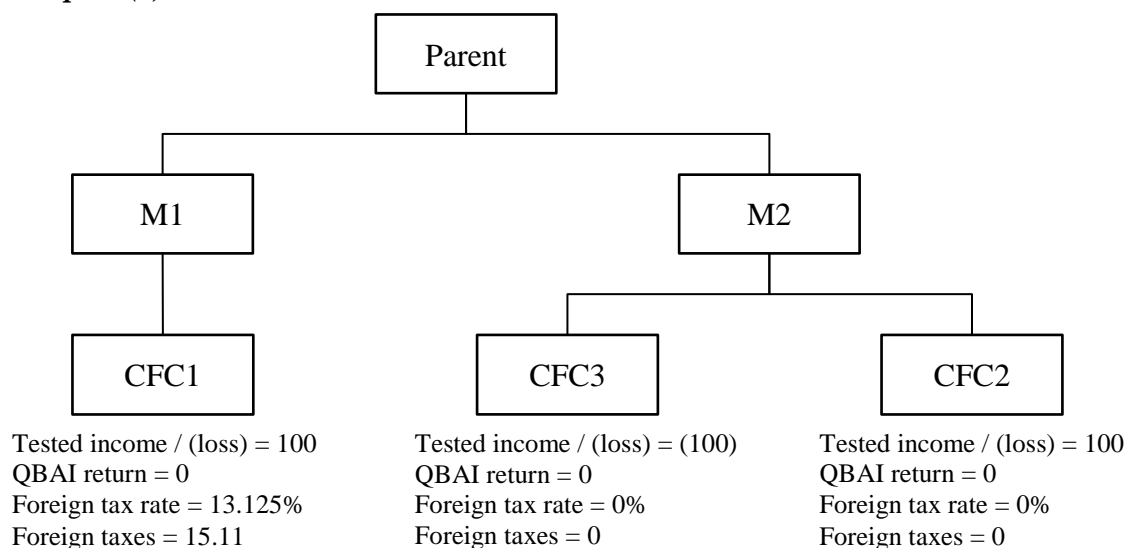
<sup>204</sup> Assumes full Section 250 deduction for GILTI is available.



**Example 8(b)**

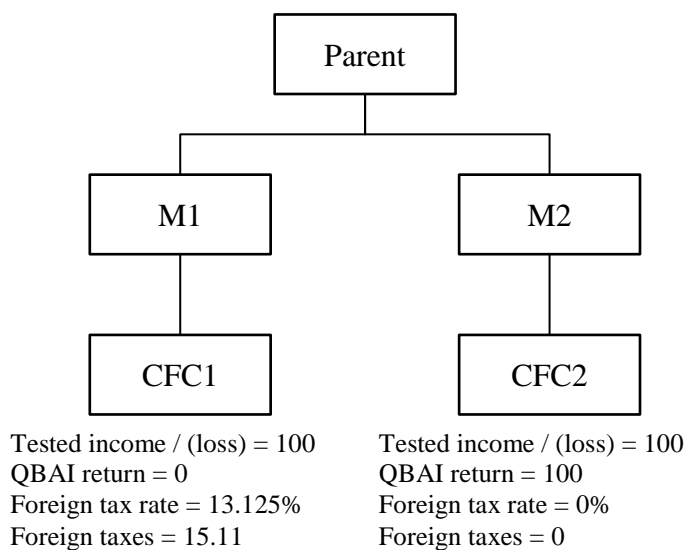
	Nonaggregation		Aggregation
	M1	M2	M
Net CFC tested income	0	100	100
NDTIR	0	0	0
Section 951A inclusion	0	100	100
Aggregate of Related CFCs' tested income	100	100	200
Inclusion percentage (Section 951A incl. / Agg. Rel. CFCs' tested income)	0%	100%	50%
Foreign tax paid by Related CFCs with tested income	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% <sup>205</sup> * 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
<b>Aggregate tax for consolidated group</b>	<b>25.61</b>		<b>20.36</b>

<sup>205</sup> Assumes full Section 250 deduction for GILTI is available.

**Example 8(c)**

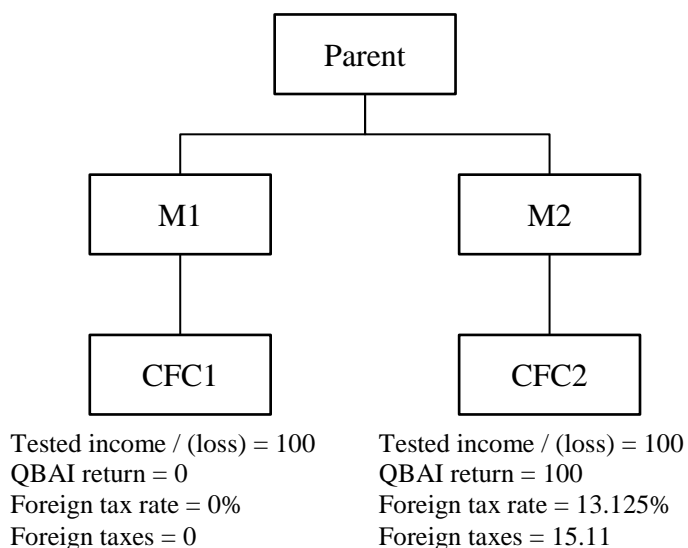
	Nonaggregation		Aggregation
	M1	M2	M
Net CFC tested income	100	0	100
NDTIR	0	0	0
Section 951A inclusion	100	0	100
Aggregate of Related CFCs' tested income	100	100	200
Inclusion percentage (Section 951A incl. / Agg. Rel. CFCs' tested income)	100%	0%	50%
Foreign tax paid by Related CFCs with tested income	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% <sup>206</sup> * 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
<b>Aggregate tax for consolidated group</b>	<b>15.11</b>		<b>20.36</b>

<sup>206</sup> Assumes full Section 250 deduction for GILTI is available.

**Example 9(b)**

	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% <sup>207</sup> * 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
<b>Aggregate tax for consolidated group</b>	<b>15.11</b>		<b>20.36</b>

<sup>207</sup> Assumes full Section 250 deduction for GILTI is available.

**Example 9(c)**

	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% <sup>208</sup> * 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
<b>Aggregate tax for consolidated group</b>	<b>25.61</b>		<b>20.36</b>

<sup>208</sup> 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
<b>Total</b>	<b>300</b>	<b>200</b>	<b>200</b>	<b>(100)</b>	<b>0</b>	<b>(100)</b>

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
<b>Total</b>	<b>400</b>	<b>200</b>	<b>200</b>	<b>0</b>	<b>0</b>	<b>0</b>

$$\text{GILTI fraction} = \frac{\text{GILTI basket income}}{\text{Worldwide income}}$$

$$\text{GILTI fraction} = \frac{200}{400} = 0.50$$

*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
<b>Total</b>	<b>300</b>	<b>60</b>	<b>240</b>	<b>(40)</b>	<b>40</b>	<b>0</b>

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
<b>Total</b>	<b>340</b>	<b>60</b>	<b>240</b>	<b>0</b>	<b>40</b>	<b>40</b>

$$\text{GILTI fraction} = \frac{\text{GILTI basket income}}{\text{Worldwide income}} = \frac{240}{340} = 0.71$$

$$\text{Foreign general basket fraction} = \frac{\text{Foreign general basket income}}{\text{Worldwide income}} = \frac{40}{340} = 0.12$$







**DEPARTMENT OF THE TREASURY****Internal Revenue Service****26 CFR Part 1**

[REG–104390–18]

RIN 1545–BO54

**Guidance Related to Section 951A  
(Global Intangible Low-Taxed Income)****AGENCY:** Internal Revenue Service (IRS), Treasury.**ACTION:** Notice of proposed rulemaking.

**SUMMARY:** This document contains proposed regulations implementing section 951A of the Internal Revenue Code. Section 951A was added to the Internal Revenue Code by the Tax Cuts and Jobs Act, which was enacted on December 22, 2017. This document also contains proposed regulations under sections 951, 1502, and 6038. These proposed regulations would affect United States shareholders of controlled foreign corporations.

**DATES:** Written or electronic comments and requests for a public hearing must be received by November 26, 2018.

**ADDRESSES:** Send submissions to: Internal Revenue Service, CC:PA:LPD:PR (REG–104390–18), Room 5203, Post Office 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 (indicate REG–104390–18), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC 20224, or sent electronically, via the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (IRS REG–104390–18).

**FOR FURTHER INFORMATION CONTACT:** Concerning proposed regulations §§ 1.951–1, 1.951A–0 through 1.951A–7, 1.6038–2, and 1.6038–5, Melinda E. Harvey or Michael Kaercher at (202) 317–6934; concerning proposed regulations §§ 1.1502–12, 1.1502–13, 1.1502–32, and 1.1502–51, Austin Diamond-Jones at (202) 317–6847 or Kevin M. Jacobs at (202) 317–5332; concerning submissions of comments or requests for a public hearing, Regina L. Johnson at (202) 317–6901 (not toll free numbers).

**SUPPLEMENTARY INFORMATION:****Background**

This document contains proposed amendments to 26 CFR part 1 under sections 951, 951A, 1502, and 6038 (the “proposed regulations”). Added to the Internal Revenue Code (“Code”) by

section 14201(a) of the Tax Cuts and Jobs Act, Public Law 115–97 (2017) (“the Act”), section 951A requires a United States shareholder (“U.S. shareholder”) of any controlled foreign corporation (“CFC”) for any taxable year to include in gross income the shareholder’s global intangible low-taxed income (“GILTI”) for such taxable year. Section 14201(d) of the Act provides that section 951A applies to taxable years of foreign corporations beginning after December 31, 2017, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end. The proposed regulations under section 951A provide guidance for U.S. shareholders to determine the amount of GILTI to include in gross income (“GILTI inclusion amount”).

Section 14201(b) of the Act added two new foreign tax credit provisions relating to GILTI—section 960(d) provides a foreign tax credit for taxes properly attributable to tested income taken into account by a domestic corporation under section 951A, and section 904(d)(1)(A) provides that any amount included in gross income under section 951A (other than passive category income) is treated as a separate category of income for purposes of section 904. In addition, section 14202(a) of the Act added section 250 to the Code providing domestic corporations a deduction equal to a percentage of their GILTI inclusion amount and foreign-derived intangible income, subject to a taxable income limitation. The proposed regulations do not include any rules relating to foreign tax credits or the deduction under section 250. Rules relating to foreign tax credits and the deduction under section 250 will be included in separate notices of proposed rulemaking. It is anticipated that the proposed regulations relating to foreign tax credits will provide rules for assigning the section 78 gross-up attributable to foreign taxes deemed paid under section 960(d) to the separate category described in section 904(d)(1)(A).

Before the Act, section 951(b) defined a U.S. shareholder of a foreign corporation as a United States person (“U.S. person”) that holds at least 10 percent of the total combined voting power of all classes of stock entitled to vote in a foreign corporation. Section 14214(a) of the Act amended this definition to include a U.S. person that holds at least 10 percent of the total value of shares of all classes of stock of the foreign corporation. Section 14215(a) of the Act amended section 951(a)(1) to eliminate the requirement that a foreign corporation must be a CFC

for an uninterrupted period of 30 days or more in order to give rise to an inclusion under section 951(a)(1) (the “30-day requirement”). These amendments apply to taxable years of foreign corporations beginning after December 31, 2017, and to taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end. See sections 14214(b) and 14215(b) of the Act. The proposed regulations under section 951 incorporate these amendments into the regulations and provide other guidance necessary for U.S. shareholders to coordinate subpart F and GILTI.

**Explanation of Provisions****I. Section 951A***A. Overview*

The Act established a participation exemption system under which certain earnings of a foreign corporation can be repatriated to a corporate U.S. shareholder without U.S. tax. See section 14101(a) of the Act and section 245A. However, Congress recognized that, without any base protection measures, the participation exemption system could incentivize taxpayers to allocate income—in particular, mobile income from intangible property—that would otherwise be subject to the full U.S. corporate tax rate to CFCs operating in low- or zero-tax jurisdictions. See Senate Committee on the Budget, 115th Cong., Reconciliation Recommendations Pursuant to H. Con. Res. 71, at 365 (Comm. Print 2017) (“Senate Explanation”). Therefore, Congress enacted section 951A in order to subject intangible income earned by a CFC to U.S. tax on a current basis, similar to the treatment of a CFC’s subpart F income under section 951(a)(1)(A). However, in order to not harm the competitive position of U.S. corporations relative to their foreign peers, GILTI of a corporate U.S. shareholder is taxed at a reduced rate by reason of the deduction under section 250 (with the resulting U.S. tax further reduced by a portion of foreign tax credits under section 960(d)). *Id.* Also, due to the administrative difficulty in identifying income attributable to intangible assets, in contrast to income from tangible assets, intangible income (and thus GILTI) is determined for purposes of section 951A based on a formulaic approach, under which a 10-percent return is attributed to certain tangible assets (“qualified business asset investment” or “QBAI”) and then each dollar of certain income above such “normal return” is effectively treated as intangible income. *Id.* at 366.

Section 951A(a) provides that a U.S. shareholder of any CFC for a taxable year must include in gross income its GILTI for that year. A GILTI inclusion is treated in a manner similar to a section 951(a)(1)(A) inclusion of a CFC's subpart F income for many purposes of the Code. See section 951A(f)(1). However, a GILTI inclusion is determined in a manner that is fundamentally different from that of an inclusion under section 951(a)(1)(A). Subpart F income is determined at the level of a CFC, and then a U.S. shareholder that owns stock directly or indirectly in the CFC generally includes in gross income its pro rata share of the CFC's subpart F income. The amount of the shareholder's section 951(a)(1)(A) inclusion with respect to one CFC is not taken into account in determining the shareholder's section 951(a)(1)(A) inclusion with respect to another CFC. A U.S. shareholder's pro rata share of a CFC's subpart F income is generally the final step in determining its section 951(a)(1)(A) inclusion.

Similar to an inclusion under section 951(a)(1)(A), the determination of a U.S. shareholder's GILTI inclusion amount begins with the calculation of certain items of each CFC owned by the shareholder, such as tested income, tested loss, or QBAI. A U.S. shareholder then determines its pro rata share of each of these CFC-level items in a manner similar to a shareholder's pro rata share of subpart F income under section 951(a)(2). See section 951A(e)(1). However, in contrast to an inclusion under section 951(a)(1)(A), the U.S. shareholder's pro rata shares of these items are not amounts included in gross income, but rather amounts taken into account by the shareholder in determining the GILTI included in the shareholder's gross income. The U.S. shareholder aggregates (and then nets or multiplies) its pro rata share of each of these items into a single shareholder-level amount—for example, aggregate tested income reduced by aggregate tested loss becomes net CFC tested income and aggregate QBAI multiplied by 10 percent becomes deemed tangible income return. A shareholder's GILTI inclusion amount for a taxable year is then calculated by subtracting one aggregate shareholder-level amount from another—the shareholder's net deemed tangible income return (“net DTIR”) is the excess of deemed tangible income return over certain interest expense, and, finally, its GILTI inclusion amount is the excess of its net CFC tested income over its net DTIR.

As explained above, a U.S. shareholder does not compute a separate GILTI inclusion amount with

respect to each CFC for a taxable year, but rather computes a single GILTI inclusion amount by reference to all its CFCs. Cf. section 951A(f)(2) (allocating the U.S. shareholder's GILTI inclusion amount to each tested income CFC for purposes of various sections of the Code). Because a U.S. shareholder's GILTI inclusion amount is determined based on the relevant items of all the CFCs of which it is a U.S. shareholder, the effect of the provision is generally to ensure that a U.S. shareholder is taxed on its GILTI wherever (and through whichever CFC) derived. See, for example, Senate Explanation at 366 (“The Committee believes that calculating GILTI on an aggregate basis, instead of on a CFC-by-CFC basis, reflects the interconnected nature of a U.S. corporation's global operations and is a more accurate way of determining a U.S. corporation's global intangible income.”).

The proposed regulations under section 951A follow an outline similar to the description in this overview. Proposed §§ 1.951A–2 through 1.951A–4 provide detailed guidance on items determined at the CFC level—that is, tested income and tested loss, QBAI, and the items necessary to determine the amount of certain interest expense that reduces net DTIR. Proposed § 1.951A–1(d) provides rules for determining the U.S. shareholder's pro rata share of these CFC-level items. Finally, proposed § 1.951A–1(c) provides rules describing the aggregation of the U.S. shareholder's pro rata share amounts to determine the shareholder's GILTI inclusion amount.

## B. General Rules and Definitions

### 1. Inclusion of GILTI in Gross Income

Proposed § 1.951A–1 provides general rules to determine a U.S. shareholder's GILTI inclusion amount and associated definitions. Some of the definitions distinguish between a CFC's taxable year and a U.S. shareholder's taxable year. For example, a “U.S. shareholder inclusion year” refers to the relevant taxable year of the U.S. shareholder and is defined as a taxable year of the U.S. shareholder that includes a CFC inclusion date (as that term is defined in the proposed regulations) of the CFC. See proposed § 1.951A–1(e)(4). A “CFC inclusion year” refers to the relevant taxable year of the CFC beginning after December 31, 2017 (the effective date of section 951A for a foreign corporation that is a CFC). See proposed § 1.951A–1(e)(2).

### 2. Determination of Net DTIR

Proposed § 1.951A–1(c)(3) defines net DTIR, which is computed at the U.S. shareholder level based on QBAI (as defined in proposed § 1.951A–3(b)) held by the shareholder's CFCs and offsets the shareholder's net CFC tested income for purposes of determining the shareholder's GILTI inclusion amount. A CFC's QBAI is equal to its aggregate average adjusted bases in specified tangible property, which is defined as tangible property used in the production of tested income. See section 951A(d)(2)(A) and proposed § 1.951A–3(c)(1). Consistent with the statute and the conference report accompanying the Act (“Conference Report”), the proposed regulations clarify that a tested loss CFC does not have specified tangible property. See H.R. Rep. No. 115–466, at 642, fn. 1536 (2017) (Conf. Rep.) and proposed § 1.951A–3(b), (c)(1), and (g)(1). Accordingly, for purposes of calculating its GILTI inclusion amount, a U.S. shareholder does not take into account the tangible property of a tested loss CFC in calculating its aggregate pro rata share of QBAI, its deemed tangible income return, or its net DTIR.

### 3. Determination of Pro Rata Share

Section 951A(e)(1) provides that, for purposes of determining a U.S. shareholder's GILTI inclusion amount, the shareholder's pro rata share of a CFC's tested income, tested loss, and QBAI “shall be determined under the rules of section 951(a)(2) in the same manner as such section applies to subpart F income.” Accordingly, the proposed regulations incorporate the pro rata share rules of section 951(a)(2) and § 1.951–1(b) and (e), with appropriate modifications to account for the differences between subpart F income, on the one hand, and tested income, tested loss, and QBAI, on the other. Similar to the determination of a U.S. shareholder's pro rata share of subpart F income, proposed § 1.951A–1(d)(1) provides that a U.S. shareholder's pro rata share of any CFC item necessary for calculating its GILTI inclusion amount is determined by reference to the stock such shareholder owns (within the meaning of section 958(a)) in the CFC (“section 958(a) stock”) as of the close of the CFC's taxable year, including section 958(a) stock treated as owned by the U.S. shareholder through a domestic partnership under proposed § 1.951A–5(c). See section I.F of this Explanation of Provisions for an explanation of proposed rules for domestic partnerships and their partners.

In several places, the provisions of proposed § 1.951A-1(d) reference section 951(a)(2) and proposed § 1.951-1(e), which amends existing § 1.951-1(e). See section II.A of this Explanation of Provisions for an explanation of the proposed modifications to § 1.951-1(e). Comments requested guidance on how to determine a preferred shareholder's pro rata share of CFC items for purposes of GILTI. Rules relating to the allocation of tested income to preferred stock are included in proposed § 1.951A-1(d)(2) by cross-reference to proposed § 1.951-1(e). In addition, the proposed regulations provide rules relating to a preferred shareholder's pro rata share of tested loss and QBAI.

A U.S. shareholder's pro rata share of tested income generally is determined in the same manner as its pro rata share of subpart F income under section 951(a)(2) and § 1.951-1(b) and (e) (that is, based on the relative amount that would be received by the shareholder in a year-end hypothetical distribution of all the CFC's current year earnings). See proposed § 1.951A-1(d)(2)(i). For purposes of determining a U.S. shareholder's pro rata share of a CFC's QBAI, the amount of QBAI distributed in the hypothetical distribution of section 951(a)(2)(A) and § 1.951-1(e) is generally proportionate to the amount of the CFC's tested income distributed in the hypothetical distribution. See proposed § 1.951A-1(d)(3)(i). However, a special rule in the proposed regulations provides that if a CFC's QBAI exceeds 10 times its tested income, so that the amount of QBAI allocated to preferred stock would exceed 10 times the tested income allocated to the preferred stock under the general proportionate allocation rule, the excess amount of QBAI is allocated solely to the CFC's common stock. See proposed § 1.951A-1(d)(3)(ii). The proposed cap on QBAI allocated to a preferred shareholder (10 times tested income) is derived from the statutory cap on the amount of QBAI that may be used to compute GILTI (10 percent of aggregate QBAI). These rules in the proposed regulations ensure that the notional "normal return" associated with the CFC's QBAI generally flows to the shareholders in a manner consistent with their economic rights in the earnings of the CFC. For illustration, see proposed § 1.951A-1(d)(3)(iii), *Examples 1 and 2*.

For purposes of determining a U.S. shareholder's pro rata share of a CFC's tested loss, the amount distributed in the hypothetical distribution is the amount of the tested loss, rather than the CFC's current earnings and profits, and the tested loss is distributed solely

with respect to the CFC's common stock, except in certain cases involving dividend arrearages with respect to preferred stock and common stock with no liquidation value. See proposed § 1.951A-1(d)(4)(i) through (iii). In the latter case, the proposed regulations provide that any amount of tested loss that would otherwise be distributed in the hypothetical distribution to a class of common stock that has no liquidation value is instead distributed to the most junior class of equity with a positive liquidation value to the extent of the liquidation value. See proposed § 1.951A-1(d)(4)(iii). In subsequent years, tested income is allocated to any class of stock to the extent that tested loss was allocated to such class in prior years under this special rule. See proposed § 1.951A-1(d)(2)(ii). In addition, the proposed regulations provide that section 951(a)(2)(B) is applied to reduce tested losses, but modified to treat the amount of a dividend received by another person as equal to the amount of the tested loss, without regard to whether an actual dividend is made by the tested loss CFC. See proposed § 1.951A-1(d)(4)(i)(D). The effect of this rule is to reduce a shareholder's pro rata share of tested loss in proportion to the number of days the shareholder did not own the stock of the tested loss CFC within the meaning of section 958(a). Each of these modifications is intended to ensure that the tested loss of a CFC is allocated to each U.S. shareholder in an amount commensurate with the economic loss borne by the shareholder by reason of the tested loss.

Proposed § 1.951A-1(d)(5) and (6) provide rules for determining a shareholder's pro rata share of "tested interest expense" and "tested interest income." Tested interest expense and tested interest income are defined in proposed § 1.951A-4, which is discussed in section I.E of this Explanation of Provisions. A U.S. shareholder's pro rata share of a CFC's tested interest expense for a taxable year equals the amount by which the CFC's tested interest expense reduces the shareholder's pro rata share of tested income, increases the shareholder's pro rata share of tested loss, or both. Conversely, a U.S. shareholder's pro rata share of tested interest income for a taxable year equals the amount by which the CFC's tested interest income increases the shareholder's pro rata share of tested income, reduces the shareholder's pro rata share of tested loss, or both. For example, tested interest income could both increase a U.S. shareholder's pro rata share of

tested income and decrease its pro rata share of tested loss if a CFC with tested income for a taxable year would have, without regard to the tested interest income, a tested loss for the taxable year.

The Department of the Treasury ("Treasury Department") and the IRS request comments on the proposed approaches for determining a U.S. shareholder's pro rata share of a CFC's QBAI and tested loss, including how (or whether) to allocate tested loss of a CFC when no class of CFC stock has positive liquidation value.

#### 4. Foreign Currency Translation

Because GILTI is computed at the U.S. shareholder level, the tested income, tested loss, tested interest expense, tested interest income, and QBAI of a CFC that uses a functional currency other than the U.S. dollar must be translated into U.S. dollars. The appropriate exchange rate under section 989(b)(3) for income inclusions under section 951(a)(1)(A) is the average exchange rate for the taxable year of the foreign corporation. GILTI inclusion amounts are similar to section 951(a)(1)(A) inclusions in that both inclusions are determined based on certain income (and, in the case of GILTI, certain losses) of the CFC for the taxable year of the CFC that ends with or within the taxable year of the U.S. shareholder. Therefore, the proposed regulations prescribe the same translation rule that is used for subpart F income for translating a pro rata share of tested income, tested loss, tested interest expense, tested interest income, and QBAI. See proposed § 1.951A-1(d)(1). Similarly, a U.S. shareholder's GILTI inclusion amount that is allocated to a tested income CFC under section 951A(f)(2) is translated from U.S. dollars into the CFC's functional currency using the average exchange rate for the taxable year of the tested income CFC. See proposed § 1.951A-6(b)(2)(iii).

#### C. Tested Income and Tested Loss

##### 1. Determination of Gross Income and Allowable Deductions

Under section 951A(c)(2), tested income and tested loss are determined by beginning with a CFC's gross income, excluding certain items (gross income after exclusions, "gross tested income"), and then subtracting properly allocable deductions determined using rules similar to the rules of section 954(b)(5). While section 951A does not specifically address which expenses of a CFC are allowable as a deduction, existing rules under § 1.952-2 apply to determine the gross income and

deductions of a CFC taken into account in determining its subpart F income. The Treasury Department and the IRS have determined that due to the similarities between gross tested income and subpart F income (for example, gross tested income and subpart F income are both determined at the CFC level and taxed to a U.S. shareholder on a current basis), and the overlap between CFCs impacted by GILTI and subpart F (since a CFC can have both tested income and subpart F income), the determinations of gross income and allowable deductions for GILTI should be made in a manner similar to the determination of subpart F income. Accordingly, the proposed regulations require that the gross income and allowable deduction determinations are made under the rules of § 1.952–2. See proposed § 1.951A–2(c)(2). Under § 1.952–2(a)(1) and proposed § 1.951A–2(c)(2), subject to the special rules in § 1.952–2(c), tested income or tested loss of a CFC is 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. Therefore, only items of deduction that would be allowable in determining the taxable income of a domestic corporation may be taken into account for purposes of determining a CFC's tested income or tested loss. If an item of a CFC would be disallowed as a deduction in determining the CFC's taxable income if the CFC were a domestic corporation, the item cannot be taken into account for purposes of determining the tested income or tested loss of the CFC even if the item reduces the CFC's earnings and profits.

The Treasury Department and the IRS request comments on the application of the rules under § 1.952–2 for purposes of determining subpart F income, tested income, and tested loss. In particular, comments are requested as to whether these rules should allow a CFC a deduction, or require a CFC to take into account income, that is expressly limited to domestic corporations under the Code. For example, questions have arisen as to whether a CFC could be entitled to a dividends received deduction under section 245A, even though section 245A by its terms applies only to dividends received by a domestic corporation. See Conf. Rep. at 599, fn. 1486. The Treasury Department and the IRS also welcome comments on other approaches to determining tested income or tested loss, including whether additional modifications should be made to § 1.952–2 for purposes of calculating GILTI.

Comments have also requested guidance on the interactions of section 163(j) and section 267A with section 951A. Issues related to sections 163(j), 245A, and 267A will be addressed in future guidance.

## 2. Income Excluded From Foreign Base Company Income and Insurance Income by Reason of Section 954(b)(4)

As noted in section I.C.1 of this Explanation of Provisions, section 951A(c)(2) requires that the gross income of the CFC for the taxable year be determined without regard to certain items. One of these items is gross income excluded from foreign base company income (as defined in section 954) or insurance income (as defined in section 953) of the CFC by reason of electing the exception under section 954(b)(4) (“high-tax exception”). In response to comments, the proposed regulations clarify that this exclusion applies only to income that is excluded from foreign base company income and insurance income *solely* by reason of an election made to exclude the income under the high-tax exception of section 954(b)(4). Accordingly, the exclusion does not apply to income that would not otherwise be subpart F income or to categories of income that do not constitute subpart F income due to exceptions other than the high-tax exception (for example, as a result of an exception to foreign personal holding company income under section 954(c)(6) or section 954(h)).

## 3. Gross Income Taken Into Account in Determining Subpart F Income

Another item excluded from gross tested income is gross income taken into account in determining a corporation's subpart F income. Comments have requested guidance on the interaction between the earnings and profits limitation to subpart F income under section 952(c), including the recapture rule in section 952(c)(2), and the determination of gross tested income for purposes of section 951A. The Treasury Department and the IRS have determined that any income described in section 952(a) is “taken into account in determining subpart F income” regardless of whether the section 952(c) limitation applies, and therefore should not be included in gross tested income. Conversely, the recapture of subpart F income under section 952(c)(2), even if by reason of earnings and profits attributable to gross tested income, does not result in excluding any amount from gross tested income. Therefore, the proposed regulations provide that tested income and tested loss are determined without regard to the application of

section 952(c). See proposed § 1.951A–2(c)(4).

## 4. Determination of Allowable Deductions Properly Allocable to Gross Tested Income

Section 951A(c)(2)(A)(ii) provides that tested income and tested loss are determined by subtracting from a CFC's gross tested income “the deductions (including taxes) 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).” Regulations under section 954(b)(5) require taxpayers to determine net subpart F income by properly allocating and apportioning deductions to the various categories of subpart F income. For this purpose, § 1.954–1(c) provides that taxpayers must first determine the gross amount of each item of income in a category of income (as described in § 1.954–1(c)(1)(iii)) and then allocate and apportion expenses to these categories under the principles of sections 861, 864, and 904(d). Accordingly, in order to apply the principles of section 954(b)(5) to section 951A (as required under section 951A(c)(2)(A)(ii)), the proposed regulations provide that allowable deductions determined under the principles of § 1.952–2 are allocated and apportioned to gross tested income under the principles of section 954(b)(5) and § 1.954–1(c), treating gross tested income that falls within a single separate category (as defined in § 1.904–5(a)(1)) as an additional category of income for this purpose. See proposed § 1.951A–2(c)(3).

Section I.D.5 of this Explanation of Provisions describes a rule that disregards basis in specified tangible property created in certain taxable transfers occurring before the effective date of section 951A for purposes of calculating QBAI. See § 1.951A–3(h)(2). These rules are cross-referenced in proposed § 1.951A–2(c)(5) to disallow any loss or deduction related to such stepped up-basis in any depreciable or amortizable property (including, for example, intangible property) for purposes of calculating tested income or tested loss.

### D. QBAI

#### 1. QBAI and Specified Tangible Property

Proposed § 1.951A–3(b) provides that a tested income CFC's QBAI for any taxable year is the average of the CFC's aggregate adjusted bases as of the close of each quarter in specified tangible property that is used in a trade or

business of the corporation and of a type with respect to which a deduction is allowable under section 167. In general, specified tangible property is tangible property used in the production of tested income. See proposed § 1.951A-3(c)(1). Tangible property is defined as property for which the depreciation deduction provided by section 167(a) is eligible to be determined under section 168 (even if the CFC has elected not to apply section 168). See proposed § 1.951A-3(c)(2). The proposed regulations define tangible property by reference to whether the property can be depreciated under section 168 because, unlike section 167, section 168 applies only to tangible property, and there is a substantial amount of guidance delineating property subject to section 168.

Property that is used in the production of both gross tested income and gross income that is not gross tested income (“dual use property”) is proportionately treated as specified tangible property. See proposed § 1.951A-3(d)(1). Generally, the proportion is determined based on the relative amount of gross tested income to income other than gross tested income that the property generates for the taxable year. See proposed § 1.951A-3(d)(2)(i). A special rule is provided for determining the proportion of the property treated as specified tangible property if the property generates no directly identifiable income (for example, because the property is used in general and administrative functions that contribute to the generation of all the income of the CFC). See proposed § 1.951A-3(d)(2)(ii).

Under § 1.167(a)-2, the depreciation allowance for tangible property applies only to that part of the property which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence. Accordingly, for purposes of section 951A, property that may be in part depreciable qualifies as specified tangible property to the extent it is depreciable. For example, precious metal used in a manufacturing process may be considered specified tangible property in part because it is depreciable in part. See Rev. Rul. 2015-11, 2015-21 I.R.B. 975.

## 2. Determination of Adjusted Basis of Specified Tangible Property

Proposed § 1.951A-3(e) provides rules to determine the adjusted basis of specified tangible property for purposes of determining QBAI. The general rule in proposed § 1.951A-3(e)(1), like section 951A(d)(3), provides that the adjusted basis in any property is

determined by using the alternative depreciation system under section 168(g) (“ADS”) and allocating the depreciation deduction with respect to the property ratably to each day during the period in the taxable year to which the depreciation relates. ADS applies for purposes of determining QBAI irrespective of whether the basis of the property is determined using another depreciation method for other purposes of the Code.

The Treasury Department and the IRS recognize that taxpayers may hold specified tangible property that was acquired before December 22, 2017, that was not depreciated using ADS. Section 951A(d) does not distinguish between property acquired before December 22, 2017, and property acquired on or after December 22, 2017. The Treasury Department and the IRS have concluded that, regardless of the date acquired, the adjusted basis in specified tangible property should be determined under ADS in order for the U.S. shareholder’s pro rata share of QBAI to be properly determined and not distorted. Therefore, the proposed regulations provide that when determining QBAI, the adjusted basis in property placed in service before December 22, 2017, is determined using ADS as if this system had applied from the date that the property was placed in service. See proposed § 1.951A-3(e)(3).

## 3. Short Taxable Year

Net DTIR is intended to reduce a U.S. shareholder’s GILTI inclusion amount by an annual return on specified tangible property. To ensure that the net DTIR of a CFC with a taxable year of less than 12 months (a “short taxable year”) reflects an annual return, the proposed regulations provide a methodology to reduce the QBAI of a CFC with a short taxable year to an amount that, if annualized, would produce an amount equal to the QBAI for a 12-month taxable year. See proposed § 1.951A-3(f).

## 4. Specified Tangible Property Held Through a Partnership

Section 951A(d)(3)<sup>1</sup> (the “partnership QBAI paragraph”) states that if a CFC holds an interest in a partnership at the close of the CFC’s taxable year, the CFC takes into account under section 951A(d)(1) its “distributive share of the aggregate of the partnership’s adjusted bases (determined as of such date in the hands of the partnership)” in specified tangible property in computing its QBAI. The partnership QBAI paragraph

further provides that a CFC’s “distributive share of the adjusted basis of any property shall be the controlled foreign corporation’s distributive share of income with respect to such property.”

The statutory language “distributive share of the aggregate of the partnership’s adjusted basis” is ambiguous because the term “distributive share” is used in subchapter K of the Code with respect to income, gain, loss, and credits of a partnership, but not the bases of assets. A partner of a partnership has a basis in its partnership interest (“outside basis”), while the partnership has a separate basis in the assets of the partnership (“inside basis”). The proposed regulations therefore use the term “share” (rather than “distributive share”) when referring to the amount of the inside basis of a partnership asset that a partner that is a CFC may include in its QBAI.

The partnership QBAI paragraph provides that a CFC “shall take into account” under section 951A(d)(1) the CFC’s distributive share of the basis in partnership specified tangible property. Because section 951A(d)(1) requires an averaging of basis over the close of each quarter of the taxable year of the CFC, and the term “distributive share” as it pertains to basis is ambiguous, it is unclear based on the statute how a CFC determines its distributive share of the basis of partnership specified tangible property for purposes of determining its QBAI. One interpretation of the partnership QBAI paragraph is that a CFC partner’s QBAI is increased by an amount equal to the CFC partner’s share of the basis that the partnership has in its specified tangible property as of the close of the CFC partner’s taxable year. However, that interpretation would be contrary to the requirement in section 951A(d)(1) that the CFC’s bases in specified tangible property be averaged over four quarters. Furthermore, giving the term “distributive share” effect, the amount determined at the end of the CFC partner’s taxable year should be reduced for any period during the taxable year when the partnership did not own the property, whereas a CFC partner of a partnership that disposed of property before the close of the CFC’s taxable year would receive no QBAI benefit if there were a single measurement date. In addition, a requirement that a partnership’s basis in specified tangible property be measured on the last day of a CFC partner’s taxable year could be burdensome for partnerships that have one or more CFC partners with taxable years that do not coincide with the partnership’s taxable

<sup>1</sup> As enacted, section 951A(d) contains two paragraphs designated as paragraph (3).

year and, in those cases, would have the effect of decoupling the CFC partner's share of the basis of partnership property used to compute the CFC partner's QBAI from the CFC partner's distributive share of the partnership's income from the property that is taken into account in computing the CFC partner's tested income. Moreover, because depreciation is treated as reducing the adjusted basis of property on each day during the taxable year, calculating a partnership's basis on the final day of the CFC partner's taxable year will generally result in an artificially low basis relative to calculating average adjusted basis over the course of the partnership's taxable year. For the foregoing reasons, the proposed regulations determine a CFC partner's share of the partnership's adjusted basis in specified tangible property by reference to the partnership's average adjusted basis in the property as of the close of each quarter of the partnership's taxable year that ends with or within the CFC's taxable year. See proposed § 1.951A-3(g)(3).

A partner that is a CFC takes into account its share of the adjusted basis of specified tangible property held by a partnership in computing QBAI if, among other things, the property "is used in the production of tested income (determined with respect to such controlled foreign corporation's distributive share of income with respect to such property)." Section 951A(d)(3)(C). Consistent with the general rule for QBAI, only a tested income CFC can increase its QBAI by reason of specified tangible property owned by a partnership. See proposed § 1.951A-3(g)(1). Further, consistent with the parenthetical in the partnership QBAI paragraph, the proposed regulations provide that a CFC partner determines its share of the partnership's average adjusted basis in specified tangible property based on the amount of its distributive share of the gross income produced by the property that is included in the CFC partner's gross tested income relative to the total amount of gross income produced by the property. See proposed § 1.951A-3(g)(2). The proposed regulations incorporate the dual use property rule of section 951A(d)(2)(B) in the context of specified tangible property owned indirectly through a partnership and include similar rules for addressing specified tangible property that does not produce any directly identifiable income. The calculation is performed separately for each item of specified tangible property held by the

partnership, taking into account the CFC partner's distributive share of income with respect to such property.

The Treasury Department and the IRS request comments on the proposed approach to specified tangible property held through a partnership, including the rules addressing specified tangible property that does not produce directly identifiable income.

#### 5. Anti-Abuse Provisions

Section 951A(d)(4) provides that "[t]he Secretary shall issue such regulations or other guidance as the Secretary determines appropriate to prevent the avoidance of the purposes of this subsection, including regulations or other guidance which provide for the treatment of property if—(A) such property is transferred, or held, temporarily, or (B) the avoidance of the purposes of this paragraph is a factor in the transfer or holding of such property." The Conference Report describes the scope of section 951A(d)(4), stating that "[t]he conferees intend that non-economic transactions intended to affect tax attributes of CFCs and their U.S. shareholders (including amounts of tested income and tested loss, tested foreign income taxes, net deemed tangible income return, and QBAI) to minimize tax under this provision be disregarded." Conf. Rep. at 645. One specific example illustrated in the Conference Report is a transaction that occurs after the measurement date of post-1986 earnings and profits under section 965 but before the first taxable year for which section 951A is effective in order to increase a CFC's QBAI. Id.

Consistent with section 951A(d)(4) and the Conference Report, as well as the Secretary's broad authority under section 7805(a) to "prescribe all needful rules and regulations for the enforcement of" the Code, the proposed regulations provide that specified tangible property of a tested income CFC is disregarded for purposes of determining the tested income CFC's average aggregate basis in specified tangible property if the tested income CFC acquires the property with a principal purpose of reducing the GILTI inclusion amount of a U.S. shareholder and holds the property temporarily but over at least one quarter end. See proposed § 1.951A-3(h)(1). For this purpose, property held for less than a twelve month period that includes at least one quarter end during the taxable year of a tested income CFC is treated as temporarily held and acquired with a principal purpose of reducing the GILTI inclusion amount of a U.S. shareholder. Id.

The Treasury Department and the IRS are aware that taxpayers are engaging in transactions like the ones described in the Conference Report involving taxable transfers of property from one CFC to another CFC before the first taxable year of the transferor CFC to which section 951A applies in order to provide the transferee CFC with a stepped-up basis in the transferred property that, for example, may increase a U.S. shareholder's amount of QBAI with respect to the CFC for periods when it is subject to section 951A. See Conf. Rep. at 645. The stepped-up basis may also reduce the transferee CFC's tested income or increase its tested loss (for example, due to increased depreciation or amortization deductions) during periods when it is subject to section 951A. The Treasury Department and the IRS have determined that it would be inappropriate for a taxpayer to reduce its GILTI inclusion amount for any taxable year by reason of a stepped-up basis in CFC assets attributable to transactions between related CFCs during the period after December 31, 2017, but before the effective date of section 951A. Accordingly, the proposed regulations disallow the benefit of a stepped-up basis in specified tangible property transferred between related CFCs during the period before the transferor CFC's first inclusion year for purposes of calculating the transferee CFC's QBAI. See proposed § 1.951A-3(h)(2). As discussed in section I.C.4 of this Explanation of Provisions, these rules are also cross-referenced in proposed § 1.951A-2(c)(5) to disregard a stepped-up basis in any property that is depreciable or amortizable for purposes of calculating tested income and tested loss.

The U.S. tax results claimed with respect to transactions that fall outside the scope of the anti-abuse rules in the proposed regulations may, nonetheless, be challenged under other statutory provisions or judicial doctrines.

#### E. Specified Interest Expense

To calculate a U.S. shareholder's net DTIR, section 951A(b)(2)(B) provides that 10 percent of the aggregate of the shareholder's pro rata share of the QBAI of each CFC (defined as "deemed tangible income return" in proposed § 1.951A-1(c)(3)(ii)) is reduced by "the amount of interest expense taken into account under subsection (c)(2)(A)(ii) in determining such shareholder's net CFC tested income for the taxable year to the extent the interest income attributable to such expense is not taken into account in determining such shareholder's net CFC tested income." Deductions taken

into account under section 951A(c)(2)(A)(ii) are deductions (including taxes) that are properly allocable to gross tested income for purposes of calculating tested income and tested loss. Thus, only a U.S. shareholder's pro rata share of interest expense that is currently deductible and properly allocable to gross tested income is taken into account for purposes of determining the interest expense described in section 951A(b)(2)(B). For purposes of the proposed regulations, interest expense described in section 951A(b)(2)(B) is referred to as "specified interest expense." See proposed § 1.951A-1(c)(3)(iii).

Specified interest expense is a U.S. shareholder-level determination which is net of "attributable" interest income taken into account by the U.S. shareholder. Specifically, specified interest expense of a U.S. shareholder is its pro rata share of interest expense properly allocable to gross tested income reduced by its pro rata share of interest income included in gross tested income to the extent attributable to such interest expense. The effect of this formulation is to count against net DTIR only a U.S. shareholder's pro rata share of interest expense allocable to gross tested income to the extent that the related interest income is not also reflected in the U.S. shareholder's pro rata share of the tested income of another CFC, such as in the case of third-party interest expense or interest expense paid to related U.S. persons.

The amount of interest income "attributable" to interest expense is not defined in section 951A(b)(2)(B). Accordingly, it is necessary to define this concept in the proposed regulations. A definition that incorporates a strict tracing approach would require a U.S. shareholder to determine each item of interest expense with respect to each debt instrument of each of its CFCs to determine whether, and to what extent, the interest income with respect to that debt instrument is taken into account by the U.S. shareholder in determining the shareholder's net CFC tested income. However, the Treasury Department and the IRS have determined that a tracing approach for specified interest expense would be administratively burdensome and difficult to reconcile with the framework of section 951A, which generally requires a determination of CFC-level items followed by a second determination of U.S. shareholder-level aggregate pro rata shares of such items. A tracing approach for specified interest expense would necessitate a hybrid determination, in which the relevant

item—"attributable" interest income—could not be determined at the level of the CFC, but rather would require a matching at the U.S. shareholder level of the shareholder's pro rata share of each item of interest expense with its pro rata share of each item of interest income attributable to such interest expense. A tracing approach would create particular complexity with respect to interest paid between CFCs that are owned by different U.S. shareholders in different proportions or with respect to interest for which the accrual of the expense and inclusion of the income occur in separate taxable years.

The Treasury Department and the IRS have instead determined that a netting approach to specified interest expense accomplishes the purpose of the specified interest expense rule in a more administrable manner and is consistent with the requirement that "attributable" interest income be netted against interest expense. Therefore, the proposed regulations provide that a U.S. shareholder's specified interest expense is the excess of its aggregate pro rata share of the tested interest expense of each CFC over its aggregate pro rata share of the tested interest income of each CFC. See proposed § 1.951A-1(c)(3)(iii). Tested interest expense and tested interest income are generally defined by reference to all interest expense and interest income that is taken into account in determining a CFC's tested income or tested loss. See proposed § 1.951A-4(b)(1) and (2).

Comments have questioned whether interest expense of a captive finance CFC must be taken into account for purposes of determining a U.S. shareholder's specified interest expense, or whether the related interest income from unrelated customers may be available to offset such interest expense. Under a netting approach to the computation of specified interest expense, without modifications, whether a CFC's active banking business increases or reduces the specified interest expense of a U.S. shareholder relative to other taxpayers depends on whether the third-party expense related to such business is greater than or less than interest income related to such business. The Treasury Department and the IRS have determined that a U.S. shareholder's specified interest expense, and therefore its net DTIR and its GILTI inclusion amount, should not depend on whether the U.S. shareholder has one or more CFCs engaged in the active conduct of a financing or insurance business, as long as the interest expense of the CFC is incurred exclusively to fund such business with unrelated

persons and thus not incurred, for instance, to fund the acquisition of specified tangible property. Therefore, the proposed regulations exclude from the definition of tested interest expense any interest expense of a CFC that is an eligible controlled foreign corporation (within the meaning of section 954(h)(2)) or a qualifying insurance company (within the meaning of section 953(e)(3)) ("qualified CFC"), except to the extent of the qualified CFC's assets unrelated to its financing or insurance business and any interest income received by the qualified CFC from loans to certain related persons (interest expense described in this sentence, "qualified interest expense"). See proposed § 1.951A-4(b)(1)(iii). Further, the proposed regulations exclude from the definition of tested interest income any interest income of a qualified CFC included in the gross tested income of the qualified CFC for the CFC inclusion year that is excluded from subpart F income due to the active financing exception of section 954(h) or the active insurance exception of section 954(i) ("qualified interest income"). See proposed § 1.951A-4(b)(2)(iii).

For purposes of determining specified interest expense, interest income and interest expense are defined broadly to encompass any amount treated as interest under the Code or regulations, and any other amount incurred or recognized in a transaction or series of integrated or related transactions in which the use or forbearance of funds is secured for a period of time if the expense or loss is predominately incurred in consideration of the time value of money. See proposed § 1.951A-4(b)(1)(ii) and (2)(ii).

Comments requested clarification of whether the interest expense of a tested loss CFC is used in the determination of specified interest expense. Regardless of whether interest expense increases tested loss or reduces tested income, the expense is "taken into account. . . in determining the shareholder's net CFC tested income" within the meaning of section 951A(b)(2)(B). In addition, if a tested loss CFC's interest expense were not taken into account for purposes of determining specified interest expense, a taxpayer could easily avoid specified interest expense by incurring offshore debt through a tested loss CFC. Therefore, the proposed regulations confirm that any interest expense taken into account for purposes of determining the tested income or tested loss of a CFC is also taken into account in determining a U.S. shareholder's specified interest expense.

### *F. Domestic Partnerships and Their Partners*

Comments requested guidance on the treatment of domestic partnerships that own stock of CFCs. Section 951A itself does not contain any specific rules on domestic partnerships and their partners that directly or indirectly own stock of CFCs. Accordingly, proposed § 1.951A-5 provides this guidance to domestic partnerships and their partners on how to compute their GILTI inclusion amounts. This guidance also applies to S corporations and their shareholders, which are treated as partnerships and partners for purposes of sections 951 through 965. See section 1373.

A domestic partnership is a U.S. person by definition under section 7701(a)(4) and (30) and can therefore be a U.S. shareholder of a CFC under section 951(b). Under current law, a domestic partnership that is a U.S. shareholder includes in gross income its section 951(a)(1)(A) inclusion with respect to a CFC, and its partners include in gross income their distributive share of such inclusion. However, as noted in section I.A of this Explanation of Provisions, there is no analog in section 951(a)(1)(A) to the U.S. shareholder-level determinations required by section 951A, and thus the level at which the section 951(a)(1)(A) determination is made—whether at the level of the partnership or its partners—does not generally affect the amount of the inclusion, if the partnership and its partners are all U.S. shareholders. On the other hand, the GILTI inclusion amount is an aggregation of the U.S. shareholder's pro rata shares of tested income, tested loss, QBAI, tested interest expense, and tested interest income of each of its CFCs. Thus, the level at which the GILTI calculation is made dictates the CFC items to be taken into account by the shareholder, and each of these items can impact the shareholder's GILTI inclusion amount.

The Treasury Department and the IRS considered a number of approaches to applying section 951A with respect to domestic partnerships and their partners. A pure aggregate approach to the treatment of domestic partnerships and their partners would treat the partnership as an aggregate of its partners, so that each partner would calculate its own GILTI inclusion amount taking into account its pro rata share of CFC items through the partnership. However, a pure aggregate approach might also be interpreted by taxpayers to exempt small partners of a domestic partnership from the GILTI regime entirely, a result that is not

clearly contemplated in section 951A or its legislative history and is inconsistent with section 951.

The Treasury Department and the IRS also considered a pure entity approach. Under a pure entity approach, the domestic partnership would determine its own GILTI inclusion amount, and each partner would take into gross income its distributive share of such amount. In the case of a partner that is a U.S. shareholder of CFCs owned by the partnership and other CFCs outside the partnership, a pure entity approach would effectively fragment the shareholder's GILTI inclusion amount into multiple GILTI inclusion amounts by separating the items of the CFCs owned by the shareholder through the partnership from the items of the CFCs owned by the shareholder outside the partnership, including through other domestic partnerships. An approach that dramatically alters a U.S. shareholder's inclusion under section 951A for a taxable year depending on the legal structure by which the shareholder owns each CFC presents both an inappropriate planning opportunity as well as a trap for the unwary. Such an approach is also inconsistent with the structure of section 951A, which requires an aggregation of all relevant items of a shareholder's CFCs in order to compute a single GILTI inclusion amount for a U.S. shareholder. As discussed in section III.A of this Explanation of Provisions, the Treasury Department and the IRS relied on similar considerations in concluding that the relevant items of each CFC owned directly or indirectly by members of a consolidated group should be taken into account in determining the GILTI inclusion amount of each member of that group.

In addition, the Treasury Department and the IRS have concluded that other provisions that are related to, and interdependent with, section 951A should apply at the level of a domestic corporate partner. Section 960(d) provides a domestic corporation that is a U.S. shareholder a credit for foreign taxes paid by a CFC that are properly attributable to tested income “taken into account” by the domestic corporation, and determines the amount of that credit by reference to the corporation's aggregate pro rata share of tested income. See section 960(d)(2)(B) and (3). A domestic partnership is not eligible to claim deemed paid credits under section 960(d). Furthermore, under a pure entity approach, a domestic corporate partner of a domestic partnership may not be eligible for a deemed paid credit by reason of its

distributive share of the partnership's GILTI inclusion because a partner would not have a pro rata share of the tested income of any CFC owned by the partnership, and thus it would not take into account the tested income of any such CFC. Similarly, only a domestic corporation is eligible for a section 250 deduction. Nonetheless, the Conference Report indicates that the domestic corporate partners of a domestic partnership should get the benefit of a section 250 deduction, which is consistent with an aggregate approach. See Conf. Rep. at 623, fn. 1517.

Based on the foregoing, the Treasury Department and the IRS have determined that the approach that best harmonizes the treatment of domestic partnerships and their partners across all provisions of the GILTI regime (sections 250, 951A, and 960(d)) is neither a pure aggregate nor a pure entity approach. Rather, the most harmonious approach treats a domestic partnership as an entity with respect to partners that are not U.S. shareholders of any CFC owned by the partnership, but treats the partnership as an aggregate for purposes of partners that are themselves U.S. shareholders with respect to one or more CFCs owned by the partnership. This approach ensures that each non-U.S. shareholder partner takes into income its distributive share of the domestic partnership's GILTI inclusion amount (similar to subpart F), while permitting a partner that is itself a U.S. shareholder to determine a single GILTI inclusion amount by reference to all its CFCs, whether owned directly or through a partnership, as well as allowing a corporate U.S. shareholder to calculate a foreign tax credit under section 960(d) with respect to each such CFC and to compute a section 250 deduction with respect to its GILTI inclusion amount determined by reference to each such CFC.

Therefore, the proposed regulations provide that, in general, a domestic partnership that is a U.S. shareholder of one or more CFCs (“U.S. shareholder partnership”) computes its own GILTI inclusion amount in the same manner as any other U.S. shareholder, and each partner takes into account its distributive share of the domestic partnership's GILTI inclusion amount under section 702 and § 1.702-1(a)(8)(ii). See proposed § 1.951A-5(b). However, for purposes of section 951A and the proposed regulations, a partner that is itself a U.S. shareholder (within the meaning of section 951(b)) (“U.S. shareholder partner”) of one or more CFCs owned directly or indirectly by a domestic partnership (“partnership CFC”) is treated as owning



proportionately section 958(a) stock in each such partnership CFC as if the partnership were a foreign partnership. See proposed § 1.951A-5(c). As a result, a partner that is itself a U.S. shareholder of a CFC owned by a domestic partnership computes its GILTI inclusion amount for a taxable year by taking into account its proportionate share of the partnership's pro rata share of each of the relevant items—tested income, tested loss, QBAI, tested interest income, and tested interest expense—of such CFC. This rule applies regardless of whether the domestic partnership itself has a GILTI inclusion amount for the taxable year. See proposed § 1.951A-5(g), *Example 6*. In the case that a partner is treated as owning the section 958(a) stock of one or more partnership CFCs, the partner's distributive share of the partnership's GILTI inclusion amount is determined solely by reference to partnership CFCs in which the partner is not a U.S. shareholder. See proposed § 1.951A-5(c) and (g), *Example 3*. A U.S. shareholder partnership is therefore required to provide to its partners their distributive share of the partnership's GILTI inclusion amount, as well as provide to each U.S. shareholder partner the partner's proportionate share of the partnership's pro rata share (if any) of each CFC tested item of each partnership CFC of the partnership, and forms and instructions will be updated accordingly. See proposed § 1.951A-5(f).

To illustrate the differences between the approach taken in the proposed regulations and the pure entity approach, consider a domestic partnership (PRS) with two domestic corporate partners, US1 and US2, owning 5 percent and 95 percent of PRS, respectively. PRS owns 100 percent of the single class of stock of FS1, a CFC with tested income of \$100x, and 100 percent of the single class of stock of FS2, a CFC with tested loss of \$50x. US2 also owns 100 percent of the single class of stock of FS3, a CFC with tested loss of \$20x. Under a pure entity approach, US2's distributive share of PRS's GILTI inclusion amount would be \$47.50x ( $95\% \times (\$100x - \$50x)$ ), and US2's pro rata share of FS3's tested loss of \$20x would be unused. Under the proposed regulations, US2, because it is a U.S. shareholder partner with respect to FS1 and FS2, aggregates its proportionate share of the tested income and tested loss of FS1 and FS2 with its pro rata share of the tested loss of FS3 in determining its GILTI inclusion amount of \$27.50x ( $(95\% \times (\$100x - \$50x)) - \$20x$ ). Accordingly,

under a pure entity approach, US2 would be incentivized to reorganize its ownership structure (for example, by liquidating PRS or contributing the stock of FS3 to PRS) in order to obtain the full benefit of the tested loss of FS3. Under the proposed regulations, however, US2 has the same GILTI inclusion amount whether it owns its CFCs directly or through one or more partnerships.

The Treasury Department and the IRS request comments as to whether any other approach to the treatment of domestic partnerships and their partners for purposes of section 951A, including a pure entity approach or a pure aggregate approach, would more appropriately harmonize the provisions of the GILTI regime than the approach of the proposed regulations, particularly in light of the administrative and compliance burdens associated with any other approach and the approach of the proposed regulations. In addition, the Treasury Department and the IRS request comments on adjustments required by reason of computing a GILTI inclusion amount, in whole or in part, at the level of the partner of a domestic partnership, including adjustments to the partner's basis in its partnership interest, the partner's section 704(b) capital account, the partnership's basis in CFC stock under section 961, and a CFC's previously taxed earnings and profits with respect to the partner or partnership under section 959.

#### *G. Treatment of GILTI Inclusion Amount and Adjustments to Earnings and Profits and Basis*

##### 1. Treatment of GILTI as Subpart F Income for Certain Purposes

A U.S. shareholder's GILTI inclusion amount is not an inclusion under section 951(a)(1)(A). Nevertheless, for purposes of some provisions, GILTI inclusion amounts are treated similarly to section 951(a)(1)(A) inclusions. Section 951A(f)(1)(A) provides that any GILTI included in gross income is treated in the same manner as an amount included under section 951(a)(1)(A) for purposes of applying sections 168(h)(2)(B), 535(b)(10), 851(b), 904(h)(1), 959, 961, 962, 993(a)(1)(E), 996(f)(1), 1248(b)(1), 1248(d)(1), 6501(e)(1)(C), 6654(d)(2)(D), and 6655(e)(4).

Section 951A(f)(1)(B) grants the Secretary authority to provide rules applying section 951A(f)(1)(A) to other provisions of the Code. A comment requested clarification as to whether GILTI inclusion amounts are net investment income under section 1411. Pursuant to the authority in section

951A(f)(1)(B), the proposed regulations provide that a GILTI inclusion amount is treated in the same manner as an amount included under section 951(a)(1)(A) for purposes of applying section 1411. See proposed § 1.951A-6(b)(1). Thus, for example, a U.S. shareholder that has made an election pursuant to § 1.1411-10(g) with respect to a CFC to treat amounts included in gross income under section 951(a)(1)(A) as net investment income and to apply the basis adjustment rules of sections 961(a) and (b) with respect to such amounts for section 1411 purposes should also treat the portion of the U.S. shareholder's GILTI inclusion amount treated as being with respect to the CFC under section 951A(f)(2) and proposed § 1.951A-6(b)(2) as net investment income.

Comments have requested that regulations clarify that an inclusion under section 951A is determined before an inclusion under section 951(a)(1)(B). The Treasury Department and the IRS have determined that clarification is unnecessary. Because a GILTI inclusion amount is treated as a section 951(a)(1)(A) inclusion for purposes of section 959, the determination of the amount included under section 951(a)(1)(B) is made after the determination of the amount of a section 951(a)(1)(A) inclusion and the GILTI inclusion amount. See section 959(a)(2) and (f)(1). The Treasury Department and the IRS intend to issue a separate notice of proposed rulemaking to update the regulations under sections 959 and 961 to account for the Act's modifications to the U.S. international tax system, including the enactment of section 245A.

The characterization of GILTI inclusions for purposes of determining the unrelated business taxable income of tax-exempt entities will be addressed in separate guidance. The Treasury Department and the IRS request comments on other areas in which the characterization of a GILTI inclusion amount is relevant, and whether it is appropriate in those areas to treat a GILTI inclusion amount in the same manner as a section 951(a)(1)(A) inclusion or in some other manner (for example, as a dividend).

##### 2. Interaction With Sections 163(e)(3)(B)(i) and 267(a)(3)(B)

Section 267(a)(3)(B) generally provides that a deduction for an item payable to a related CFC is not allowed until paid, except to the extent that an amount attributable to that item is includible (determined without regard to properly allocable deductions and qualified deficits) in the gross income of

a U.S. shareholder. Section 163(e)(3)(B)(i) provides a similar rule for original issue discount on a debt instrument held by a related CFC.

The Treasury Department and the IRS have determined that deductions should not be deferred under sections 163(e)(3)(B)(i) and 267(a)(3)(B) to the extent an item is taken into account in determining a U.S. shareholder's GILTI inclusion amount. Accordingly, the proposed regulations provide that a deduction is allowed under sections 163(e)(3)(B)(i) and 267(a)(3)(B) for an item taken into account in determining the net CFC tested income of a U.S. shareholder, including a U.S.

shareholder treated under the proposed regulations as owning section 958(a) stock of a CFC owned by a domestic partnership. See proposed § 1.951A-6(c)(1). In the case of a U.S. shareholder that is a domestic partnership, this rule applies only to the extent that one or more U.S. persons (other than domestic partnerships) that are direct or indirect partners of the domestic partnership include in gross income their distributive share of the partnership's GILTI inclusion amount or the item is taken into account by a U.S. shareholder partner of the domestic partnership by reason of § 1.951A-5(c). See proposed § 1.951A-6(c)(2).

### 3. Basis Adjustments for the Use of Tested Losses

In determining a U.S. shareholder's net CFC tested income, the U.S. shareholder's pro rata share of a tested loss of one CFC may offset the shareholder's pro rata share of tested income of another CFC. Under the statute, such a use of a tested loss does not reduce the U.S. shareholder's basis in the stock of the tested loss CFC, increase the stock basis of the tested income CFC, or affect the earnings and profits of either the tested loss CFC or the tested income CFC.

The Treasury Department and the IRS have determined that in certain cases the lack of adjustments to stock basis of a tested loss CFC can lead to inappropriate results. For example, if the U.S. shareholder's basis in the stock of the tested loss CFC is not reduced to reflect the use of the tested loss to offset tested income taken into account by the U.S. shareholder, the U.S. shareholder would recognize a second and duplicative benefit of the loss—either through the recognition of a loss or the reduction of gain—if the stock of the tested loss CFC is disposed of. See *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62 (1934) (denying the loss on stock of subsidiaries upon liquidation when operating losses were previously

claimed from the subsidiaries' operations because “[i]f allowed, this would be the practical equivalent of double deduction”); *U.S. v. Skelly Oil Co.*, 394 U.S. 678 (1969) (“the Code should not be interpreted to allow respondent ‘the practical equivalent of a double deduction’” (citing *Charles Ilfeld Co.*)); § 1.161-1. On the other hand, in the case of a corporate U.S. shareholder, but not in the case of an individual, gain recognized on the disposition of a CFC attributable to offset tested income would, in most cases, be eliminated as a result of the application of section 964(e) or section 1248(a) and (j), to the extent the gain is recharacterized as a dividend that is eligible for the dividends received deduction under section 245A. Accordingly, proposed § 1.951A-6(e) generally provides that in the case of a corporate U.S. shareholder (excluding regulated investment companies and real estate investment trusts), for purposes of determining the gain, loss, or income on the direct or indirect disposition of stock of a CFC, the basis of the stock is reduced by the amount of tested loss that has been used to offset tested income in calculating net CFC tested income of the U.S. shareholder. The basis reduction is only made at the time of the disposition and therefore does not affect the stock basis prior to a disposition. Requiring the basis reduction only at the time of the disposition prevents the use of tested losses alone from causing the recognition of gain if the reduction exceeds the amount of stock basis.

The basis adjustments apply only to the extent a “net” tested loss of the controlled foreign corporation has been used. This limitation is intended to ensure that the reduction applies only to the extent necessary to eliminate the duplicative loss in the stock. For example, if a \$100x tested loss of a CFC (CFC1) offsets \$100x of tested income of another CFC (CFC2) in one year in determining a U.S. shareholder's net CFC tested income, and in the next year CFC1 has \$20x of tested income that is offset by a \$20x tested loss of CFC2, then the \$100x used tested loss attributable to the CFC1 stock from the first year is reduced by the \$20x of its tested income from the second year that was offset by the tested loss of CFC2, resulting in a “net” used tested loss of \$80x. See proposed § 1.951A-6(e)(2).

Similar adjustments apply when the tested loss CFC is treated as owned by the U.S. shareholder through certain intervening foreign entities by reason of section 958(a)(2) to prevent the indirect use of the duplicative loss through the disposition of interests in those intervening entities. The regulations

provide an exception to those rules in certain cases when the tested loss CFC and the CFC that generated the tested income that is offset by the tested loss are in the same section 958(a)(2) ownership chain; adjustments are not appropriate in these cases because there is no duplicative loss to the extent the shares of both CFCs are directly or indirectly disposed of. See proposed § 1.951A-6(e)(1)(ii).

A direct disposition of the stock of a CFC can result in the indirect disposition of the stock of one or more lower-tier CFCs. See proposed § 1.951A-6(e)(6)(ii)(B). In such a case, basis adjustments may be made to both the stock of the upper-tier CFC and the stock of the lower-tier CFCs. Accordingly, the proposed regulations provide ordering rules for making these adjustments that, in general, are intended to prevent gain resulting from a basis adjustment attributable to the use of a single tested loss from being taken into account more than once. See proposed § 1.951A-6(e)(1)(iv).

The proposed regulations also include rules that take into account certain nonrecognition transactions involving CFCs, such as the acquisition of CFC stock by a domestic corporation and transactions described in section 381. See proposed § 1.951A-6(e)(4)(ii) and (e)(5). These rules are intended to prevent the elimination or avoidance of the basis adjustments through these types of transactions.

Finally, the proposed regulations provide a special rule to address dispositions of CFC stock by another CFC that is not wholly owned by a single domestic corporation. See proposed § 1.951A-6(e)(7). This rule, which is consistent with proposed § 1.961-3(b) and Revenue Ruling 82-16, 1982-1 C.B. 106, is intended to ensure that the appropriate amount of subpart F income is taken into account by U.S. shareholders of the CFC as a result of the disposition.

The Treasury Department and the IRS request comments on these rules, including whether additional adjustments to stock basis or earnings and profits should be made to account for a used tested loss or offset tested income (for example, whether adjustments should be provided that are consistent with those set forth in proposed § 1.965-2(d) and (f) (REG-104226-18, 83 FR 39514, August 9, 2018)). Comments are also requested on whether similar rules should apply to non-corporate U.S. shareholders, taking into account the fact that non-corporate U.S. shareholders are not entitled to a dividends received deduction under section 245A. Additionally, comments

are requested as to whether the definition of “disposition” should be modified. For example, the Treasury Department and the IRS are considering broadening the term to include transactions that do not involve an actual transfer of stock but might result in taxable gain but for the presence of tax basis in CFC stock. Examples of such transactions include distributions subject to section 301(c)(2) or 1059.

## II. Section 951

### A. Pro Rata Share Rules

Section 1.951–1(e) was revised in 2005 and 2006 to address certain avoidance structures, such as structures that resulted in non-economic allocations of subpart F income to shareholders of CFCs that are not U.S. shareholders. The Treasury Department and the IRS have become aware of additional avoidance structures. For example, the existing regulations require an allocation of earnings and profits between classes of stock with discretionary distribution rights based on the fair market value of the stock. While this rule appropriately allocates subpart F income in some cases (for example, involving multiple classes of common stock), some taxpayers have attempted to improperly allocate subpart F income by applying these rules to certain structures involving shares with preferred liquidation and distribution rights. Similar avoidance structures involve cumulative preferred stock with dividends that compound less frequently than annually.

This notice of proposed rulemaking proposes to amend § 1.951–1(e) to address these avoidance structures, which implicate section 951A as well as section 951. The proposed regulations clarify that, for purposes of determining a U.S. shareholder’s pro rata share of subpart F income, earnings and profits for the taxable year are first hypothetically distributed among the classes of stock and then hypothetically distributed to each share in the class on the hypothetical distribution date, which is the last day of the CFC’s taxable year on which it is a CFC. In lieu of prescribing a determination based on fair market value, the proposed regulations provide that the amount of earnings and profits that would be distributed with respect to classes of stock is based on all relevant facts and circumstances. See proposed § 1.951–1(e)(3). In addition, the proposed regulations disregard any transaction or arrangement that is part of a plan a principal purpose of which is to reduce a U.S. shareholder’s pro rata share of the subpart F income of a CFC. See

proposed § 1.951–1(e)(6). This rule also applies for purposes of determining a U.S. shareholder’s pro rata share of amounts for purposes of calculating the shareholder’s GILTI inclusion amount. *Id.* As a result of adding this broader rule, the proposed regulations do not include the specific anti-avoidance rule involving section 304 transactions in existing § 1.951–1(e)(3)(v).

The proposed regulations also modify § 1.951–1(e) in specific ways to take into account section 951A. For example, the proposed regulations provide that a U.S. shareholder’s pro rata share of a CFC’s subpart F income is determined by reference to the shareholder’s proportionate share of the total current earnings and profits that would be distributed in the hypothetical distribution. In addition to determining a U.S. shareholder’s pro rata share of a CFC’s subpart F income, § 1.951–1(e) also applies for purposes of determining the shareholder’s pro rata share of the CFC’s tested income. See also proposed § 1.951A–1(d)(2). However, because tested income is not limited to the earnings and profits of a CFC, and because a CFC’s tested loss increases its earnings and profits for purposes of determining the subpart F income limitation in section 952(c)(1), the earnings and profits allocated in the hypothetical distribution may exceed the earnings and profits of the CFC computed under section 964. Accordingly, the hypothetical distribution in the proposed regulations is based on the greater of the section 964 earnings and profits or the sum of the subpart F income (increased by reason of any tested loss add-back under section 951A(c)(2)(B)(ii) and proposed § 1.951A–6(d)) and tested income of the CFC.

### B. Partnership Blocker Structures

Notice 2010–41, 2010–22 I.R.B. 715, stated that forthcoming regulations would treat a domestic partnership as a foreign partnership for purposes of identifying the U.S. shareholder of a CFC required to include in gross income its pro rata share of the CFC’s subpart F income in the circumstances described in the notice. The Treasury Department and the IRS have determined that the same rules should also apply to identify the U.S. shareholder of a CFC for purposes of section 951A. Accordingly, the proposed regulations treat certain controlled domestic partnerships as foreign partnerships for purposes of identifying a U.S. shareholder for purposes of sections 951 through 964. See also proposed § 1.965–1(e) (REG–104226–18, 83 FR 39514, August 9,

2018) (adopting a similar partnership blocker rule for purposes of the section 965 regulations).

### C. Other Modifications

The proposed regulations also update § 1.951–1 consistent with the modification in the Act of the definition of a U.S. shareholder and the elimination in the Act of the 30-day requirement. See proposed § 1.951–1(a) and (g)(1).

## III. Section 1502

### A. In General

Section 1502 provides the Secretary authority to

prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

A consolidated group member’s inclusion of subpart F income under section 951(a)(1)(A) is determined at the member level. However, as discussed in section I.A of this Explanation of Provisions, a section 951(a)(1)(A) inclusion with respect to a CFC is determined solely by reference to the subpart F income of the CFC, and therefore determining a member’s section 951(a)(1)(A) inclusion solely by reference to a CFC the stock of which is owned (within the meaning of section 958(a)) by the member is not distortive of the consolidated group’s income tax liability. As a result, the location of the CFC within the group generally has no effect on the consolidated group’s income tax liability by reason of section 951(a)(1)(A). In contrast, section 951A requires an aggregate, U.S. shareholder-level calculation, under which a member’s pro rata share of the relevant items of one CFC can increase or decrease a member’s GILTI inclusion amount otherwise resulting from its ownership of another CFC. Accordingly, a determination of a member’s GILTI inclusion amount solely based on its pro rata share of the items of a CFC the stock of which is owned (within the meaning of section 958(a)) by that member may not result in a clear reflection of the consolidated group’s income tax liability. For example, a consolidated group could segregate one CFC with tested interest expense under one member and another CFC with QBAI under another member, thereby increasing the net DTIR of the second

member relative to the consolidated group's net DTIR if determined at a group level. Alternatively, a strict, separate-entity application of section 951A could inappropriately increase a consolidated group's income tax liability, because one member's excess pro rata share of tested losses or QBAI over tested income would be unavailable to reduce another member's GILTI inclusion amount.

#### B. Section 1.1502-51

In response to comments, the Treasury Department and the IRS have determined that a member's GILTI inclusion amount should be determined by reference to the relevant items of each CFC owned by members of the same consolidated group. As discussed in section I.A of this Explanation of Provisions, a U.S. shareholder includes in gross income its GILTI inclusion amount for any taxable year. GILTI inclusion amount is defined under proposed § 1.951A-1(c)(1) as, with respect to a U.S. shareholder for a taxable year of the shareholder, the excess (if any) of the shareholder's net CFC tested income over the shareholder's net DTIR for the taxable year. Under proposed § 1.1502-51, this definition applies equally to a U.S. shareholder that is a member of a consolidated group. However, consistent with the authority in section 1502, the proposed regulations provide special definitions of net CFC tested income and net DTIR in order to clearly reflect the income tax liability of the consolidated group. Specifically, the proposed regulations provide that, to determine a member's GILTI inclusion amount, the pro rata shares of tested loss, QBAI, tested interest expense, and tested interest income of each member are aggregated, and then a portion of each aggregate amount is allocated to each member of the group that is a U.S. shareholder of a tested income CFC based on the proportion of such member's aggregate pro rata share of tested income to the total tested income of the consolidated group. See proposed § 1.1502-51(e).

As discussed in section I.G.3 of this Explanation of Provisions, proposed § 1.951A-6(e) provides that the adjusted basis of the stock of a CFC is adjusted immediately before its disposition. Proposed § 1.1502-51(c) provides special rules for making these adjustments to the adjusted basis of the stock of a CFC owned by a member in a manner that reflects the special definitions applicable to members.

#### C. Section 1.1502-32

Section 1.1502-32 provides rules for adjusting the basis of the stock of a subsidiary owned by another member to reflect, among other items, the subsidiary's items of income. Accordingly, no new rules are necessary to adjust the basis of the stock of a member because of a GILTI inclusion. However, as previously discussed, proposed §§ 1.951A-6(e) and 1.1502-51(c) provide rules for adjusting the basis of the stock of a CFC immediately before its disposition. As a result, proposed § 1.1502-32(b)(3)(ii)(E) and (iii)(C) provide for adjustments to the basis of the stock of a member to reflect those rules. Specifically, the proposed rules treat a portion of a member's offset tested income amount as tax-exempt income and all of a member's used tested loss amount as a noncapital, nondeductible expense.

As previously discussed, the Treasury Department and the IRS have determined that in the case of a corporate U.S. shareholder, gain recognized on the disposition of stock of a CFC attributable to offset tested income would, in most cases, be eliminated as a result of the application of section 964(e)(4) or section 1248(a) and (j), to the extent the gain or income is eligible for the dividends received deduction under section 245A. In order to not incentivize a sale of the stock of a CFC over a sale of stock of a member, proposed § 1.1502-32(b)(3)(ii)(F) provides that a member is also treated as receiving tax-exempt income immediately before another member recognizes income, gain, deduction, or loss with respect to a share of the first member's stock. The amount of this additional tax-exempt income is the net offset tested income amount allocable to the shares of any CFC owned by the first member to the extent that a distribution of such amount would have been characterized as a dividend eligible for a section 245A deduction and not subject to section 1059.

The Treasury Department and the IRS request comments regarding the coordination of the rules of proposed §§ 1.951A-6(e) and 1.1502-51(c) with the investment adjustment regime of § 1.1502-32. Comments are specifically requested on: (1) Whether the amount of the adjustments to the basis of member stock should be limited to the amount of the adjustments to the basis of the stock of a CFC under the rules of proposed § 1.951A-6(e); (2) whether the adjustments to the basis of member stock should all be made on a current basis, made to the extent of the basis adjustments provided in proposed

§ 1.951A-6(e) on a current basis with any remaining adjustments being made at the time of a disposition of stock of a CFC or of a member, or made only at the time of a disposition of the stock of a CFC or of a member; and (3) whether rules should provide that a deduction under section 245A should not be treated as tax-exempt income to the extent that the underlying dividend is attributable to offset tested income for which basis adjustments have already been made. Additionally, comments are specifically requested as to whether there are any circumstances in which there should be a deemed disposition of the stock of a CFC owned by a member, such that the rules of proposed § 1.951A-6(e) would apply, including, but not limited to, a deconsolidation or taxable disposition of the stock of a member that owns (directly or indirectly) the stock of a CFC to either a person outside of the consolidated group or to another member, and a transfer of the stock of a member in an intercompany transaction that is a nonrecognition transaction. Similarly, comments are specifically requested as to whether there are other transactions that should be described in the definition of transferred shares in proposed § 1.1502-32(b)(3)(ii)(F)(1), such as a deemed disposition pursuant to § 1.1502-19(c)(1)(iii)(B). Lastly, comments are specifically requested as to whether any other adjustments are necessary to prevent the duplication of gain or loss resulting from a member's ownership of a CFC, including situations where a member owning a CFC joins another consolidated group.

In response to comments received, no new rules are being proposed under § 1.1502-33, which provides rules for adjusting the earnings and profits of a subsidiary and any member owning stock of the subsidiary. The Treasury Department and the IRS request comments on whether additional rules under § 1.1502-33 or any other regulations issued under section 1502 are necessary.

#### IV. Sections 1.6038-2(a) and 1.6038-5

Under section 6038(a)(1), U.S. persons that control foreign corporations must file certain information returns with respect to those corporations. Before the Act, a U.S. shareholder would not have had an income inclusion under section 951(a)(1) with respect to a foreign corporation unless the corporation had been a CFC for an uninterrupted period of at least 30 days during the taxable year. While section 6038 does not limit the reporting requirements to foreign corporations that a U.S. person controls for an uninterrupted period of at least

30 days, § 1.6038–2(a) does provide for such a limit. To coordinate with the amendment to section 951(a)(1) that removed the 30-day requirement, this notice of proposed rulemaking proposes to revise § 1.6038–2(a) to provide that certain information reporting is required for U.S. persons that control a foreign corporation at any time during an annual accounting period.

Section 6038(a)(4) allows the Secretary to require any U.S. shareholder of a CFC to provide information required under section 6038(a)(1), which includes information that is similar to the listed information in section 6038(a)(1)(A) through (a)(1)(E), as well as information that “the Secretary determines to be appropriate to carry out the provisions of this title.” In order to effectively administer and enforce section 951A, the Treasury Department and the IRS have determined that, in general, U.S. shareholders must file a new Schedule I–1, Information for Global Intangible Low-Taxed Income, to Form 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations, as well as new Form 8992, U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI), to provide the information that a U.S. shareholder needs with respect to each of its CFCs to determine the U.S. shareholder’s GILTI inclusion amount for a taxable year. Proposed § 1.6038–5 provides the filing requirements for new Form 8992.

## V. Applicability Dates

Consistent with the applicability date of section 951A, proposed §§ 1.951–1(e)(1)(ii)(B), 1.951A–1 through 1.951A–6, 1.1502–32(b)(3)(ii)(E), (b)(3)(ii)(F), and (b)(3)(iii)(C), and 1.1502–51 are proposed to apply to taxable years of foreign corporations beginning after December 31, 2017, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end. See section 7805(b)(2). Proposed § 1.951–1(e) (pro rata share of subpart F income) (other than § 1.951–1(e)(1)(ii)(B)) is proposed to apply to taxable years of U.S. shareholders ending on or after October 3, 2018. See section 7805(b)(1)(B). Consistent with the applicability date of the modification to section 951 in the Act, proposed § 1.951–1(a) (controlled foreign corporations) and § 1.951–1(g) (definition of U.S. shareholder) are proposed to apply to taxable years of foreign corporations beginning after December 31, 2017, and to taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end. See section

7805(b)(2). Proposed § 1.951–1(h) (special rule for partnership blocker structure) is proposed to apply to taxable years of domestic partnerships ending on or after May 14, 2010. See Notice 2010–41 and section 7805(b)(1)(C). Although proposed § 1.951–1(h) applies for purposes of both section 951 and section 951A, the only practical effect of applying this rule to taxable years of domestic partnerships ending on or after May 14, 2010, and before January 1, 2018, concerns the application of section 951. The proposed rule does not have relevance to the application of section 951A until the first taxable year of a CFC owned by a domestic partnership beginning after December 31, 2017 (the effective date of section 951A). Proposed § 1.6038–2(a) (information returns required of U.S. persons with respect to annual accounting periods of certain foreign corporations) and proposed § 1.6038–5 (information returns required of certain U.S. persons to report amounts determined with respect to certain foreign corporations for GILTI purposes) are proposed to apply to taxable years of foreign corporations beginning on or after October 3, 2018. See sections 6038(a)(3) and 7805(b)(1)(B).

## Special Analyses

### *Regulatory Planning and Review—Economic Analysis*

Executive Orders 13563 and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing rules, and of promoting flexibility. The Executive Order 13771 designation for any final rule resulting from these proposed regulations will be informed by comments received.

The proposed regulations have been designated by the Office of Information and Regulatory Affairs (OIRA) as subject to review under Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations. OIRA has determined that the proposed rulemaking is significant. Accordingly, the proposed regulations have been reviewed by OIRA. For more detail on

the economic analysis, please refer to the following analysis.

### A. Overview

The proposed regulations provide taxpayers with computational, definitional, and anti-avoidance guidance regarding the application of section 951A. They provide guidance for U.S. shareholders to determine the amount of GILTI to include in gross income and how to compute the components of GILTI. Among other benefits, this clarity helps ensure that taxpayers all calculate GILTI in a similar manner, which promotes efficiency and equity contingent on the provisions of the overall Code.

The proposed regulations under sections 951A, 1502, and 6038 (proposed §§ 1.951A–1 through 1.951A–7, 1.1502–12, 1.1502–13, 1.1502–32, and 1.1502–51, and 1.6038–5) provide details for taxpayers (including members of a consolidated group) regarding the computation of certain components of GILTI (for example, tested income and tested loss, QBAI, net deemed tangible income return, and specified interest expense), describe the consequences of a GILTI inclusion for purposes of other sections of the Code, and detail the reporting requirements associated with GILTI. These proposed regulations further establish anti-abuse rules to prevent taxpayers from taking measures to inappropriately reduce their GILTI through certain transfers of property. They also disallow certain losses that reduce GILTI from being used a second time.

The proposed regulations under sections 951 and 6038 (proposed §§ 1.951–1 and 1.6038–2) prevent taxpayers from avoiding an inclusion of subpart F income under section 951(a) or the inclusion of GILTI under section 951A through certain artificial arrangements involving the ownership of CFC stock, coordinate the calculation of a U.S. shareholder’s subpart F with its GILTI, and conform the regulations to other amendments in the Act, including a modification to the definition of U.S. shareholder for purposes of sections 951(a) and 951A and the elimination of the 30-day CFC status requirement. This economic analysis describes the economic benefits and costs of the proposed regulations.

### B. Economic Analysis of the Proposed Regulations

#### 1. Background

Because section 951A is a new Code section, many of the details behind the relevant terms and necessary calculations required for the

computation of a U.S. shareholder's GILTI inclusion amount would benefit from greater specificity. Thus, as is expected after the passage of major tax reform legislation, the regulations answer open questions and provide detail and specificity for the definitions and concepts described in section 951A, so that U.S. shareholders can readily and accurately determine their GILTI inclusion amounts. For example, the regulations provide definitions of crucial terms, such as tested income, tested loss, specified tangible property, and specified interest expense.

As discussed in section I.A. of the Explanation of Provisions, although a GILTI inclusion is treated similarly to an inclusion of subpart F income for some purposes, it is determined in a manner fundamentally different from that of a subpart F inclusion. Therefore, in some cases it is appropriate for the regulations to rely on subpart F principles, but in other cases different rules are necessary. For example, the regulations apply subpart F rules for purposes of (1) determining a U.S. shareholder's pro rata share of certain items of a CFC, (2) translating foreign currency to U.S. dollars, (3) determining gross income and allowable deductions, and (4) allocating and apportioning allowable deductions to gross tested income. However, it would be inappropriate to rely on subpart F rules for the GILTI computations that are performed at the U.S. shareholder level because subpart F income is determined solely at the level of a CFC. For example, the regulations provide detail on how a U.S. shareholder determines its specified interest expense at the shareholder level based on the interest expense and interest income of each CFC owned by the shareholder.

Additionally, the proposed regulations provide rules regarding the interaction of certain aspects of section 951A with other provisions. For example, they clarify that, regarding the interaction of the earnings and profits limitation (including recapture) for subpart F income and the determination of gross tested income, tested income and tested loss are computed without regard to the earnings and profits limitation in section 952(c). In addition, the proposed regulations provide that GILTI inclusion amounts are considered net investment income under section 1411. Finally, the proposed regulations provide that certain deductions between related parties are not deferred under sections 163(e)(3)(B)(i) and 267(a)(3)(B) to the extent the income is taken into account in determining a U.S. shareholder's GILTI inclusion amount.

Section 951A provides the Secretary of the Treasury the authority to issue regulations and other guidance to prevent the avoidance of the purposes of section 951A(d). As such, regulations under §§ 1.951A-2 and 1.951A-3 provide that certain transactions that reduce a U.S. shareholder's GILTI inclusion amount, for example, by increasing a CFC's qualified business asset investment (QBAI) or decreasing a CFC's tested income, will be disregarded for purposes of the GILTI computation.

Further, the Treasury Department and the IRS have determined that, in the absence of any adjustment, inappropriate results may arise in cases that a U.S. shareholder's pro rata share of the tested loss of one CFC offsets the shareholder's pro rata share of the tested income of another CFC in determining the shareholder's GILTI inclusion amount. In particular, a U.S. shareholder disposing of the stock of a tested loss CFC could recognize second, duplicative benefits from a single economic loss. Therefore, the proposed regulations provide that, when determining gain or loss on the disposition of the stock of a tested loss CFC, the U.S. shareholder's basis in the stock of the tested loss CFC is reduced by the cumulative amount of tested losses that were used to offset tested income in determining the shareholder's net CFC tested income.

The statute is silent on the computation of GILTI for members of a consolidated group and for domestic partnerships and their partners. Absent these regulations, there would be uncertainty among taxpayers as to whether to calculate a GILTI inclusion amount at the level of a member or its consolidated group, or at the level of a domestic partnership or its partners. Without guidance, different taxpayers would likely take different positions on these matters. The proposed regulations provide clarity by (1) determining the GILTI inclusion amount of each member of a consolidated group by taking into account the relevant items of each CFC owned by members of such group, and (2) providing guidance on the computation of the GILTI inclusion amount of domestic partnerships and their partners.

Finally, these proposed regulations provide reporting requirements necessary to properly administer and enforce section 951A. In particular, the Treasury Department and the IRS have determined that U.S. shareholders must file a new Schedule I-1, Information for Global Intangible Low-Taxed Income, associated with Form 5471, Information Return of U.S. Persons With Respect To

Certain Foreign Corporations, as well as new Form 8992, U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI), in order to provide the information that a U.S. shareholder is using with respect to each of its CFCs to determine the U.S. shareholder's GILTI inclusion amount for a taxable year. The proposed regulations also provide that a U.S. shareholder partnership must include on its Schedule K-1, associated with Form 1065, U.S. Return of Partnership Income, certain information necessary for its partners to determine their distributive share of the partnership's GILTI inclusion amount or, in the case of U.S. shareholder partners, to determine their own GILTI inclusion amounts. Finally, to coordinate with the amendment to section 951(a)(1) that removed the 30-day CFC status requirement for subpart F inclusions, the proposed regulations provide that certain information reporting is required for U.S. persons that control a foreign corporation at any time during an annual accounting period.

## 2. Anticipated Benefits and Costs of the Proposed Regulations

### a. Baseline

The Treasury Department and the IRS have assessed the benefits and costs of the proposed regulations against a baseline—the way the world would look in the absence of the proposed regulations.

### b. Anticipated Benefits

The Treasury Department and the IRS expect that the certainty and clarity provided by these proposed regulations, relative to the baseline, will enhance U.S. economic performance under the statute. Because a tax has not previously been imposed on GILTI and the statute is silent on certain aspects of definitions and calculations, taxpayers can particularly benefit from enhanced specificity regarding the relevant terms and necessary calculations they are required to apply under the statute. In the absence of this enhanced specificity, similarly situated taxpayers might interpret the statutory rules of section 951A differently, potentially resulting in inequitable outcomes. For example, different taxpayers might pursue income-generating activities based on different assumptions about whether that income will be counted as GILTI, and some taxpayers may forego specific investments that other taxpayers deem worthwhile based on different interpretations of the tax consequences alone. The guidance provided in these regulations helps to ensure that

taxpayers face more uniform incentives when making economic decisions, a tenet of economic efficiency. Consistent reporting across taxpayers also increases the IRS's ability to consistently enforce the tax rules, thus increasing equity and decreasing opportunities for tax evasion.

For example, the proposed regulations provide a definition of specified interest expense that adopts a netting approach. Alternatives would be to adopt a tracing approach or to remain silent. The Treasury Department and the IRS rejected a tracing approach because it would be more burdensome for taxpayers due to the complexity of matching, at the U.S. shareholder-level, of the shareholder's pro rata share of each item of interest expense with its pro rata share of each item of interest income. The Treasury Department and the IRS also rejected the option of remaining silent because if taxpayers relied on statutory language alone, taxpayers would adopt different approaches because the statute does not define what "attributable" means, leaving it open to differing interpretations.

As discussed above, there are similarities between GILTI and subpart F. Where appropriate, these proposed regulations rely on rules already developed under subpart F. Since taxpayers to whom GILTI applies are already subject to the subpart F regime, it is less costly to them to apply rules they are already familiar with, and they will benefit in reduced time and cost spent learning new rules. For example, the proposed regulations apply existing subpart F rules for determining allowable deductions for GILTI purposes. By relying on existing infrastructure, the proposed regulations allow taxpayers to use the same analysis that they already conduct for subpart F purposes. For additional discussion of the rules for determining allowable deductions, see section I.C.1 of the Explanation of Provisions section.

The Treasury Department and the IRS next considered the benefits and costs of providing these specific proposed terms, calculations, and other details regarding GILTI. In developing these proposed regulations, the Treasury Department and the IRS have generally aimed to apply the principle that an economically efficient tax system would treat income derived from similar economic decisions similarly, to the extent consistent with the statute and considerations of administrability of the tax system. Similar economic decisions, in the context of GILTI, are those that involve property of a similar degree of immobility and that demonstrate active business operations and presence in any

particular jurisdiction. See, for example, Senate Explanation, at 366.

An economically efficient tax system would also generally keep the choice among businesses' ownership and organizational structures neutral contingent on the provisions of the corporate income tax and other tax provisions that may affect organizational structure. The Treasury Department and the IRS expect that the proposed regulations, in providing that GILTI be generally calculated on a consolidated group basis and at the partner level in the case of partners that are U.S. shareholders of one or more partnership CFCs, will ensure that shareholders face uniform tax treatment on their GILTI-relevant investments regardless of ownership or organizational structure, thus encouraging market-driven as opposed to tax-driven structuring decisions. If, as an alternative policy approach, GILTI were determined solely at the level of a member (in the case of consolidated groups) or solely at the level of a partnership (in the case of domestic partnerships and their partners), many taxpayers would be compelled to reorganize their ownership structures just to obtain the full aggregation of CFC attributes as envisioned by Congress. Yet other taxpayers would be incentivized to reorganize in an attempt to avoid full aggregation so as to reduce their inclusion below an amount that accurately reflects their GILTI. For an illustration, see section I.F of the Explanation of Provisions. Therefore, the Treasury Department and the IRS propose that GILTI be calculated on a consolidated group basis and at the partner level in the case of partners that are U.S. shareholders of one or more partnership CFCs. The preamble discusses further why those approaches were taken, as well as describing alternative approaches considered. The Treasury Department and the IRS request comments on this proposed approach.

#### c. Anticipated Impacts on Administrative and Compliance Costs

Because the statute requires payment of tax regardless of the issuance of regulations or instructions, the new forms, revisions to existing forms, and proposed regulations can lower the burden on taxpayers of determining their tax liability. The Treasury Department and the IRS expect that the proposed regulations will reduce the costs for taxpayers to comply with the Act, relative to the baseline of no promulgated regulations. The proposed regulations require that each U.S. shareholder partnership provide to each

partner its distributive share of the partnership's GILTI inclusion amount and, if the partner is a U.S. shareholder of one or more partnership CFCs, the partner's proportionate share of the partnership's pro rata share of each relevant item of the partnership CFC. Under the baseline, the burden would potentially have fallen on each partner, who would be required to determine its own distributive share of the partnership's GILTI inclusion amount or, if a U.S. shareholder of a partnership CFC, determine its own GILTI inclusion amount by reference to the partnership's pro rata share of items of the partnership CFC. While this latter burden is difficult to assess, because it is unclear how partners would calculate these amounts in the absence of a determination by the partnership and it is similarly unclear what efforts might be made by the partnership to help the partners fulfill this obligation, the Treasury Department and the IRS expect that it would be significantly greater than the burden incurred under the proposed regulations.

Proposed § 1.6038-2(a) increases record-keeping requirements for taxpayers because it requires all taxpayers to file Form 5471 if they held stock in a CFC during the taxable year regardless of the duration of the holding period, rather than only if they held the stock for a 30-day period under the current regulation. The changes in the proposed regulation derive directly from statutory changes to the holding period requirement in the Act.

#### C. Paperwork Reduction Act

The collections of information in these proposed regulations with respect to section 951A are in proposed §§ 1.951A-5(f) and 1.6038-5. A separate collection of information applicable to controlling U.S. shareholders of a foreign corporation is in proposed § 1.6038-2(a).

The collection of information in proposed § 1.6038-5 is mandatory for each U.S. shareholder (including a U.S. shareholder partner) that owns (within the meaning of section 958(a)) stock of a CFC. The collection of information in proposed § 1.6038-5 is satisfied by submitting a new reporting form, Form 8992, U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI), with an income tax return. In addition, for those U.S. shareholders that are required to file Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations, a new Schedule I-1, Information for Global Intangible Low-Taxed Income, has been added. For purposes of the Paperwork Reduction Act of 1995 (44

U.S.C. 3507(d)) (“PRA”), the reporting burden associated with proposed § 1.6038–5 will be reflected in the IRS Form 14029, Paperwork Reduction Act Submission, associated with Form 5471 (OMB control number 1545–0704) and the new Form 8992 (OMB control number 1545–0123).

The collection of information in proposed § 1.951A–5(f) requires each U.S. shareholder partnership to provide to its partners their distributive share of the partnership’s GILTI inclusion amount, as well as provide to each U.S. shareholder partner their proportionate share of the partnership’s pro rata share (if any) of each CFC tested item of each partnership CFC of the partnership. The Treasury Department and the IRS anticipate revising Schedule K–1 (Form

1065), Partner’s Share of Income, Deductions, Credits, etc., or its instructions to require the provision of this information. For purposes of the PRA, the reporting burden associated with proposed § 1.951A–5(f) will be reflected in the IRS Form 14029, Paperwork Reduction Act Submission, associated with Schedule K–1 (Form 1065, OMB control number 1545–0123).

The collection of information currently required from a U.S. person that controls a foreign corporation is revised by proposed § 1.6038–2(a). Section 1.6038–2(a) presently requires only those U.S. persons with uninterrupted control of a foreign corporation for 30 days or more during the shareholder’s annual accounting period to file Form 5471 for that period.

Consistent with statutory changes in the Act, the revised collection of information in proposed § 1.6038–2(a) eliminates the 30-day holding period as a precondition to reporting and requires every U.S. person that controls a foreign corporation at any time during an annual accounting period to file Form 5471 for that period. For purposes of the PRA, the reporting burden associated with proposed § 1.6038–2(a) will be reflected in the IRS Form 14029, Paperwork Reduction Act Submission, associated with Form 5471.

When available, drafts of IRS forms are posted for comment at <https://apps.irs.gov/app/picklist/list/draftTaxForms.html>.

RELATED NEW OR REVISED TAX FORMS

	New	Revision of existing form	Number of respondents (estimated)
Schedule I–1 (Form 5471) .....	✓	.....	25,000–35,000
Form 8992 .....	✓	.....	25,000–35,000
Form 1065/1120S, Schedule K .....	.....	✓	8,000–12,000
Form 5471 (30 days) .....	.....	✓	<1,000

D. Regulatory Flexibility Act

It is hereby certified that this notice of proposed rulemaking will not have a significant economic impact on a substantial number of small entities within the meaning of section 601(6) of the Regulatory Flexibility Act (5 U.S.C. chapter 6).

The domestic small business entities that are subject to section 951A and this notice of proposed rulemaking are those domestic small business entities that are U.S. shareholders of a CFC.<sup>2</sup> Generally, a U.S. shareholder is any U.S. person that owns 10 percent or more of a foreign corporation’s stock, measured either by value or voting power. A CFC is a foreign corporation in which more than 50 percent of its stock is owned by U.S. shareholders, again measured either by value or voting power. Data about the number of domestic small business entities potentially affected by these regulations are not readily available.

The domestic small business entities that are subject to the requirements of proposed § 1.951A–5(f) or 1.6038–5 of this notice of proposed rulemaking are U.S. shareholders of one or more CFCs.

The Treasury Department and the IRS do not have data to assess the number of small entities potentially affected by § 1.951A–5(f) or 1.6038–5. However, businesses that are U.S. shareholders of CFCs are generally not small businesses because the ownership of sufficient stock in a CFC in order to be a U.S. shareholder generally entails significant resources and investment. Therefore, the Treasury Department and the IRS do not believe that a substantial number of domestic small business entities will be subject to proposed § 1.951A–5(f) or 1.6038–5. Consequently, the Treasury Department and the IRS do not believe that proposed § 1.951A–5(f) or 1.6038–5 will have a significant economic impact on a substantial number of domestic small business entities. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act is not required with respect to the collection of information requirements of proposed § 1.951A–5(f) or 1.6038–5.

Existing § 1.6038–2(a) requires only those U.S. persons with uninterrupted control of a foreign corporation for 30 days or more during the shareholder’s annual accounting period to file Form 5471 for that period. Proposed § 1.6038–2(a) eliminates the 30-day holding period as a precondition to reporting and requires every U.S. person that controls a foreign corporation at any time during an annual accounting

period to file Form 5471 for that period. As a result, those U.S. shareholders that control a foreign corporation for less than 30 days will now be required to file Form 5471 pursuant to proposed § 1.6038–2(a). The domestic small business entities subject to the requirements of proposed § 1.6038–2(a) are those domestic small business entities that control a foreign corporation at any time during a taxable year. For these purposes, a domestic small business entity controls a foreign corporation by owning more than 50 percent of that foreign corporation’s stock, measured either by voting power or value. The Treasury Department and the IRS do not believe that a substantial number of domestic small business entities that are controlling shareholders of a foreign corporation will become Form 5471 filers due to the information collection in proposed § 1.6038–2(a) for the following reasons. First, significant resources and investment are required for a U.S. person to own and operate a business in a foreign country as a corporation. Second, the Treasury Department and the IRS believe that satisfying the stock ownership requirement for control for purposes of proposed § 1.6038–2(a) requires a potential outlay of significant resources and investment, including active involvement in managing the foreign corporation due to controlling ownership of the corporation, such that

<sup>2</sup> The Treasury Department and the IRS estimate that there are 25,000–35,000 respondents of all sizes that are likely to file Schedule I–1, Form 5471. Only a small proportion of these are likely to be small businesses. The Treasury Department and the IRS request comments on the number of small businesses that are likely to file Schedule I–1.



few domestic small business entities are likely to control foreign corporations for purposes of proposed § 1.6038-2(a). For these reasons, the Treasury Department and the IRS do not believe it likely that a domestic small business entity would have controlling ownership of a foreign corporation for less than a 30-day period in a taxable year. As a result, the Treasury Department and the IRS do not believe that a substantial number of domestic small business entities will be affected by the proposed § 1.6038-2(a) eliminating the 30-day holding period as a precondition to filing Form 5471. Consequently, the Treasury Department and the IRS do not believe that proposed § 1.6038-2(a) will have a significant economic impact on a substantial number of domestic small business entities. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act is not required with respect to the requirements of proposed § 1.6038-2(a).

Notwithstanding this certification, the Treasury Department and the IRS invite comments from the public about the impact of this proposed rule on small entities.

Pursuant to section 7805(f), this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses. The IRS invites the public to comment on this certification.

#### *E. Unfunded Mandates Reform Act*

Section 202 of the Unfunded Mandates Reform Act of 1995 requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of \$100 million in 1995 dollars, updated annually for inflation. In 2018, that threshold is approximately \$150 million. This rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

#### *F. Executive Order 13132: Federalism*

Executive Order 13132 (entitled “Federalism”) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This

proposed rule does not have federalism implications and does not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

#### **Comments and Requests for Public Hearing**

Before the 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 regulations, and specifically on the issues identified in sections I.B.3, I.C.1, I.D.4, I.F, I.G.1, I.G.3, and III.C of the Explanations of Provisions. All comments will be available at [www.regulations.gov](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, then notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

#### **Drafting Information**

The principal authors of the proposed regulations are Melinda E. Harvey and Michael Kaercher of the Office of Associate Chief Counsel (International) and Austin Diamond-Jones and Kevin M. Jacobs of the Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and the Treasury Department participated in the development of the proposed regulations.

#### **Statement of Availability of IRS Documents**

IRS Revenue Procedures, Revenue Rulings, notices, and other guidance 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 Printing 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:

#### **PART 1—INCOME TAXES**

■ **Paragraph 1.** The authority citation for part 1 is amended by adding entries

in numerical order to read in part as follows:

**Authority:** 26 U.S.C. 7805 \* \* \*

Section 1.951-1 also issued under 26 U.S.C. 7701(a). \* \* \*

Sections 1.951A-2 and 1.951A-3 also issued under 26 U.S.C. 951A(d). \* \* \*

Section 1.951A-5 also issued under 26 U.S.C. 6031.

Section 1.951A-6 also issued under 26 U.S.C. 951A(f)(1)(B). \* \* \*

Section 1.1502-51 also issued under 26 U.S.C. 1502. \* \* \*

Section 1.6038-2 also issued under 26 U.S.C. 6038. \* \* \*

Section 1.6038-5 also issued under 26 U.S.C. 6038. \* \* \*

■ **Par. 2.** Section 1.951-1 is amended by:

■ 1. Revising the introductory language in paragraph (a).

■ 2. Revising paragraphs (e) and (g)(1).

■ 3. Adding paragraphs (h) and (i).

The revisions and additions read as follows:

#### **§ 1.951-1 Amounts included in gross income of United States shareholders.**

(a) *In general.* If a foreign corporation is a controlled foreign corporation (within the meaning of section 957) at any time during any taxable year of such corporation, every person—

\* \* \* \* \*

(e) *Pro rata share of subpart F income defined—(1) In general—(i)*

*Hypothetical distribution.* For purposes of paragraph (b) of this section, a United States shareholder’s pro rata share of a controlled foreign corporation’s subpart F income for a taxable year is the amount that bears the same ratio to the corporation’s subpart F income for the taxable year as the amount of the corporation’s current earnings and profits that would be distributed with respect to the stock of the corporation which the United States shareholder owns (within the meaning of section 958(a)) for the taxable year bears to the total amount of the corporation’s current earnings and profits that would be distributed with respect to the stock owned by all the shareholders of the corporation if all the current earnings and profits of the corporation for the taxable year (not reduced by actual distributions during the year) were distributed (*hypothetical distribution*) on the last day of the corporation’s taxable year on which such corporation is a controlled foreign corporation (*hypothetical distribution date*).

(ii) *Determination of current earnings and profits.* For purposes of this paragraph (e), the amount of current earnings and profits of a controlled foreign corporation for a taxable year is treated as the greater of the following two amounts:

(A) The earnings and profits of the corporation for the taxable year determined under section 964; or

(B) The sum of the subpart F income (as determined under section 952 and increased as provided under section 951A(c)(2)(B)(ii) and § 1.951A-6(d)) of the corporation for the taxable year and the tested income (as defined in section 951A(c)(2)(A) and § 1.951A-2(b)(1)) of the corporation for the taxable year.

(2) *One class of stock.* If a controlled foreign corporation for a taxable year has only one class of stock outstanding, the amount of the corporation's current earnings and profits distributed in the hypothetical distribution with respect to each share in the class of stock is determined as if the hypothetical distribution were made pro rata with respect to each share in the class of stock.

(3) *More than one class of stock.* If a controlled foreign corporation for a taxable year has more than one class of stock outstanding, the amount of the corporation's current earnings and profits distributed in the hypothetical distribution with respect to each class of stock is determined under this paragraph (e)(3) based on the distribution rights of each class of stock on the hypothetical distribution date, and then further distributed pro rata with respect to each share in the class of stock. Subject to paragraphs (e)(4) through (6) of this section, the distribution rights of a class of stock are determined taking into account all facts and circumstances related to the economic rights and interest in the current earnings and profits of the corporation of each class, including the terms of the class of stock, any agreement among the shareholders and, where appropriate, the relative fair market value of shares of stock.

(4) *Special rules—(i) Redemptions, liquidations, and returns of capital.* Notwithstanding the terms of any class of stock of the controlled foreign corporation or any agreement or arrangement with respect thereto, no amount of current earnings and profits is distributed in the hypothetical distribution with respect to a particular class of stock to the extent that a distribution of such amount would constitute a distribution in redemption of stock (even if such redemption would be treated as a distribution of property to which section 301 applies pursuant to section 302(d)), a distribution in liquidation, or a return of capital.

(ii) *Certain cumulative preferred stock.* If a controlled foreign corporation has outstanding 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 (as defined in section 1274(d)(1)) (*AFR*), the amount of the corporation's current earnings and profits distributed in the hypothetical distribution with respect to the class of stock may not exceed the amount of dividends actually paid during the taxable year with respect to the class of stock plus the present value of the unpaid current dividends with respect to the class determined using the *AFR* that applies on the date the stock is issued for the term from such issue date to the mandatory redemption date and assuming the dividends will be paid at the mandatory redemption date. For purposes of this paragraph (e)(4)(ii), if the class of preferred stock does not have a mandatory redemption date, the mandatory redemption date is the date that the class of preferred stock is expected to be redeemed based on all facts and circumstances.

(iii) *Dividend arrearages.* If there is an arrearage in dividends for prior taxable years with respect to a class of preferred stock of a controlled foreign corporation, an amount of the corporation's current earnings and profits is distributed in the hypothetical distribution to the class of preferred stock by reason of the arrearage only to the extent the arrearage exceeds the accumulated earnings and profits of the controlled foreign corporation remaining from prior taxable years beginning after December 31, 1962, as of the beginning of the taxable year, or the date on which such stock was issued, whichever is later. If there is an arrearage in dividends for prior taxable years with respect to more than one class of preferred stock, the previous sentence is applied to each class in order of priority, except that the accumulated earnings and profits remaining after the applicable date are reduced by the earnings and profits necessary to satisfy arrearages with respect to classes of stock with a higher priority. For purposes of this paragraph (e)(4)(iii), the amount of any arrearage is determined by taking into account the time value of money principles in paragraph (e)(4)(ii) of this section.

(5) *Restrictions or other limitations on distributions—(i) In general.* A restriction or other limitation on distributions of an amount of earnings and profits by a controlled foreign corporation is not taken into account in determining the amount of the corporation's current earnings and profits distributed in a hypothetical distribution to a class of stock of the controlled foreign corporation.

(ii) *Definition.* For purposes of paragraph (e)(5)(i) of this section, a restriction or other limitation on distributions includes any limitation that has the effect of limiting the distribution of an amount of earnings and profits by a controlled foreign corporation with respect to a class of stock of the corporation, other than currency or other restrictions or limitations imposed under the laws of any foreign country as provided in section 964(b).

(iii) *Exception for certain preferred distributions.* For purposes of paragraph (e)(5)(i) of this section, the right to receive periodically a fixed amount (whether determined by a percentage of par value, a reference to a floating coupon rate, a stated return expressed in terms of a certain amount of U.S. dollars or foreign currency, or otherwise) with respect to a class of stock the distribution of which is a condition precedent to a further distribution of earnings and profits that year with respect to any class of stock (not including a distribution in partial or complete liquidation) is not a restriction or other limitation on the distribution of earnings and profits by a controlled foreign corporation.

(iv) *Illustrative list of restrictions and limitations.* Except as provided in paragraph (e)(5)(iii) of this section, restrictions or other limitations on distributions include, but are not limited to—

(A) An arrangement that restricts the ability of a controlled foreign corporation to pay dividends on a class of stock of the corporation until a condition or conditions are satisfied (for example, until another class of stock is redeemed);

(B) A loan agreement entered into by a controlled foreign corporation that restricts or otherwise affects the ability to make distributions on its stock until certain requirements are satisfied; or

(C) An arrangement that conditions the ability of a controlled foreign corporation to pay dividends to its shareholders on the financial condition of the corporation.

(6) *Transactions and arrangements with a principal purpose of reducing pro rata shares.* For purposes of this paragraph (e), any transaction or arrangement that is part of a plan a principal purpose of which is the 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. This paragraph (e)(6) also applies for purposes of the pro rata share rules described in § 1.951A-1(d) that reference this paragraph (e), including the rules in § 1.951A-1(d)(3) that determine the pro rata share of qualified business asset investment based on the pro rata share of tested income.

(7) *Examples.* The application of this section is illustrated by the examples in this paragraph (e)(7).

(i) *Common facts for examples in paragraph (e)(7).* Except as otherwise stated, the following facts are assumed for purposes of the examples.

(A) FC1 is a controlled foreign corporation.

(B) USP1, USP2, and USP3 are domestic corporations and United States shareholders of FC1.

(C) Individual A is a foreign individual, and FC2 is a foreign corporation.

(D) All persons use the calendar year as their taxable year.

(E) Any ownership of FC1 by any shareholder is for all of Year 1.

(F) The common shareholders of FC1 are entitled to dividends when declared by FC1's board of directors.

(G) There are no accrued but unpaid dividends with respect to preferred shares, and common shares have positive liquidation value.

(H) FC1 makes no distributions during Year 1.

(I) There are no other facts and circumstances related to the economic rights and interest of any class of stock in the current earnings and profits of a foreign corporation, and no transaction or arrangement was entered into as part of a plan a principal purpose of which is the avoidance of Federal income taxation.

(J) FC1 does not have tested income within the meaning of section 951A(c)(2)(A) and § 1.951A-2(b)(1) or tested loss within the meaning of section 951A(c)(2)(B) and § 1.951A-2(b)(2).

(ii) *Example 1: Single class of stock—*(A) *Facts.* FC1 has outstanding 100 shares of one class of stock. USP1 owns 60 shares of FC1. USP2 owns 40 shares of FC1. For Year 1, FC1 has \$1,000x of earnings and profits and \$100x of subpart F income within the meaning of section 952.

(B) *Facts. Analysis.* FC1 has one class of stock. Therefore, under paragraph (e)(2) of this section, FC1's current earnings and profits of \$1,000x are distributed in the hypothetical distribution pro rata to each share of stock. Accordingly, under paragraph (e)(1) of this section, for Year 1, USP1's pro rata share of FC1's subpart F income is \$60x

(\$100x × \$600x/\$1,000x) and USP2's pro rata share of FC1's subpart F income is \$40x (\$100x × \$400x/\$1,000x).

(iii) *Example 2: Common and preferred stock—*(A) *Facts.* FC1 has outstanding 70 shares of common stock and 30 shares of 4% nonparticipating, voting preferred stock with a par value of \$10x per share. USP1 owns all of the common shares. Individual A owns all of the preferred shares. For Year 1, FC1 has \$100x of earnings and profits and \$50x of subpart F income within the meaning of section 952. In Year 1, FC1 distributes as a dividend \$12x to Individual A with respect to Individual A's preferred shares.

(B) *Analysis.* The distribution rights of the preferred shares are not a restriction or other limitation within the meaning of paragraph (e)(5) of this section. Under paragraph (e)(3) of this section, the amount of FC1's current earnings and profits distributed in the hypothetical distribution with respect to Individual A's preferred shares is \$12x and with respect to USP1's common shares is \$88x. Accordingly, under paragraph (e)(1) of this section, USP1's pro rata share of FC1's subpart F income is \$44x (\$50x × \$88x/\$100x) for Year 1.

(iv) *Example 3: Restriction based on cumulative income—*(A) *Facts.* FC1 has outstanding 10 shares of common stock and 400 shares of 2% nonparticipating, voting preferred stock with a par value of \$1x per share. USP1 owns all of the common shares. FC2 owns all of the preferred shares. USP1 and FC2 cause the governing documents of FC1 to provide that no dividends may be paid to the common shareholders until FC1 cumulatively earns \$100,000x of income. For Year 1, FC1 has \$50x of earnings and profits and \$50x of subpart F income within the meaning of section 952. In Year 1, FC1 distributes as a dividend \$8x to FC2 with respect to FC2's preferred shares.

(B) *Analysis.* The agreement restricting FC1's ability to pay dividends to common shareholders until FC1 cumulatively earns \$100,000x of income is a restriction or other limitation within the meaning of paragraph (e)(5) of this section. Therefore, the restriction is disregarded for purposes of determining the amount of FC1's current earnings and profits distributed in the hypothetical distribution to a class of stock. The distribution rights of the preferred shares are not a restriction or other limitation within the meaning of paragraph (e)(5) of this section. Under paragraph (e)(3) of this section, the amount of FC1's current earnings and profits distributed in the hypothetical distribution with respect to FC2's preferred shares is \$8x and with respect to USP1's common shares is \$42x. Accordingly, under paragraph (e)(1) of this section, USP1's pro rata share of FC1's subpart F income is \$42x for Year 1.

(v) *Example 4: Redemption rights—*(A) *Facts.* 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 earnings and profits 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.

(B) *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 earnings and profits is distributed in the hypothetical distribution to the preferred shareholders on the hypothetical distribution date 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 earnings and profits in the hypothetical distribution to FC1's shareholders. As a result, the amount of FC1's current earnings and profits 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.

(vi) *Example 5: Shareholder owns common and preferred stock—*(A) *Facts.* FC1 has outstanding 40 shares of common stock and 60 shares of 6% nonparticipating, nonvoting preferred stock with a par value of \$100x per share. USP1 owns 30 shares of the common stock and 15 shares of the preferred stock during Year 1. The remaining 10 shares of common stock and 45 shares of preferred stock of FC1 are owned by Individual A. For Year 1, FC1 has \$1,000x of earnings and profits and \$500x of subpart F income within the meaning of section 952.

(B) *Analysis.* Under paragraph (e)(5)(iii) of this section, the right of the holder of the preferred stock to receive 6% of par value is not a restriction or other limitation within the meaning of paragraph (e)(5) of this section. The amount of FC1's current earnings and profits distributed in the hypothetical distribution with respect to FC1's preferred shares is \$360x (0.06 × \$100x × 60) and with respect to its common shares is \$640x (\$1,000x - \$360x). As a result, the amount of FC1's current earnings and profits distributed in the hypothetical distribution to USP1 is \$570x, the sum of \$90x (\$360x × 15/60) with respect to its preferred shares and \$480x (\$640x × 30/40) with respect to its common shares. Accordingly, under paragraph (e)(1) of this section, USP1's pro rata share of the subpart F income of FC1 is \$285x (\$500x × \$570x/\$1,000x).

(vii) *Example 6: Subpart F income and tested income—*(A) *Facts.* FC1 has outstanding 700 shares of common stock and 300 shares of 4% nonparticipating, voting preferred stock with a par value of \$100x per share. USP1 owns all of the common shares. USP2 owns all of the preferred shares. For Year 1, FC1 has \$10,000x of earnings and profits, \$2,000x of subpart F income within the meaning of section 952, and \$9,000x of tested income within the meaning of section 951A(c)(2)(A) and § 1.951A-2(b)(1).

(B) *Analysis—*(1) *Pro rata share of subpart F income.* The current earnings and profits of

FC1 determined under paragraph (e)(1)(ii) of this section are \$11,000x, the greater of FC1's earnings and profits as determined under section 964 (\$10,000x) or the sum of FC1's subpart F income and tested income (\$2,000x + \$9,000x). The amount of FC1's current earnings and profits distributed in the hypothetical distribution with respect to USP2's preferred shares is \$1,200x (.04 × \$100x × 300) and with respect to USP1's common shares is \$9,800x (\$11,000x – \$1,200x). Accordingly, under paragraph (e)(1) of this section, USP1's pro rata share of FC1's subpart F income is \$1,782x (\$2,000x × \$9,800x/\$11,000x), and USP2's pro rata share of FC1's subpart F income is \$218x (\$2,000x × \$1,200x/\$11,000x).

(2) *Pro rata share of tested income.* The same analysis applies for the hypothetical distribution with respect to the tested income as under paragraph (ii)(A) of this *Example 6* with respect to the subpart F income. Accordingly, under § 1.951A–1(d)(2), USP1's pro rata share of FC1's tested income is \$8,018x (\$9,000x × \$9,800x/\$11,000x), and USP2's pro rata share of FC1's tested income is \$982x (\$9,000x × \$1,200x/\$11,000x) for Year 1.

(viii) *Example 7: Subpart F income and tested loss—(A) Facts.* The facts are the same as in paragraph (A) of *Example 6*, except that for Year 1, FC1 has \$8,000x of earnings and profits, \$10,000x of subpart F income within the meaning of section 952 (but without regard to the limitation in section 952(c)), and \$2,000x of tested loss within the meaning of section 951A(c)(2)(B) and § 1.951A–2(b)(2). Under section 951A(c)(2)(B)(ii) and § 1.951A–6(d), the earnings and profits of FC1 are increased for purposes of section 952 by the amount of FC1's tested loss. Accordingly, taking into account section 951A(c)(2)(B)(ii) and § 1.951A–6(d), the subpart F income of FC1 is \$10,000x.

(B) *Analysis—(1) Pro rata share of subpart F income.* The current earnings and profits determined under paragraph (e)(1)(ii) of this section are \$10,000x, the greater of the earnings and profits of FC1 determined under section 964 (\$8,000x) or the sum of FC1's subpart F income and tested income (\$10,000x + \$0). The amount of FC1's current earnings and profits distributed in the hypothetical distribution with respect to USP2's preferred shares is \$1,200x (.04 × \$100x × 300) and with respect to Corp A's common shares is \$8,800x (\$10,000x – \$1,200x). Accordingly, under paragraph (e)(1) of this section, for Year 1, USP1's pro rata share of FC1's subpart F income is \$8,800x and USP2's pro rata share of FC1's subpart F income is \$1,200x.

(2) *Pro rata share of tested loss.* The current earnings and profits determined under § 1.951A–1(d)(4)(B) are \$2,000x, the amount of FC1's tested loss. Under § 1.951A–1(d)(4)(i)(C), the entire \$2,000x tested loss is distributed in the hypothetical distribution with respect to USP1's common shares. Accordingly, USP1's pro rata share of the tested loss is \$2,000x.

\* \* \* \* \*

(g) \* \* \*

(1) *In general.* For purposes of sections 951 through 964, the term “United States shareholder” means, with respect to a foreign corporation, a United States person (as defined in section 957(c)) who owns within the meaning of section 958(a), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation, or 10 percent or more of the total value of shares of all classes of stock of such foreign corporation.

\* \* \* \* \*

(h) *Special rule for partnership blocker structures—(1) In general.* For purposes of sections 951 through 964, a controlled domestic partnership is treated as a foreign partnership in determining the stock of a controlled foreign corporation owned (within the meaning of section 958(a)) by a United States person if the following conditions are satisfied—

(i) Without regard to this paragraph (h), the controlled domestic partnership owns (within the meaning of section 958(a)) stock of a controlled foreign corporation; and

(ii) If the controlled domestic partnership (and all other controlled domestic partnerships in the chain of ownership of the controlled foreign corporation) were treated as foreign—

(A) The controlled foreign corporation would continue to be a controlled foreign corporation; and

(B) At least one United States shareholder of the controlled foreign corporation would be treated as owning (within the meaning of section 958(a)) stock of the controlled foreign corporation through another foreign corporation that is a direct or indirect partner in the controlled domestic partnership.

(2) *Definition of a controlled domestic partnership.* For purposes of paragraph (h)(1) of this section, the term *controlled domestic partnership* means, with respect to a United States shareholder described in paragraph (h)(1)(ii)(B) of this section, a domestic partnership that is controlled by the United States shareholder and persons related to the United States shareholder. For purposes of this paragraph (h)(2), control generally is determined based on all the facts and circumstances, except that a partnership will be deemed to be controlled by a United States shareholder and related persons in any case in which those persons, in the aggregate, own (directly or indirectly through one or more partnerships) more than 50 percent of the interests in the

partnership capital or profits. For purposes of this paragraph (h)(2), a related person is, with respect to a United States shareholder, a person that is related to the United States shareholder within the meaning of section 267(b) or 707(b)(1).

(3) *Example—(i) Facts.* USP, a domestic corporation, owns all of the stock of CFC1 and CFC2. CFC1 and CFC2 own 60% and 40%, respectively, of the interests in the capital and profits of DPS, a domestic partnership. DPS owns all of the stock of CFC3. Each of CFC1, CFC2, and CFC3 is a controlled foreign corporation. USP, DPS, CFC1, CFC2, and CFC3 all use the calendar year as their taxable year. For Year 1, CFC3 has \$100x of subpart F income (as defined under section 952) and \$100x of earnings and profits.

(ii) *Analysis.* DPS is a controlled domestic partnership with respect to USP within the meaning of paragraph (h)(2) of this section because more than 50% of the interests in its capital or profits are owned by persons related to USP within the meaning of section 267(b) (that is, CFC1 and CFC2), and thus DPS is controlled by USP and related persons. Without regard to paragraph (h) of this section, DPS is a United States shareholder that owns (within the meaning of section 958(a)) stock of CFC3, a controlled foreign corporation. If DPS were treated as foreign, CFC3 would continue to be a controlled foreign corporation, and USP would be treated as owning (within the meaning of section 958(a)) stock in CFC3 through CFC1 and CFC2, which are both partners in DPS. Thus, under paragraph (h)(1) of this section, DPS is treated as a foreign partnership for purposes of determining the stock of CFC3 owned (within the meaning of section 958(a)) by USP. Accordingly, USP's pro rata share of CFC3's subpart F income for Year 1 is \$100x, and USP includes in its gross income \$100x under section 951(a)(1)(A). DPS is not a United States shareholder of CFC3 for purposes of sections 951 through 964.

(i) *Applicability dates.* Paragraphs (a), (e)(1)(ii)(B), and (g)(1) of this section apply to taxable years of foreign corporations beginning after December 31, 2017, and to taxable years of United States shareholders with or within which such taxable years of foreign corporations end. Except for paragraph (e)(1)(ii)(B), paragraph (e) of this section applies to taxable years of United States shareholders ending on or after October 3, 2018. Paragraph (h) of this section applies to taxable years of domestic partnerships ending on or after May 14, 2010.

\* \* \* \* \*

■ **Par. 3.** Section 1.951A–0 is added to read as follows:

**§ 1.951A–0 Outline of section 951A regulations.**

This section lists the headings for §§ 1.951A–1 through 1.951A–7.

**§ 1.951A-1 General provisions.**

- (a) Overview.
  - (1) In general.
  - (2) Scope.
- (b) Inclusion of global intangible low-taxed income.
- (c) Determination of GILTI inclusion amount.
  - (1) In general.
  - (2) Definition of net CFC tested income.
  - (3) Definition of net deemed tangible income return.
    - (i) In general.
    - (ii) Definition of deemed tangible income return.
    - (iii) Definition of specified interest expense.
  - (4) Determination of GILTI inclusion amount for consolidated groups.
    - (d) Determination of pro rata share.
      - (1) In general.
      - (2) Tested income.
        - (i) In general.
        - (ii) Special rule for prior allocation of tested loss.
    - (3) Qualified business asset investment.
      - (i) In general.
      - (ii) Special rule for preferred stock in case of excess QBAI.
      - (iii) Examples.
    - (4) Tested loss.
      - (i) In general.
      - (ii) Special rule in case of accrued but unpaid dividends.
      - (iii) Special rule for stock with no liquidation value.
    - (iv) Examples.
    - (5) Tested interest expense.
    - (6) Tested interest income.
  - (e) Definitions.
    - (1) CFC inclusion date.
    - (2) CFC inclusion year.
    - (3) Section 958(a) stock.
    - (4) U.S. shareholder inclusion year.

**§ 1.951A-2 Tested income and tested loss.**

- (a) Scope.
- (b) Definitions related to tested income and tested loss.
  - (1) Tested income and tested income CFC.
  - (2) Tested loss and tested loss CFC.
- (c) Rules relating to the determination of tested income and tested loss.
  - (1) Definition of gross tested income.
  - (2) Determination of gross tested income and allowable deductions.
  - (3) Allocation of deductions to gross tested income.
  - (4) Nonapplication of section 952(c).
    - (i) In general.
    - (ii) Example.
  - (5) Disregard of basis in property related to certain transfers during the disqualified period.
    - (i) In general.
    - (ii) Definition of specified property.

- (iii) Definition of disqualified basis.
- (iv) Example.

**§ 1.951A-3 Qualified business asset investment.**

- (a) Scope.
- (b) Definition of qualified business asset investment.
- (c) Specified tangible property.
  - (1) In general.
  - (2) Tangible property.
  - (d) Dual use property.
    - (1) In general.
    - (2) Dual use ratio.
  - (3) Example.
- (e) Determination of adjusted basis of specified tangible property.
  - (1) In general.
  - (2) Effect of change in law.
  - (3) Specified tangible property placed in service before enactment of section 951A.
- (f) Special rules for short taxable years.
  - (1) In general.
  - (2) Determination of quarter closes.
  - (3) Reduction of qualified business asset investment.
- (4) Example.
- (g) Partnership property.
  - (1) In general.
  - (2) Definitions related to partnership QBAI.
    - (i) In general.
    - (ii) Partnership QBAI ratio.
    - (iii) Partnership specified tangible property.
      - (3) Determination of adjusted basis.
      - (4) Examples.
  - (h) Anti-abuse rules for certain transfers of property.
    - (1) Disregard of basis in specified tangible property held temporarily.
    - (2) Disregard of basis in specified tangible property related to transfers during the disqualified period.
      - (i) In general.
      - (ii) Determination of disqualified basis.
        - (A) In general.
        - (B) Definition of qualified gain amount.
        - (C) Definition of disqualified transfer.
        - (D) Definition of disqualified period.
        - (E) Related person.

**§ 1.951A-4 Tested interest expense and tested interest income.**

- (a) Scope.
- (b) Definitions related to specified interest expense.
  - (1) Tested interest expense.
    - (i) In general.
  - (ii) Interest expense.
  - (iii) Qualified interest expense.
  - (iv) Qualified CFC.
    - (2) Tested interest income.
      - (i) In general.

- (ii) Interest income.
- (iii) Qualified interest income.
- (c) Examples.

**§ 1.951A-5 Domestic partnerships and their partners.**

- (a) Scope.
- (b) In general.
  - (1) Determination of GILTI inclusion amount of a U.S. shareholder partnership.
  - (2) Determination of distributive share of U.S. shareholder partnership's GILTI inclusion amount of partner other than a U.S. shareholder partner.
  - (c) Determination of GILTI inclusion amount of a U.S. shareholder partner.
  - (d) Tiered U.S. shareholder partnerships.
    - (e) Definitions.
      - (1) CFC tested item.
      - (2) Partnership CFC.
      - (3) U.S. shareholder partner.
      - (4) U.S. shareholder partnership.
    - (f) Reporting requirement.
    - (g) Examples.

**§ 1.951A-6 Treatment of GILTI inclusion amount and adjustments to earnings and profits and basis related to tested loss CFCs.**

- (a) Scope.
- (b) Treatment as subpart F income for certain purposes.
  - (1) In general.
  - (2) Allocation of GILTI inclusion amount to tested income CFCs.
    - (i) In general.
    - (ii) Example.
    - (iii) Translation of portion of GILTI inclusion amount allocated to tested income CFC.
- (c) Treatment as an amount includible in the gross income of a United States person.
  - (1) In general.
  - (2) Special rule for a United States shareholder that is a domestic partnership.
    - (d) Increase of earnings and profits of tested loss CFC for purposes of section 952(c)(1)(A).
    - (e) Adjustments to basis related to net used tested loss.
      - (1) In general.
      - (i) Disposition of stock of a controlled foreign corporation.
      - (ii) Disposition of stock of an upper-tier controlled foreign corporation.
      - (iii) Disposition of an interest in a foreign entity other than a controlled foreign corporation.
      - (iv) Order of application of basis reductions.
      - (v) No duplicative adjustments.
- (2) Net used tested loss amount.
  - (i) In general.
  - (ii) Used tested loss amount.
  - (3) Net offset tested income amount.

- (i) In general.
- (ii) Offset tested income amount.
- (4) Attribution to stock.
- (i) In general.
- (ii) Nonrecognition transactions.
- (5) Section 381 transactions.
- (6) Other definitions.
- (i) Domestic corporation.
- (ii) Disposition.
- (7) Special rule for disposition by controlled foreign corporation less than 100 percent owned by a single domestic corporation.
- (8) Special rules for members of a consolidated group.
- (9) Examples.

#### § 1.951A-7 Applicability dates.

■ **Par. 4.** Section 1.951A-1 is added to read as follows:

#### § 1.951A-1 General provisions.

(a) *Overview*—(1) *In general.* This section and §§ 1.951A-2 through 1.951A-7 (collectively, the *section 951A regulations*) provide rules to determine a United States shareholder's income inclusion under section 951A and certain definitions for purposes of section 951A and the section 951A regulations. This section provides general rules for determining a United States shareholder's inclusion of global intangible low-taxed income. Section 1.951A-2 provides rules for determining a controlled foreign corporation's tested income or tested loss. Section 1.951A-3 provides rules for determining a controlled foreign corporation's qualified business asset investment. Section 1.951A-4 provides rules for determining a controlled foreign corporation's tested interest expense and tested interest income. Section 1.951A-5 provides rules relating to the application of section 951A and the section 951A regulations to domestic partnerships and their partners. Section 1.951A-6 provides rules relating to the treatment of the inclusion of global intangible low-taxed income for certain purposes and adjustments to earnings and profits and basis of a controlled foreign corporation related to a tested loss. Section 1.951A-7 provides dates of applicability.

(2) *Scope.* Paragraph (b) of this section provides the general rule requiring a United States shareholder to include in gross income its global intangible low-taxed income for a U.S. shareholder inclusion year. Paragraph (c) of this section provides rules for determining the amount of a United States shareholder's global intangible low-taxed income for the U.S. shareholder inclusion year, including a rule for the application of section 951A and the section 951A regulations to

consolidated groups. Paragraph (d) of this section provides rules for determining a United States shareholder's pro rata share of certain items for purposes of determining the United States shareholder's global intangible low-taxed income. Paragraph (e) of this section provides additional general definitions for purposes of this section and the section 951A regulations.

(b) *Inclusion of global intangible low-taxed income.* Each person who is a United States shareholder (as defined in section 951(b)) of any controlled foreign corporation (as defined in section 957) and owns section 958(a) stock (as defined in paragraph (e)(3) of this section) in any such controlled foreign corporation includes in gross income in the U.S. shareholder inclusion year (as defined in paragraph (e)(4) of this section) the shareholder's GILTI inclusion amount (as defined in paragraph (c) of this section), if any, for the U.S. shareholder inclusion year.

(c) *Determination of GILTI inclusion amount*—(1) *In general.* Except as provided in paragraph (c)(4) of this section, the term *GILTI inclusion amount* means, with respect to a United States shareholder and a U.S. shareholder inclusion year, the excess (if any) of—

(i) The shareholder's net CFC tested income (as defined in paragraph (c)(2) of this section) for the year, over

(ii) The shareholder's net deemed tangible income return (as defined in paragraph (c)(3) of this section) for the year.

(2) *Definition of net CFC tested income.* The term *net CFC tested income* means, with respect to a United States shareholder and a U.S. shareholder inclusion year, the excess (if any) of—

(i) The aggregate of the shareholder's pro rata share of the tested income of each tested income CFC (as defined in § 1.951A-2(b)(1)) for the year, over

(ii) The aggregate of the shareholder's pro rata share of the tested loss of each tested loss CFC (as defined in § 1.951A-2(b)(2)) for the year.

(3) *Definition of net deemed tangible income return*—(i) *In general.* The term *net deemed tangible income return* means, with respect to a United States shareholder and a U.S. shareholder inclusion year, the excess (if any) of—

(A) The shareholder's deemed tangible income return (as defined in paragraph (c)(3)(ii) of this section) for the year, over

(B) The shareholder's specified interest expense (as defined in paragraph (c)(3)(iii) of this section) for the year.

(ii) *Definition of deemed tangible income return.* The term *deemed tangible income return* means, with respect to a United States shareholder and a U.S. shareholder inclusion year, 10 percent of the aggregate of the shareholder's pro rata share of the qualified business asset investment (as defined in § 1.951A-3(b)) of each tested income CFC for the year.

(iii) *Definition of specified interest expense.* The term *specified interest expense* means, with respect to a United States shareholder and a U.S. shareholder inclusion year, the excess (if any) of—

(A) The aggregate of the shareholder's pro rata share of the tested interest expense (as defined in § 1.951A-4(b)(1)) of each controlled foreign corporation for the year, over

(B) The aggregate of the shareholder's pro rata share of the tested interest income (as defined in § 1.951A-4(b)(2)) of each controlled foreign corporation for the year.

(4) *Determination of GILTI inclusion amount for consolidated groups.* For purposes of section 951A and the section 951A regulations, a member of a consolidated group (as defined in § 1.1502-1(h)) determines its GILTI inclusion amount under the rules provided in § 1.1502-51.

(d) *Determination of pro rata share*—(1) *In general.* For purposes of paragraph (c) of this section, each United States shareholder that owns section 958(a) stock in a controlled foreign corporation as of a CFC inclusion date (as defined in paragraph (e)(1) of this section) determines for a U.S. shareholder inclusion year that includes such CFC inclusion date its pro rata share (if any) of the controlled foreign corporation's tested income, tested loss, qualified business asset investment, tested interest expense, and tested interest income (each a *CFC tested item*), as applicable, for the CFC inclusion year (as defined in paragraph (e)(2) of this section). Except as otherwise provided in this paragraph (d), a United States shareholder's pro rata share of each CFC tested item is determined independently of its pro rata share of any other CFC tested item. Except as modified in this paragraph (d), a United States shareholder's pro rata share of any CFC tested item is determined under the rules of section 951(a)(2) and § 1.951-1(b) and (e) in the same manner as those provisions apply to subpart F income. Under section 951(a)(2) and § 1.951-1(b) and (e), as modified by this paragraph (d), a United States shareholder's pro rata share of any CFC tested item for a U.S. shareholder inclusion year is

determined with respect to the section 958(a) stock of the controlled foreign corporation owned by the United States shareholder on the CFC inclusion date. A United States shareholder's pro rata share of any CFC tested item is translated into United States dollars using the average exchange rate for the CFC inclusion year of the controlled foreign corporation. Paragraphs (d)(2) through (5) of this section provide rules for determining a United States shareholder's pro rata share of each CFC tested item of a controlled foreign corporation.

(2) *Tested income*—(i) *In general*. Except as provided in paragraph (d)(2)(ii) of this section, a United States shareholder's pro rata share of the tested income of each tested income CFC for a U.S. shareholder inclusion year is determined under section 951(a)(2) and § 1.951-1(b) and (e), substituting "tested income" for "subpart F income" each place it appears, other than in § 1.951-1(e)(1)(ii)(B).

(ii) *Special rule for prior allocation of tested loss*. In any case in which tested loss has been allocated to any class of stock in a prior CFC inclusion year under paragraph (d)(4)(iii) of this section, tested income is first allocated to each such class of stock in the order of its liquidation priority to the extent of the excess (if any) of the sum of the tested loss allocated to each such class of stock for each prior CFC inclusion year under paragraph (d)(4)(iii) of this section, over the sum of the tested income allocated to each such class of stock for each prior CFC inclusion year under this paragraph (d)(2)(ii). Paragraph (d)(2)(i) of this section applies for purposes of determining a United States shareholder's pro rata share of the remainder of the tested income, except that, for purposes of the hypothetical distribution of section 951(a)(2)(A) and § 1.951-1(b) and (e), the amount of current earnings and profits of the tested income CFC is reduced by the amount of tested income allocated under the first sentence of this paragraph (d)(2)(ii). For an example of the application of this paragraph (d)(2), see *Example 2* of paragraph (d)(4)(iv) of this section.

(3) *Qualified business asset investment*—(i) *In general*. Except as provided in paragraph (d)(3)(ii) of this section, a United States shareholder's pro rata share of the qualified business asset investment of a tested income CFC for a U.S. shareholder inclusion year bears the same ratio to the total qualified business asset investment of the tested income CFC for the CFC inclusion year as the United States shareholder's pro rata share of the tested

income of the tested income CFC for the U.S. shareholder inclusion year bears to the total tested income of the tested income CFC for the CFC inclusion year.

(ii) *Special rule for preferred stock in case of excess QBAI*. If a tested income CFC's qualified business asset investment for a CFC inclusion year exceeds 10 times its tested income for the CFC inclusion year (such excess, *excess QBAI*), a United States shareholder's pro rata share of the tested income CFC's qualified business asset investment is the sum of its pro rata share determined under paragraph (d)(3)(i) of this section without regard to the excess QBAI, plus its pro rata share determined under paragraph (d)(3)(i) of this section solely with respect to the excess QBAI and without regard to tested income allocated to any share of preferred stock of the tested income CFC under paragraph (d)(2) of this section.

(iii) *Examples*. The following examples illustrate the application of paragraphs (d)(2) and (3) of this section. See also § 1.951-1(e)(7), *Example 6* (illustrating a United States shareholder's pro rata share of tested income).

(A) *Example 1—(1) Facts*. FS, a controlled foreign corporation, has outstanding 70 shares of common stock and 30 shares of 4% nonparticipating, cumulative preferred stock with a par value of \$10x per share. P Corp, a domestic corporation and a United States shareholder of FS, owns all of the common shares. Individual A, a United States shareholder, owns all of the preferred shares. Both FS and P Corp use the calendar year as their taxable year. Individual A and P Corp are shareholders of FS for all of Year 4. At the beginning of Year 4, FS had no dividend arrearages with respect to its preferred stock. For Year 4, FS has \$100x of earnings and profits, \$120x of tested income, and no subpart F income within the meaning of section 952. FS also has \$750x of qualified business asset investment for Year 4.

(2) *Analysis*—(i) *Determination of pro rata share of tested income*. For purposes of determining P Corp's pro rata share of FS's tested income under paragraph (d)(2) of this section, the amount of FS's current earnings and profits for purposes of the hypothetical distribution described in § 1.951-1(e)(1)(i) is \$120x, the greater of its earnings and profits as determined under section 964 (\$100x) or the sum of its subpart F income and tested income (\$0 + \$120x). Under paragraph (d)(2) of this section and § 1.951-1(e)(3), the amount of FS's current earnings and profits distributed in the hypothetical distribution is \$12x (.04 × \$10x × 30) with respect to Individual A's preferred shares and \$108x (\$120x - \$12x) with respect to P Corp's common shares. Accordingly, under paragraph (d)(2) of this section and § 1.951-1(e)(1), Individual A's pro rata share of FS's tested income is \$12x, and P Corp's pro rata share of FS's tested income is \$108x for Year 4.

(ii) *Determination of pro rata share of qualified business asset investment*. The special rule of paragraph (d)(3)(ii) of this section does not apply because FS's qualified business asset investment of \$750x does not exceed \$1,200x, which is 10 times FS's tested income of \$120x. Accordingly, under the general rule of paragraph (d)(3)(i) of this section, Individual A's and P Corp's pro rata share of FS's qualified business asset investment bears the same ratio to FS's total qualified business asset investment as Individual A's and P Corp's pro rata share, respectively, of FS's tested income bears to FS's total tested income. Thus, Individual A's pro rata share of FS's qualified business asset investment is \$75x (\$750x × \$12x/\$120x), and P Corp's pro rata share of FS's qualified business asset investment is \$675x (\$750x × \$108x/\$120x).

(B) *Example 2—(1) Facts*. The facts are the same as in paragraph (1) of *Example 1*, except that FS has \$1,500x of qualified business asset investment for Year 4.

(2) *Analysis*. (i) *Determination of pro rata share of tested income*. The analysis and the result are the same as in paragraph (2)(i) of *Example 1*.

(ii) *Determination of pro rata share of qualified business asset investment*. The special rule of paragraph (d)(3)(ii) of this section applies because FS's qualified business asset investment of \$1,500x exceeds \$1,200x, which is 10 times FS's tested income of \$120x. Under paragraph (d)(3)(ii) of this section, Individual A's and P Corp's pro rata share of FS's qualified business asset investment is the sum of their pro rata share determined under paragraph (d)(3)(i) of this section without regard to the excess QBAI plus their pro rata share with respect to the excess QBAI but without regard to tested income allocated to preferred stock under paragraph (d)(2) of this section. Without regard to the excess QBAI of \$300x, Individual A's pro rata share of FS's qualified business asset investment is \$120x (\$1,200x × \$12x/\$120x), and P Corp's pro rata share of FS's qualified business asset investment is \$1,080x (\$1,200x × \$108x/\$120x). Solely with respect to the excess QBAI and without regard to tested income allocated to the preferred stock under paragraph (d)(2) of this section, Individual A's pro rata share of FS's qualified business asset investment is \$0 (\$300x × \$0/\$108x), and P Corp's pro rata share of FS's qualified business asset investment is \$300x (\$300x × \$108x/\$108x). Thus, Individual A's pro rata share of FS's qualified business asset investment is \$120x (\$120x + \$0), and P Corp's pro rata share of FS's qualified business asset investment is \$1,380x (\$1,080x + \$300x).

(4) *Tested loss*—(i) *In general*. A United States shareholder's pro rata share of the tested loss of each tested loss CFC for a U.S. shareholder inclusion year is determined under section 951(a)(2) and § 1.951-1(b) and (e) with the following modifications—

(A) "Tested loss" is substituted for "subpart F income" each place it appears;

(B) For purposes of the hypothetical distribution described in section

951(a)(2)(A) and § 1.951-1(e)(1)(i), the amount of current earnings and profits of a controlled foreign corporation for a CFC inclusion year is treated as being equal to the tested loss of the tested loss CFC for the CFC inclusion year;

(C) Except as provided in paragraphs (d)(4)(ii) and (iii) of this section, the hypothetical distribution described in section 951(a)(2)(A) and § 1.951-1(e)(1)(i) is treated as made solely with respect to the common stock of the tested loss CFC; and

(D) The amount of the dividend received by any other person for purposes of section 951(a)(2)(B) and § 1.951-1(b)(1)(ii) is treated as being equal to the amount of the tested loss of the tested loss CFC for the CFC inclusion year (regardless of whether, or the extent to which, the other person actually receives a dividend).

(ii) *Special rule in case of accrued but unpaid dividends.* If a tested loss CFC's earnings and profits that have accumulated since the issuance of preferred shares are reduced below the amount necessary to satisfy any accrued but unpaid dividends with respect to such preferred shares, then the amount by which the tested loss reduces the earnings below the amount necessary to satisfy the accrued but unpaid dividends is distributed in the hypothetical distribution described in section 951(a)(2)(A) and § 1.951-1(e)(1)(i) with respect to the preferred stock of the tested loss CFC and the remainder of the tested loss is distributed with respect to the common stock of the tested loss CFC.

(iii) *Special rule for stock with no liquidation value.* If a tested loss CFC's common stock has a liquidation value of zero and there is at least one other class of equity with a liquidation preference relative to the common stock, then the tested loss is distributed in the hypothetical distribution described in section 951(a)(2)(A) and § 1.951-1(e)(1)(i) with respect to the most junior class of equity with a positive liquidation value to the extent of such liquidation value. Thereafter, tested loss is distributed with respect to the next most junior class of equity to the extent of its liquidation value and so on. All determinations of liquidation value are to be made as of the beginning of the CFC inclusion year of the tested loss CFC.

(iv) *Examples.* The following examples illustrate the application of this paragraph (d)(4). See also § 1.951-1(e)(7), *Example 7* (illustrating a United States shareholder's pro rata share of subpart F income and tested loss).

(A) *Example—(1) Facts.* FS, a controlled foreign corporation, has outstanding 70

shares of common stock and 30 shares of 4% nonparticipating, cumulative preferred stock with a par value of \$10x per share. P Corp, a domestic corporation and a United States shareholder of FS, owns all of the common shares. Individual A, a United States citizen and a United States shareholder, owns all of the preferred shares. FS, Individual A, and P Corp all use the calendar year as their taxable year. Individual A and P Corp are shareholders of FS for all of Year 5. At the beginning of Year 5, FS had earnings and profits of \$120x, which accumulated after the issuance of the preferred stock. At the end of Year 5, the accrued but unpaid dividends with respect to the preferred stock are \$36x. For Year 5, FS has a \$100x tested loss, and no other items of income, gain, deduction or loss. At the end of Year 5, FS has earnings and profits of \$20x.

(2) *Analysis.* FS is a tested loss CFC for Year 5. Before taking into account the tested loss in Year 5, FS had sufficient earnings and profits to satisfy the accrued but unpaid dividends of \$36x. The amount of the reduction in earnings below the amount necessary to satisfy the accrued but unpaid dividends attributable to the tested loss is \$16x (\$36x - \$120x - \$100x). Accordingly, under paragraph (d)(4)(ii) of this section, Individual A's pro rata share of the Year 5 tested loss is \$16x, and P Corp's pro rata share of the tested loss is \$84x (\$100x - \$16x).

(B) *Example 2—(1) Facts.* FS, a controlled foreign corporation, has outstanding 100 shares of common stock and 50 shares of 4% nonparticipating, cumulative preferred stock with a par value of \$100x per share. P Corp, a domestic corporation and a United States shareholder of FS, owns all of the common shares. Individual A, a United States citizen and a United States shareholder, owns all of the preferred shares. FS, Individual A, and P Corp all use the calendar year as their taxable year. Individual A and P Corp are shareholders of FS for all of Year 1 and Year 2. At the beginning of Year 1, the common stock had no liquidation value and the preferred stock had a liquidation value of \$5,000x and no accrued but unpaid dividends. In Year 1, FS has a tested loss of \$1,000x and no other items of income, gain, deduction, or loss. In Year 2, FS has tested income of \$3,000x and no other items of income, gain, deduction, or loss and paid no dividends. FS has earnings and profits of \$3,000x for Year 2. At the end of Year 2, FS has accrued but unpaid dividends of \$400x with respect to the preferred stock (\$5000x × 0.04 for Year 1 and \$5000x × 0.04 for Year 2).

(2) *Analysis—(i) Year 1.* FS is a tested loss CFC in Year 1. The common stock of FS has liquidation value of zero and the preferred stock has a liquidation preference relative to the common stock. The tested loss (\$1,000x) does not exceed the liquidation value of the preferred stock (\$5,000x). Accordingly, under paragraph (d)(4)(iii) of this section, the tested loss is distributed with respect to the preferred stock in the hypothetical distribution described in section 951(a)(2)(A) and § 1.951-1(e). Individual A's pro rata share of the tested loss is \$1,000x, and P Corp's pro rata share of the tested loss is \$0.

(ii) *Year 2.* FS is a tested income CFC in Year 2. Because \$1,000x of tested loss was

allocated to the preferred stock in Year 1 under paragraph (d)(4)(iii) of this section, the first \$1,000x of tested income in Year 2 is allocated to the preferred stock under paragraph (d)(2)(ii) of this section. P Corp's and Individual A's pro rata shares of the remaining \$2,000x of tested income are determined under the general rule of paragraph (d)(2)(i) of this section, except that for purposes of the hypothetical distribution the amount of FS's current earnings and profits is reduced by the tested income allocated under paragraph (d)(2)(ii) of this section to \$2,000x (\$3,000x - \$1,000x). Accordingly, under paragraph (d)(2)(i) of this section, the amount of FS's current earnings and profits distributed in the hypothetical distribution with respect to Individual A's preferred stock is \$400x (\$400x of accrued but unpaid dividends) and with respect to P Corp's common stock is \$1,600x (\$2,000x - \$400x). Individual A's pro rata share of the tested income is \$1,400x (\$1,000x + \$400x), and P Corp's pro rata share of the tested income is \$1,600x.

(5) *Tested interest expense.* A United States shareholder's pro rata share of tested interest expense of a controlled foreign corporation for a U.S. shareholder inclusion year is equal to the amount by which the tested interest expense reduces the shareholder's pro rata share of tested income of the controlled foreign corporation for the U.S. shareholder inclusion year, increases the shareholder's pro rata share of tested loss of the controlled foreign corporation for the U.S. shareholder inclusion year, or both.

(6) *Tested interest income.* A United States shareholder's pro rata share of tested interest income of a controlled foreign corporation for a U.S. shareholder inclusion year is equal to the amount by which the tested interest income increases the shareholder's pro rata share of tested income of the controlled foreign corporation for the U.S. shareholder inclusion year, reduces the shareholder's pro rata share of tested loss of the controlled foreign corporation for the U.S. shareholder inclusion year, or both.

(e) *Definitions.* This paragraph (e) provides additional definitions that apply for purposes of the section 951A regulations. Other definitions relevant to the section 951A regulations are included in §§ 1.951A-2 through 1.951A-6.

(1) *CFC inclusion date.* The term *CFC inclusion date* means the last day of a CFC inclusion year on which a foreign corporation is a controlled foreign corporation.

(2) *CFC inclusion year.* The term *CFC inclusion year* means any taxable year of a foreign corporation beginning after December 31, 2017, at any time during which the corporation is a controlled foreign corporation.



(3) *Section 958(a) stock.* The term *section 958(a) stock* means stock of a controlled foreign corporation owned (directly or indirectly) by a United States shareholder within the meaning of section 958(a).

(4) *U.S. shareholder inclusion year.* The term *U.S. shareholder inclusion year* means a taxable year of a United States shareholder that includes a CFC inclusion date of a controlled foreign corporation of the United States shareholder.

■ **Par. 5.** Section 1.951A-2 is added to read as follows:

**§ 1.951A-2 Tested income and tested loss.**

(a) *Scope.* This section provides general rules for determining the tested income or tested loss of a controlled foreign corporation for purposes of determining a United States shareholder's net CFC tested income under § 1.951A-1(c)(2). Paragraph (b) of this section provides definitions related to tested income and tested loss. Paragraph (c) of this section provides rules for determining the gross tested income of a controlled foreign corporation and the deductions that are properly allocable to gross tested income.

(b) *Definitions related to tested income and tested loss—(1) Tested income and tested income CFC.* The term *tested income* means the excess (if any) of a controlled foreign corporation's gross tested income for a CFC inclusion year, over the allowable deductions (including taxes) properly allocable to the gross tested income for the CFC inclusion year (a controlled foreign corporation with tested income for a CFC inclusion year, a *tested income CFC*).

(2) *Tested loss and tested loss CFC.* The term *tested loss* means the excess (if any) of a controlled foreign corporation's allowable deductions (including taxes) properly allocable to gross tested income (or that would be allocable to gross tested income if there were gross tested income) for a CFC inclusion year, over the gross tested income of the controlled foreign corporation for the CFC inclusion year (a controlled foreign corporation without tested income for a CFC inclusion year, a *tested loss CFC*).

(c) *Rules relating to the determination of tested income and tested loss—(1) Definition of gross tested income.* The term *gross tested income* means the gross income of a controlled foreign corporation for a CFC inclusion year determined without regard to—

(i) Items of income described in section 952(b),

(ii) Gross income taken into account in determining the subpart F income of the corporation,

(iii) Gross income excluded from the foreign base company income (as defined in section 954) or the insurance income (as defined in section 953) of the corporation solely by reason of an election made under section 954(b)(4) and § 1.954-1(d)(5),

(iv) Dividends received by the corporation from related persons (as defined in section 954(d)(3)), and

(v) Foreign oil and gas extraction income (as defined in section 907(c)(1)) of the corporation.

(2) *Determination of gross income and allowable deductions.* For purposes of determining tested income and tested loss, the gross income and allowable deductions of a controlled foreign corporation for a CFC inclusion year are determined under the rules of § 1.952-2 for determining the subpart F income of a controlled foreign corporation.

(3) *Allocation of deductions to gross tested income.* Any deductions of a controlled foreign corporation allowable under paragraph (c)(2) of this section are allocated and apportioned to gross tested income under the principles of section 954(b)(5) and § 1.954-1(c), by treating gross tested income that falls within a single separate category (as defined in § 1.904-5(a)(1)) as a single item of gross income, in addition to the items set forth in § 1.954-1(c)(1)(iii).

(4) *Nonapplication of section 952(c)—(i) In general.* The gross tested income and allowable deductions properly allocable to gross tested income of a controlled foreign corporation for a CFC inclusion year are determined without regard to the application of section 952(c).

(ii) *Example.* The following example illustrates the application of this paragraph (c)(4).

(A) *Example—(1) Facts.* A Corp, a domestic corporation, owns 100% of the single class of stock of FS, a controlled foreign corporation. Both A Corp and FS use the calendar year as their taxable year. In Year 1, FS has foreign base company income of \$100x, a loss in foreign oil and gas extraction income of \$100x, and earnings and profits of \$0. FS has no other income. In Year 2, FS has gross income of \$100x and earnings and profits of \$100x. Without regard to section 952(c)(2), in Year 2 FS has no income described in any of the categories of income excluded from gross tested income in paragraphs (c)(1)(i) through (v) of this section. FS has no allowable deductions properly allocable to gross tested income for Year 2. (2) *Analysis.* As a result of the earnings and profits limitation of section 952(c)(1), FS has no subpart F income in Year 1, and A Corp has no inclusion with respect to FS under section 951(a)(1)(A). Under paragraph (c)(4)(i) of this

section, the gross tested income of FS is determined without regard to section 952(c)(1). Therefore, in determining the gross tested income of FS in Year 1, the \$100x foreign base company income of FS in Year 1 is excluded under paragraph (c)(1)(ii) of this section, and FS has no gross tested income in Year 1. In Year 2, under section 952(c)(2), FS's earnings and profits (\$100x) in excess of its subpart F income (\$0) are treated as subpart F income. Therefore, FS has subpart F income of \$100x in Year 2, and A Corp has an inclusion of \$100x with respect to FS under section 951(a)(1)(A). Under paragraph (c)(4)(i) of this section, the gross tested income of FS is determined without regard to section 952(c)(2). Accordingly, FS's income in Year 2 is not subpart F income described in paragraph (c)(1)(ii) of this section, and FS has \$100x of gross tested income in Year 2.

(5) *Disregard of basis in property related to certain transfers during the disqualified period—(i) In general.* Any deduction or loss attributable to disqualified basis of any specified property allocated and apportioned to gross tested income under paragraph (c)(3) of this section is disregarded for purposes of determining tested income or tested loss of a controlled foreign corporation. For purposes of this paragraph (c)(5), in the case that a deduction or loss arises with respect to specified property with disqualified basis and adjusted basis other than disqualified basis, the deduction or loss is treated as attributable to the disqualified basis in the same proportion that the disqualified basis bears to the total adjusted basis of the property.

(ii) *Definition of specified property.* The term *specified property* means property that is of a type with respect to which a deduction is allowable under section 167 or 197.

(iii) *Definition of disqualified basis.* Solely for purposes of paragraph (c)(5)(i) of this section, the term *disqualified basis* has the meaning set forth in § 1.951A-3(h)(2)(ii) (including with respect to property owned by a partnership by reason of § 1.951A-3(g)(3)), except that, in applying the provisions of § 1.951A-3(h)(2) to determine the disqualified basis, the term "specified property" is substituted for "specified tangible property" and the term "controlled foreign corporation" is substituted for "tested income CFC" each place they appear.

(iv) *Example—(A) Facts.* USP, a domestic corporation, owns all of the stock of CFC1 and CFC2, each a controlled foreign corporation. Both USP and CFC1 use the calendar year as their taxable year. CFC2 uses a taxable year ending November 30. On November 1, 2018, before the start of its first CFC inclusion year, CFC2 sells intangible property to CFC1 that is amortizable under

section 197 in exchange for \$100x of cash. The intangible property has a basis of \$20x in the hands of CFC2, and CFC2 recognizes \$80x of gain as a result of the sale (\$100x – \$20x). CFC2's gain is not subject to U.S. tax or taken into account in determining USP's inclusion under section 951(a)(1)(A).

(B) *Analysis.* The sale by CFC1 is a disqualified transfer (within the meaning of § 1.951A–3(h)(2)(ii)(C), as modified by paragraph (c)(5)(iii) of this section) because it is a transfer of specified property, CFC2 and CFC1 are related persons, and the transfer occurs during the disqualified period (within the meaning of § 1.951A–3(h)(2)(ii)(D)). The disqualified basis is \$80x, the excess of CFC1's adjusted basis in the property immediately after the disqualified transfer (\$100x), over the sum of CFC2's basis in the property immediately before the transfer (\$20x) and the qualified gain amount (as defined in § 1.951A–3(h)(2)(ii)(B)) (\$0). Accordingly, under paragraph (c)(5)(i) of this section, any deduction or loss attributable to the disqualified basis is disregarded for purposes of determining the tested income or tested loss of any CFC for any CFC inclusion year.

■ **Par. 6.** Section 1.951A–3 is added to read as follows:

**§ 1.951A–3 Qualified business asset investment.**

(a) *Scope.* This section provides general rules for determining the qualified business asset investment of a controlled foreign corporation for purposes of determining a United States shareholder's deemed tangible income return under § 1.951A–1(c)(3)(ii). Paragraph (b) of this section defines qualified business asset investment. Paragraph (c) of this section defines tangible property and specified tangible property. Paragraph (d) of this section provides rules and examples for determining the portion of property that is specified tangible property when the property is used in the production of both gross tested income and gross income that is not gross tested income. Paragraph (e) of this section provides rules for determining the adjusted basis of specified tangible property. Paragraph (f) of this section provides rules for determining qualified business asset investment of a tested income CFC with a short taxable year. Paragraph (g) of this section provides rules and examples for increasing the qualified business asset investment of a tested income CFC by reason of property owned through a partnership. Paragraph (h) of this section provides anti-abuse rules that disregard the basis of specified tangible property transferred in certain transactions when determining the qualified business asset investment of a tested income CFC.

(b) *Definition of qualified business asset investment.* The term *qualified*

*business asset investment* means the average of a tested income CFC's aggregate adjusted bases as of the close of each quarter of a CFC inclusion year in specified tangible property that is used in a trade or business of the tested income CFC and is of a type with respect to which a deduction is allowable under section 167. A tested loss CFC has no qualified business asset investment. See paragraph (f) of this section for rules relating to the qualified business asset investment of a tested income CFC with a short taxable year.

(c) *Specified tangible property—(1) In general.* The term *specified tangible property* means, subject to paragraph (d) of this section, tangible property used in the production of gross tested income. None of the tangible property of a tested loss CFC is specified tangible property.

(2) *Tangible property.* The term *tangible property* means property for which the depreciation deduction provided by section 167(a) is eligible to be determined under section 168 without regard to section 168(f)(1), (2), or (5) and the date placed in service.

(d) *Dual use property—(1) In general.* In the case of tangible property of a tested income CFC that is used in both the production of gross tested income and the production of gross income that is not gross tested income in a CFC inclusion year, the portion of the adjusted basis in the property treated as adjusted basis in specified tangible property for the CFC inclusion year is determined by multiplying the average of the tested income CFC's adjusted basis in the property by the dual use ratio with respect to the property for the CFC inclusion year.

(2) *Dual use ratio.* The term *dual use ratio* means, with respect to specified tangible property:

(i) In the case of specified tangible property that produces directly identifiable income for a CFC inclusion year, the ratio of the gross tested income produced by the property for the CFC inclusion year to the total amount of gross income produced by the property for the CFC inclusion year.

(ii) In the case of specified tangible property that does not produce directly identifiable income for a CFC inclusion year, the ratio of the gross tested income of the tested income CFC for the CFC inclusion year to the total amount of gross income of the tested income CFC for the CFC inclusion year.

(3) *Example.* The following example illustrates the application of this paragraph (d).

(i) *Example—(A) Facts.* FS is a tested income CFC. FS owns a machine that only packages Product A. In Year 1, FS sells Product A to related and unrelated resellers

and earns \$1,000x of gross income. For Year 1, sales of Product A produce gross tested income of \$750x and foreign base company sales income (as defined in section 954(d)) of \$250x. The average adjusted basis of the machine for Year 1 in the hands of FS is \$4,000x. FS also owns an office building for its administrative functions with an average adjusted basis for Year 1 of \$10,000x. The office building does not produce directly identifiable income. FS has no other specified tangible property. For year 1, FS also earns \$1,250x of gross tested income and \$2,750x of foreign base company sales income from sales of Product B. Neither the machine nor the office building is used in the production of income related to Product B. For Year 1, FS's gross tested income is \$2,000x and its total gross income is \$5,000x.

(B) *Analysis.* The machine and office building are both property for which the depreciation deduction provided by section 167(a) is eligible to be determined under section 168. Therefore, under paragraph (c)(2) of this section, the machine and office building are tangible property. Under paragraph (d)(1) of this section, the portion of the basis in the machine treated as basis in specified tangible property is equal to FS's average basis in the machine for the year (\$4,000x), multiplied by the dual use ratio under paragraph (d)(2)(i) of this section (75%), which is the proportion that the gross tested income produced by the property (\$750x) bears to the total gross income produced by the property (\$1,000x). Accordingly, \$3,000x (\$4,000x × 75%) of FS's adjusted basis in the machine is taken into account in determining the average of FS's aggregate adjusted bases described in paragraph (b) of this section. Under paragraph (d)(1) of this section, the portion of the basis in the office building treated as basis in specified tangible property is equal to FS's average basis in the office building for the year (\$10,000x), multiplied by the dual use ratio under paragraph (d)(2)(ii) of this section (40%), which is the ratio of FS's gross tested income for Year 1 (\$2,000x) to FS's total gross income for Year 1 (\$5,000x). Accordingly, \$4,000x (\$10,000x × 40%) of FS's adjusted basis in the office building is taken into account in determining the average of FS's aggregate adjusted bases described in paragraph (b) of this section.

(e) *Determination of adjusted basis of specified tangible property—(1) In general.* The adjusted basis in specified tangible property is determined by using the alternative depreciation system under section 168(g), and by allocating the depreciation deduction with respect to such property for the CFC inclusion year ratably to each day during the period in the taxable year to which such depreciation relates.

(2) *Effect of change in law.* The determination of adjusted basis for purposes of paragraph (b) of this section is made without regard to any provision of law enacted after December 22, 2017, unless such later enacted law specifically and directly amends the

definition of qualified business asset investment under section 951A.

(3) *Specified tangible property placed in service before enactment of section 951A.* The adjusted basis in property placed in service before December 22, 2017, is determined using the alternative depreciation system under section 168(g), as if this system had applied from the date that the property was placed in service.

(f) *Special rules for short taxable years—(1) In general.* In the case of a tested income CFC that has a CFC inclusion year that is less than twelve months (a *short taxable year*), the rules for determining the qualified business asset investment of the tested income CFC under this section are modified as provided in paragraphs (f)(2) and (3) of this section with respect to the CFC inclusion year.

(2) *Determination of quarter closes.* For purposes of determining quarter closes, in determining the qualified business asset investment of a tested income CFC for a short taxable year, the quarters of the tested income CFC for purposes of this section are the full quarters beginning and ending within the short taxable year (if any), determining quarter length as if the tested income CFC did not have a short taxable year, plus one or more short quarters (if any).

(3) *Reduction of qualified business asset investment.* The qualified business asset investment of a tested income CFC for a short taxable year is the sum of—

(i) The sum of the tested income CFC's aggregate adjusted bases in specified tangible property as of the close of each full quarter (if any) in the CFC inclusion year divided by four, plus

(ii) The tested income CFC's aggregate adjusted bases in specified tangible property as of the close of each short quarter (if any) in the CFC inclusion year multiplied by the sum of the number of days in each short quarter divided by 365.

(4) *Example.* The following example illustrates the application of this paragraph (f).

(i) *Example—(A) Facts.* USP1, a domestic corporation, owns all of the stock of FS, a controlled foreign corporation. USP1 owns FS from the beginning of Year 1. On July 15, Year 1, USP1 sells FS to USP2, an unrelated person. USP2 makes a section 338(g) election with respect to the purchase of FS, as a result of which FS's taxable year is treated as ending on July 15. USP1, USP2, and FS all use the calendar year as their taxable year. FS's aggregate adjusted bases in specified tangible property are \$250x as of March 31, \$300x as of June 30, \$275x as of July 15, \$500x as of September 30, and \$450x as of December 31.

(B) *Analysis—(1) Determination of short taxable years and quarters.* FS has two short taxable years in Year 1. The first short taxable year is from January 1 to July 15, with two full quarters (January 1–March 31 and April 1–June 30) and one short quarter (July 1–July 15). The second taxable year is from July 16 to December 31, with one short quarter (July 16–September 30) and one full quarter (October 1–December 31).

(2) *Calculation of qualified business asset investment for the first short taxable year.* Under paragraph (f)(2) of this section, for the first short taxable year in Year 1, FS has three quarter closes (March 31, June 30, and July 15). Under paragraph (f)(3) of this section, the qualified business asset investment of FS for the first short taxable year is \$148.80x, the sum of \$137.50x ( $(\$250x + \$300x)/4$ ) attributable to the two full quarters and \$11.30x ( $\$275x \times 15/365$ ) attributable to the short quarter.

(3) *Calculation of qualified business asset investment for the second short taxable year.* Under paragraph (f)(2) of this section, for the second short taxable year in Year 1, FS has two quarter closes (September 30 and December 31). Under paragraph (f)(3) of this section, the qualified business asset investment of FS for the second short taxable year is \$217.98x, the sum of \$112.50x ( $\$450x/4$ ) attributable to the one full quarter and \$105.48x ( $\$500x \times 77/365$ ) attributable to the short quarter.

(g) *Partnership property—(1) In general.* For purposes of paragraph (b) of this section, if a tested income CFC holds an interest in one or more partnerships as of the close of the CFC inclusion year, the qualified business asset investment of the tested income CFC for the CFC inclusion year is increased by the sum of the tested income CFC's partnership QBAI with respect to each partnership for the CFC inclusion year. A tested loss CFC has no partnership QBAI for a CFC inclusion year.

(2) *Definitions related to partnership QBAI—(i) In general.* The term *partnership QBAI* means the sum of the tested income CFC's share of the partnership's adjusted basis in partnership specified tangible property as of the close of a partnership taxable year that ends with or within a CFC inclusion year. A tested income CFC's share of the partnership's adjusted basis in partnership specified tangible property is determined separately with respect to each partnership specified tangible property of the partnership by multiplying the partnership's adjusted basis in the property by the partnership QBAI ratio with respect to the property. If the partnership's taxable year is less than twelve months, the principles of paragraph (f) of this section apply in determining a tested income CFC's partnership QBAI with respect to the partnership.

(ii) *Partnership QBAI ratio.* The term *partnership QBAI ratio* means, with respect to partnership specified tangible property:

(A) In the case of partnership specified tangible property that produces directly identifiable income for a partnership taxable year, the ratio of the tested income CFC's distributive share of the gross income produced by the property for the partnership taxable year that is included in the gross tested income of the tested income CFC for the CFC inclusion year to the total gross income produced by the property for the partnership taxable year.

(B) In the case of partnership specified tangible property that does not produce directly identifiable income for a partnership taxable year, the ratio of the tested income CFC's distributive share of the gross income of the partnership for the partnership taxable year that is included in the gross tested income of the tested income CFC for the CFC inclusion year to the total amount of gross income of the partnership for the partnership taxable year.

(iii) *Partnership specified tangible property.* The term *partnership specified tangible property* means tangible property (as defined in paragraph (c)(2) of this section) of a partnership that is—

(A) Used in the trade or business of the partnership,

(B) Of a type with respect to which a deduction is allowable under section 167, and

(C) Used in the production of tested income.

(3) *Determination of adjusted basis.* For purposes of this paragraph (g), a partnership's adjusted basis in partnership specified tangible property is determined based on the average of the partnership's adjusted basis in the property as of the close of each quarter in the partnership taxable year. The principles of paragraphs (e) and (h) of this section apply for purposes of determining a partnership's adjusted basis in partnership specified tangible property and the portion of such adjusted basis taken into account in determining a tested income CFC's partnership QBAI.

(4) *Examples.* The following examples illustrate the rules of this paragraph (g).

(i) *Example 1—(A) Facts.* FC, a tested income CFC, is a partner in PRS. Both FC and PRS use the calendar year as their taxable year. PRS owns two assets, Asset A and Asset B, both of which are tangible property used in PRS's trade or business that it depreciates under section 168. The average of PRS's adjusted basis as of the close of each quarter of PRS's taxable year in Asset A is \$100x and the average of PRS's adjusted basis as of the end of each quarter of PRS's taxable year in

Asset B is \$50x. Asset A produces \$10x of directly identifiable gross income in Year 1, and Asset B produces \$50x of directly identifiable gross income in Year 1. FC's distributive share of the gross income from Asset A is \$8x and its distributive share of the gross income from Asset B is \$10x. FC's entire distributive share of income from Asset A and Asset B is included in FC's gross tested income for Year 1. PRS partners' distributive shares satisfy the requirements of section 704.

(B) *Analysis.* Each of Asset A and Asset B is partnership specified tangible property because each is tangible property, of a type with respect to which a deduction is allowable under section 167, used in PRS's trade or business, and used in the production of tested income. FC's partnership QBAI ratio for Asset A is 80%, the ratio of FC's distributive share of the gross income from Asset A for Year 1 that is included in FC's gross tested income (\$8x) to the total gross income produced by Asset A for Year 1 (\$10x). FC's partnership QBAI ratio for Asset B is 20%, the ratio of FC's distributive share of the gross income from Asset B for Year 1 that is included in FC's gross tested income (\$10x) to the total gross income produced by Asset B for Year 1 (\$50x). FC's share of the average of PRS's adjusted basis of Asset A is \$80x, PRS's adjusted basis in Asset A of \$100x multiplied by FC's partnership QBAI ratio for Asset A of 80%. FC's share of the average of PRS's adjusted basis of Asset B is \$10x, PRS's adjusted basis in Asset B of \$50x multiplied by FC's partnership QBAI ratio for Asset B of 20%. Therefore, FC's partnership QBAI with respect to PRS is \$90x (\$80x + \$10x). Accordingly, under paragraph (g)(1) of this section, FC increases its qualified business asset investment for Year 1 by \$90x.

(ii) *Example 2—(A) Facts.* FC, a tested income CFC, owns a 50% interest in PRS. PRS owns Asset A, which is specified tangible property. The average of PRS's adjusted basis as of the close of each quarter of PRS's taxable year in Asset A is \$100x. FC has the same taxable year as PRS. Asset A produces \$20x of directly identifiable gross income in Year 1, and PRS has \$22x of expenses in Year 1 that are properly allocable to such income. Therefore, FC's allocation of net income or loss from PRS is \$1x loss, which is comprised of FC's distributive share of the gross income from Asset A of \$10x, all of which is included in FC's gross tested income for Year 1, and FC's distributive share of the expenses related to Asset A of \$11x, all of which is taken into account in determining its tested income under § 1.951-2(c). PRS has no other income or loss in Year 1. FC also has \$8x of gross tested income from other sources in Year 1, and no deductions properly allocable to such income. PRS partners' distributive shares satisfy the requirements of section 704.

(B) *Analysis.* FC's partnership QBAI ratio for Asset A is 50%, the ratio of FC's distributive share of the gross income from Asset A for Year 1 that is included in FC's gross tested income (\$10x) to the total gross income produced by Asset A for Year 1 (\$20x). FC's share of the average of PRS's adjusted basis in Asset A is \$50x, PRS's adjusted basis in Asset A of \$100x multiplied

by FC's partnership QBAI ratio for Asset A of 50%. FC increases its qualified business asset investment by \$50x, notwithstanding that FC would not be a tested income CFC but for its \$8x of gross tested income from other sources.

(h) *Anti-abuse rules for certain transfers of property—(1) Disregard of basis in specified tangible property held temporarily.* If a tested income CFC (acquiring CFC) acquires specified tangible property (as defined in paragraph (c)(1) of this section) with a principal purpose of reducing the GILTI inclusion amount of a United States shareholder for any U.S. shareholder inclusion year, and the tested income CFC holds the property temporarily but over at least the close of one quarter, the specified tangible property is disregarded in determining the acquiring CFC's average adjusted basis in specified tangible property for purposes of determining the acquiring CFC's qualified business asset investment for any CFC inclusion year during which the tested income CFC held the property. For purposes of this paragraph (h)(1), specified tangible property held by the tested income CFC for less than a twelve month period that includes at least the close of one quarter during the taxable year of a tested income CFC is treated as temporarily held and acquired with a principal purpose of reducing the GILTI inclusion amount of a United States shareholder for a U.S. shareholder inclusion year if such acquisition would, but for this paragraph (h)(1), reduce the GILTI inclusion amount of a United States shareholder for a U.S. shareholder inclusion year.

(2) *Disregard of basis in specified tangible property related to transfers during the disqualified period—(i) In general.* For purposes of determining the qualified business asset investment of a tested income CFC for a CFC inclusion year, in applying the alternative depreciation system under section 168(g) to determine the tested income CFC's adjusted basis in specified tangible property, any disqualified basis with respect to the specified tangible property is not taken into account.

(ii) *Determination of disqualified basis—(A) In general.* The term *disqualified basis* means, with respect to specified tangible property, the excess (if any) of the property's adjusted basis immediately after a disqualified transfer, over the sum of the property's adjusted basis immediately before the disqualified transfer and the qualified gain amount with respect to the disqualified transfer. Disqualified basis may be reduced or eliminated through

depreciation, amortization, sales or exchanges, section 362(e), and other methods. In such circumstances, in the case of specified tangible property with disqualified basis and adjusted basis other than disqualified basis, the disqualified basis is reduced or eliminated in the same proportion that the disqualified basis bears to the total adjusted basis of the property.

(B) *Definition of qualified gain amount.* The term *qualified gain amount* means, with respect to a disqualified transfer, the sum of the following amounts:

(1) The amount of gain recognized by a controlled foreign corporation (transferor CFC) on the disqualified transfer of the specified tangible property that is subject to U.S. federal income tax under section 882 (except to the extent the gain is subject to a reduced rate of tax, or is exempt from tax, pursuant to an applicable treaty obligation of the United States); and

(2) Any United States shareholder's pro rata share of the gain recognized by the transferor CFC on the disqualified transfer of the specified tangible property (determined without regard to properly allocable deductions) taken into account in determining the United States shareholder's inclusion under section 951(a)(1)(A), excluding any amount that is described in paragraph (h)(2)(ii)(B)(1) of this section.

(C) *Definition of disqualified transfer.* The term *disqualified transfer* means a transfer of specified tangible property during a transferor CFC's disqualified period by the transferor CFC to a related person in which gain was recognized, in whole or in part, by the transferor CFC, regardless of whether the property was specified tangible property in the hands of the transferor CFC. For purposes of the preceding sentence, a transfer includes any disposition, sale or exchange, contribution, or distribution of the specified tangible property, and includes an indirect transfer (for example, a transfer of an interest in a partnership is treated as a transfer of the assets of the partnership and transfer by or to a partnership is treated as a transfer by or to its partners).

(D) *Definition of disqualified period.* The term *disqualified period* means, with respect to a transferor CFC, the period beginning on January 1, 2018, and ending as of the close of the transferor CFC's last taxable year that is not a CFC inclusion year. A transferor CFC that has a CFC inclusion year beginning January 1, 2018, has no disqualified period.

(E) *Related person.* For purposes of this paragraph (h)(2), a person is related to a controlled foreign corporation if the

person bears a relationship to the controlled foreign corporation described in section 267(b) or 707(b) immediately before or immediately after the transfer.

(iii) *Examples.* The following examples illustrate the application of this paragraph (h)(2).

(A) *Example 1—(1) Facts.* USP, a domestic corporation, owns all of the stock of CFC1 and CFC2, each a controlled foreign corporation. Both USP and CFC1 use the calendar year as their taxable year. CFC2 uses a taxable year ending November 30. On November 1, 2018, before the start of its first CFC inclusion year, CFC2 sells specified tangible property that has a basis of \$10x in the hands of CFC2 to CFC1 in exchange for \$100x of cash. CFC2 recognizes \$90x of gain as a result of the sale (\$100x – \$10x), \$30x of which is foreign base company income (within the meaning of section 954). USP includes in gross income under section 951(a)(1)(A) its pro rata share of the subpart F income of \$30x. CFC2's gain is not otherwise subject to U.S. tax or taken into account in determining USP's inclusion under section 951(a)(1)(A).

(2) *Analysis.* The transfer is a disqualified transfer because it is a transfer of specified tangible property; CFC1 and CFC2 are related persons; and the transfer occurs during the disqualified period, the period that begins on January 1, 2018, and ends the last day before the first CFC inclusion year of CFC2 (November 30, 2018). The disqualified basis is \$60x, the excess of CFC1's adjusted basis in the property immediately after the disqualified transfer (\$100x), over the sum of CFC2's basis in the property immediately before the transfer (\$10x) and USP's pro rata share of the gain recognized by CFC1 on the transfer of the property taken into account by USP under section 951(a)(1)(A) (\$30x). Accordingly, under paragraph (h)(2)(i) of this section, for purposes of determining the qualified business asset investment of any tested income CFC for any CFC inclusion year, in applying section 168(g) to determine the CFC's basis in the specified tangible property, the \$60x disqualified basis of the property is not taken into account.

(B) *Example 2—(1) Facts.* The facts are the same as in paragraph (1) of *Example 1*, except that CFC2 uses the calendar year as its taxable year.

(2) *Analysis.* Because CFC2 has a taxable year beginning January 1, 2018, CFC2 has no disqualified period. Accordingly, the property was not transferred during a disqualified period of CFC2, and there is no disqualified basis with respect to the property.

■ **Par. 7** Section 1.951A–4 is added to read as follows:

**§ 1.951A–4 Tested interest expense and tested interest income.**

(a) *Scope.* This section provides general rules for determining the tested interest expense and tested interest income of a controlled foreign corporation for purposes of determining a United States shareholder's specified interest expense under § 1.951A–

1(c)(3)(iii). Paragraph (b) of this section provides the definitions related to tested interest expense and tested interest income. Paragraph (c) of this section provides examples illustrating these definitions and the application of § 1.951A–1(c)(3)(iii). The amount of specified interest expense determined under § 1.951A–1(c)(3)(iii) and this section is the amount of interest expense described in section 951A(b)(2)(B).

(b) *Definitions related to specified interest expense—(1) Tested interest expense—(i) In general.* The term *tested interest expense* means interest expense paid or accrued by a controlled foreign corporation taken into account in determining the tested income or tested loss of the controlled foreign corporation for the CFC inclusion year under § 1.951A–2(c), reduced by the qualified interest expense of the controlled foreign corporation.

(ii) *Interest expense.* The term *interest expense* means any expense or loss that is treated as interest expense by reason of the Internal Revenue Code or the regulations thereunder, and any other expense or loss incurred in a transaction or series of integrated or related transactions in which the use of funds is secured for a period of time if such expense or loss is predominately incurred in consideration of the time value of money.

(iii) *Qualified interest expense.* The term *qualified interest expense* means, with respect to a qualified CFC, the interest expense paid or accrued by the qualified CFC taken into account in determining the tested income or tested loss of the qualified CFC for the CFC inclusion year, multiplied by the fraction (not to exceed one) described in paragraph (b)(1)(iii)(A) of this section, and then reduced (but not to less than zero) by the amount described in paragraph (b)(1)(iii)(B) of this section.

(A) The numerator of the fraction described in this paragraph (b)(1)(iii)(A) is the average of the aggregate adjusted bases as of the close of each quarter of obligations or financial instruments held by the qualified CFC that give rise to income excluded from foreign personal holding company income (as defined in section 954(c)(1)) by reason of section 954(h) or (i), and the denominator is the average of the aggregate adjusted bases as of the close of each quarter of all assets held by the qualified CFC. For purposes of this paragraph (b)(1)(iii)(A), the basis of the stock of another qualified CFC held by a qualified CFC is treated as basis of an obligation or financial instrument giving rise to income excluded from foreign personal holding company income by

reason of section 954(h) or (i) in an amount equal to the basis of the stock multiplied by the fraction described in this paragraph (b)(1)(iii)(A) determined with respect to the assets of such other qualified CFC.

(B) The amount described in this paragraph (b)(1)(iii)(B) is the amount of interest income of the qualified CFC for the CFC inclusion year that is excluded from foreign personal holding company income (as defined in section 954(c)(1)) by reason of section 954(c)(3) or (6).

(iv) *Qualified CFC.* The term *qualified CFC* means an eligible controlled foreign corporation (within the meaning of section 954(h)(2)) or a qualifying insurance company (within the meaning of section 953(e)(3)).

(2) *Tested interest income—(i) In general.* The term *tested interest income* means interest income included in the gross tested income of a controlled foreign corporation for the CFC inclusion year, reduced by qualified interest income of the controlled foreign corporation.

(ii) *Interest income.* The term *interest income* means any income or gain that is treated as interest income by reason of the Internal Revenue Code or the regulations thereunder, and any other income or gain recognized in a transaction or series of integrated or related transactions in which the forbearance of funds is secured for a period of time if such income or gain is predominately derived from consideration of the time value of money.

(iii) *Qualified interest income.* The term *qualified interest income* means, with respect to a qualified CFC, interest income of the qualified CFC included in the gross tested income of the qualified CFC for the CFC inclusion year that is excluded from foreign personal holding company income (as defined in section 954(c)(1)) by reason of section 954(h) or (i).

(c) *Examples.* The following examples illustrate the application of this section.

(1) *Example 1: Wholly-owned CFCs—(i) Facts.* A Corp, a domestic corporation, owns 100% of the single class of stock of each of FS1 and FS2, each a controlled foreign corporation. A Corp, FS1, and FS2 all use the calendar year as their taxable year. In Year 1, FS1 pays \$100x of interest to FS2. Also, in Year 1, FS2 pays \$100x of interest to a bank that is not related to A Corp, FS1, or FS2. The interest paid by each of FS1 and FS2 is taken into account in determining the tested income and tested loss of FS1 and FS2 under § 1.951A–2(c), and the interest received by FS2 is not foreign personal holding company income (as defined in section 954(c)(1)) by reason of section 954(c)(6) and thus is included in gross tested income. For Year 1, taking into account

interest income and expense, FS1 has \$500x of tested income and FS2 has \$400x of tested loss. Neither FS1 nor FS2 is a qualified CFC.

(ii) *Analysis*—(A) *CFC-level determination; tested interest expense and tested interest income.* FS1 has \$100x of tested interest expense for Year 1. FS2 has \$100x of tested interest expense and \$100x of tested interest income for Year 1.

(B) *United States shareholder-level determination; pro rata share and specified interest expense.* Under § 1.951A–1(d)(5) and (6), A Corp's pro rata share of FS1's tested interest expense is \$100x, its pro rata share of FS2's tested interest expense is \$100x, and its pro rata share of FS2's tested interest income is \$100x. For Year 1, A Corp's aggregate pro rata share of tested interest expense is \$200x and its aggregate pro rata share of tested interest income is \$100x. Accordingly, under § 1.951A–1(c)(3)(iii), A Corp's specified interest expense is \$100x ( $\$200x - \$100x$ ) for Year 1.

(2) Example 2: Less than wholly-owned CFCs—(i) *Facts.* The facts are the same as in paragraph (i) of Example 1, except that A Corp owns 50% of the single class of stock of FS1 and 80% of the single class of stock of FS2.

(ii) *Analysis.* (A) *CFC-level determination; tested interest expense and tested interest income.* The analysis is the same as in paragraph (ii)(A) of Example 1.

(B) *United States shareholder-level determination; pro rata share and specified interest expense.* Under § 1.951A–1(d)(5) and (6), A Corp's pro rata share of FS1's tested interest expense is \$50x ( $\$100x \times 0.50$ ), its pro rata share of FS2's tested interest expense is \$80x ( $\$100x \times 0.80$ ), and its pro rata share of FS2's tested interest income is \$80x ( $\$100x \times 0.80$ ). For Year 1, A Corp's aggregate pro rata share of the tested interest expense is \$130x and its aggregate pro rata share of the tested interest income is \$80x. Accordingly, under § 1.951A–1(c)(3)(iii), A Corp's specified interest expense is \$50x ( $\$130x - \$80x$ ) for Year 1.

(3) Example 3: *Qualified CFC*—(i) *Facts.* B Corp, a domestic corporation, owns 100% of the single class of stock of each of FS1 and FS2, each a controlled foreign corporation. B Corp, FS1, and FS2 all use the calendar year as their taxable year. FS2 is an eligible controlled foreign corporation within the meaning of section 954(h)(2). In Year 1, FS1 pays \$100x of interest to FS2, which interest income is excluded from the foreign personal holding company income (as defined in section 954(c)(1)) of FS2 by reason of section 954(c)(6). Also, in Year 1, FS2 pays \$250x of interest to a bank, and receives an additional \$300x of interest from customers that are not related to FS2, which interest income is excluded from foreign personal holding company income by reason of section 954(h). The interest paid by each of FS1 and FS2 is taken into account in determining the tested income and tested loss of FS1 and FS2, and the interest received by FS2 is included in gross tested income. FS1 is not a qualified CFC. FS2 does not own stock in any qualified CFC. FS2's average adjusted bases in obligations or financial instruments that give rise to income excluded from foreign personal holding company income by reason

of section 954(h) is \$8,000x, and FS2's average adjusted bases in all its assets is \$10,000x.

(ii) *Analysis*—(A) *CFC-level determination; tested interest expense and tested interest income.* FS1 has \$100x of tested interest expense for Year 1. FS2 is a qualified CFC because it is an eligible controlled foreign corporation within the meaning of section 954(h)(2). As a result, in determining the tested interest income and tested interest expense of FS2, the qualified interest income and qualified interest expense of FS2 are excluded. FS2 has qualified interest income of \$300x, the amount of FS2's interest income that is excluded from foreign personal holding company income by reason of section 954(h). In addition, FS2 has qualified interest expense of \$100x, the amount of FS2's interest expense taken into account in determining FS2's tested income or tested loss under § 1.951A–2(c) ( $\$250x$ ), multiplied by a fraction, the numerator of which is FS2's average adjusted bases in obligations or financial instruments that give rise to income excluded from foreign personal holding company income by reason of section 954(h) ( $\$8,000x$ ), and the denominator of which is FS2's average adjusted bases in all its assets ( $\$10,000x$ ), and then reduced by the amount of the interest income received from FS1 excluded from foreign personal holding company income by reason of section 954(c)(6) ( $\$100x$ ). Therefore, for Year 1, FS2 has tested interest income of \$100x ( $\$400x - \$300x$ ) and tested interest expense of \$150x ( $\$250x - \$100x$ ).

(B) *United States shareholder-level determination; pro rata share and specified interest expense.* Under § 1.951A–1(d)(5) and (6), B Corp's pro rata share of FS1's tested interest expense is \$100x, its pro rata share of FS2's tested interest expense is \$150x, and its pro rata share of FS2's tested interest income is \$100x. For Year 1, B Corp's aggregate pro rata share of tested interest expense is \$250x ( $\$100x + \$150x$ ) and its aggregate pro rata share of tested interest income is \$100x ( $\$0 + \$100x$ ). Accordingly, under § 1.951A–1(c)(3)(iii), B Corp's specified interest expense is \$150x ( $\$250x - \$100x$ ) for Year 1.

■ **Par. 8.** Section 1.951A–5 is added to read as follows:

**§ 1.951A–5 Domestic partnerships and their partners.**

(a) *Scope.* This section provides rules regarding the application of section 951A and the section 951A regulations to domestic partnerships that own (within the meaning of section 958(a)) stock in one or more controlled foreign corporations and to partners of such domestic partnerships, including United States persons (within the meaning of section 957(c)). Paragraph (b) of this section provides rules for the determination of the GILTI inclusion amount of a domestic partnership and the distributive share of such amount of a partner that is not a United States shareholder with respect to one or more controlled foreign corporations owned

by the domestic partnership. Paragraph (c) of this section provides rules for the determination of the GILTI inclusion amount of a partner that is a United States shareholder with respect to one or more controlled foreign corporations owned by a domestic partnership. Paragraph (d) of this section provides rules for tiered domestic partnerships. Paragraph (e) of this section provides the definitions of CFC tested item, partnership CFC, U.S. shareholder partner, and U.S. shareholder partnership. Paragraph (f) of this section requires a domestic partnership to provide certain information to each partner necessary for the partner to determine its GILTI inclusion amount or its distributive share of the partnership's GILTI inclusion amount. Paragraph (g) of this section provides examples illustrating the rules of this section. For rules regarding the treatment of certain controlled domestic partnerships owned through one or more foreign corporations as foreign partnerships for purposes of sections 951 through 964, including section 951A and the section 951A regulations, see § 1.951–1(h).

(b) *In general*—(1) *Determination of GILTI inclusion amount of a U.S. shareholder partnership.* A U.S. shareholder partnership determines its GILTI inclusion amount for its U.S. shareholder inclusion year under the general rules applicable to United States shareholders in section 951A and the section 951A regulations.

(2) *Determination of distributive share of U.S. shareholder partnership's GILTI inclusion amount of a partner other than a U.S. shareholder partner.* Each partner of a U.S. shareholder partnership that is not a U.S. shareholder partner takes into account its distributive share of the U.S. shareholder partnership's GILTI inclusion amount (if any) for the U.S. shareholder inclusion year in accordance with section 702 and § 1.702–1(a)(8)(ii).

(c) *Determination of GILTI inclusion amount of a U.S. shareholder partner.* For purposes of section 951A and the section 951A regulations, section 958(a) stock of a partnership CFC owned by a U.S. shareholder partnership is treated as section 958(a) stock owned proportionately by each U.S. shareholder partner that is a United States shareholder of the partnership CFC in the same manner as if the U.S. shareholder partnership were a foreign partnership under section 958(a)(2) and § 1.958–1(b). Accordingly, for purposes of determining a U.S. shareholder partner's GILTI inclusion amount, the U.S. shareholder partner determines its pro rata share of any CFC tested item of

a partnership CFC based on the section 958(a) stock owned by the U.S. shareholder partner by reason of this paragraph (c). In addition, a U.S. shareholder partner's distributive share of the GILTI inclusion amount of a U.S. shareholder partnership is determined without regard to the partnership's pro rata share of any CFC tested item of a partnership CFC with respect to which the U.S. shareholder partner is a United States shareholder.

(d) *Tiered U.S. shareholder partnerships.* In the case of tiered U.S. shareholder partnerships, section 958(a) stock of a partnership CFC treated as owned under paragraph (c) of this section by a U.S. shareholder partner that is also a U.S. shareholder partnership is treated as section 958(a) stock owned by the U.S. shareholder partnership for purposes of applying paragraph (c) of this section to a U.S. shareholder partner of such U.S. shareholder partnership.

(e) *Definitions.* The following definitions apply for purposes of this section:

(1) *CFC tested item.* The term *CFC tested item* has the meaning set forth in § 1.951A-1(d)(1).

(2) *Partnership CFC.* The term *partnership CFC* means, with respect to a U.S. shareholder partnership, a controlled foreign corporation stock of which is owned (within the meaning of section 958(a)) by the U.S. shareholder partnership.

(3) *U.S. shareholder partner.* The term *U.S. shareholder partner* means, with respect to a U.S. shareholder partnership and a partnership CFC of the U.S. shareholder partnership, a United States person that is a partner in the U.S. shareholder partnership and that is also a United States shareholder (as defined in section 951(b)) of the partnership CFC.

(4) *U.S. shareholder partnership.* The term *U.S. shareholder partnership* means a domestic partnership (within the meaning of section 7701(a)(4)) that is a United States shareholder of one or more controlled foreign corporations.

(f) *Reporting requirement.* A U.S. shareholder partnership must furnish to each partner on or with such partner's Schedule K-1 (Form 1065 or successor form) for each U.S. shareholder inclusion year of the partnership the partner's distributive share of the partnership's GILTI inclusion amount (if any) and, with respect to a U.S. shareholder partner, the partner's proportionate share of the partnership's pro rata share (if any) of each CFC tested item of each partnership CFC of the partnership and any other information

required in the form or instructions. See section 6031(b).

(g) *Examples.* The following examples illustrate the rules of this section. None of the persons in the following examples own an interest in any controlled foreign corporation other than as described.

(1) *Example 1: Domestic partnership with partners that are not United States shareholders—*(i) *Facts.* Eleven U.S. citizens ("individuals") each own a 9% interest of PRS, a domestic partnership. The remaining 1% interest of PRS is owned by X Corp, a domestic corporation. None of the individuals or X Corp are related. PRS owns 100% of the single class of stock of FC, a controlled foreign corporation. The individuals, X Corp, PRS, and FC all use the calendar year as their taxable year. In Year 1, FC has \$130x of tested income and \$50x of qualified business asset investment.

(ii) *Analysis—*(A) *Partnership-level calculation.* PRS is a U.S. shareholder partnership with respect to FC. Under paragraph (b)(1) of this section, PRS determines its GILTI inclusion amount for Year 1. PRS's pro rata share of FC's tested income is \$130x. PRS's pro rata share of FC's qualified business asset investment is \$50x. PRS's net CFC tested income is \$130x. PRS's net deemed tangible income return is \$5x ( $\$50x \times 0.10$ ). PRS's GILTI inclusion amount for Year 1 is \$125x ( $\$130x - \$5x$ ).

(B) *Partner-level calculation.* Neither X Corp nor the individuals are U.S. shareholder partners with respect to FC. Accordingly, under paragraph (b)(2) of this section, each of the individuals and X Corp includes its distributive share of PRS's GILTI inclusion amount (\$11.25x each for the individuals and \$1.25x for X Corp) in gross income for Year 1.

(2) *Example 2: Domestic partnership with partners that are United States shareholders; multiple partnership CFCs—*

(i) *Facts.* X Corp and Y Corp are domestic corporations that own 40% and 60%, respectively, of PRS, a domestic partnership. PRS owns 100% of the single class of stock of FC1 and of FC2, each a controlled foreign corporation. X Corp, Y Corp, PRS, FC1, and FC2 all use the calendar year as their taxable year. In Year 1, FC1 has \$130x of tested income and \$50x of qualified business asset investment, and FC2 has \$30x of tested loss.

(ii) *Analysis—*(A) *Partnership-level calculation.* PRS is a U.S. shareholder partnership with respect to each of FC1 and FC2. Under paragraph (b)(1) of this section, PRS determines its GILTI inclusion amount for Year 1. PRS's pro rata share of FC1's tested income is \$130x and of FC2's tested loss is \$30x. PRS's pro rata share of FC1's qualified business asset investment is \$50x. PRS's net CFC tested income is \$100x ( $\$130x - \$30x$ ). PRS's net deemed tangible income return is \$5x ( $\$50x \times 0.10$ ). PRS's GILTI inclusion amount for Year 1 is \$95x ( $\$100x - \$5x$ ).

(B) *Partner-level calculation.* X Corp and Y Corp are U.S. shareholder partners with respect to FC1 and FC2. Accordingly, under paragraph (c) of this section, X Corp and Y Corp are treated as owning section 958(a)

stock of FC1 and FC2 proportionately as if PRS were a foreign partnership. Thus, X Corp's pro rata share of FC1's tested income is \$52x ( $\$130x \times 0.40$ ), and its pro rata share of FC2's tested loss is \$12x ( $\$30x \times 0.40$ ). X Corp's pro rata share of FC1's qualified business asset investment is \$20x ( $\$50x \times 0.40$ ). Accordingly, X Corp's net CFC tested income is \$40x ( $\$52x - \$12x$ ), and its net deemed tangible income return is \$2x ( $\$20x \times 0.10$ ). X Corp's GILTI inclusion amount for Year 1 is \$38x ( $\$40x - \$2x$ ). Y Corp's pro rata share of FC1's tested income is \$78x ( $\$130x \times 0.60$ ), and its pro rata share of FC2's tested loss is \$18x ( $\$30x \times 0.60$ ). Y Corp's pro rata share of FC1's qualified business asset investment is \$30x ( $\$50x \times 0.60$ ).

Accordingly, Y Corp's net CFC tested income is \$60x ( $\$78x - \$18x$ ), and its net deemed tangible income return is \$3x ( $\$30x \times 0.10$ ). Y Corp's GILTI inclusion amount for Year 1 is \$57x ( $\$60x - \$3x$ ). Because X Corp and Y Corp are both U.S. shareholder partners with respect to FC1 and FC2, the only partnership CFCs of PRS, X Corp and Y Corp each includes its proportionate share of PRS's share of each CFC tested item of FC1 and FC2 under paragraph (c) of this section rather than including a distributive share of the GILTI inclusion amount of PRS.

(3) *Example 3: Domestic partnership with partners that are United States shareholders with respect to some, but not all, of the controlled foreign corporations owned by the domestic partnership—*(i) *Facts.* X Corp and Y Corp are domestic corporations that own 40% and 60%, respectively, of PRS, a domestic partnership. PRS owns 20% of the single class of stock of FC1 and 10% of the single class of stock of FC2. In addition, Y Corp owns 100% of the single class of stock of FC3. FC1, FC2, and FC3 are controlled foreign corporations. X Corp, Y Corp, PRS, FC1, FC2, and FC3 all use the calendar year as their taxable year. In Year 1, FC1 has \$100x of tested income, FC2 has \$80x of tested income, and FC3 has \$10x of tested loss.

(ii) *Analysis.* (A) *Partnership-level calculation.* PRS is a U.S. shareholder partnership with respect to each of FC1 and FC2. Under paragraph (b)(1) of this section, PRS determines its GILTI inclusion amount for Year 1. PRS's pro rata share of FC1's tested income is \$20x ( $\$100x \times 0.20$ ) and of FC2's tested income is \$8x ( $\$80x \times 0.10$ ). PRS's net CFC tested income is \$28x ( $\$20x + \$8x$ ). PRS has no net deemed tangible income return. PRS's GILTI inclusion amount for Year 1 is \$28x.

(B) *Partner-level calculation—*(1) *X Corp.* X Corp is not a U.S. shareholder partner with respect to either FC1 or FC2 because X Corp owns (within the meaning of section 958) less than 10% of each of FC1 ( $40\% \times 20\% = 8\%$ ) and FC2 ( $40\% \times 10\% = 4\%$ ). Accordingly, under paragraph (b)(2) of this section, X Corp includes in income its distributive share, or \$11.20x ( $\$28x \times 0.40$ ), of PRS's GILTI inclusion amount in Year 1.

(2) *Y Corp.* Y Corp is a United States shareholder of FC3. Y Corp is also a U.S. shareholder partner with respect to FC1, because it owns (within the meaning of section 958) at least 10% ( $60\% \times 20\% = 12\%$ ) of the stock of FC1, but not with respect to

FC2, because Y Corp owns (within the meaning of section 958) less than 10% of the stock of FC2 ( $60\% \times 10\% = 6\%$ ).

Accordingly, under paragraph (c) of this section, Y Corp is treated as owning section 958(a) stock of FC1 proportionately as if PRS were a foreign partnership. Thus, Y Corp's pro rata share of FC1's tested income is \$12x ( $\$20x \times 0.60$ ). Y Corp's pro rata share of FC3's tested loss is \$10x ( $\$10x \times 1$ ). Accordingly, Y Corp's net CFC tested income is \$2x ( $\$12x - \$10x$ ) and Y Corp has no net deemed tangible income return. Y Corp's GILTI inclusion amount for Year 1 is \$2x. In addition, under paragraph (c) of this section, for purposes of determining Y Corp's distributive share of PRS's GILTI inclusion amount, Y Corp's distributive share of PRS's GILTI inclusion amount is determined without regard to PRS's pro rata share of any item of FC1. PRS's GILTI inclusion amount computed solely with respect to FC2 is \$8x ( $\$80x \times 0.10$ ). Y Corp's distributive share of PRS's GILTI inclusion amount is \$4.80x ( $\$8x \times 0.60$ ) in Year 1.

(4) *Example 4: Tiered domestic partnerships*—(i) *Facts*. X Corp and Y Corp are domestic corporations that own, respectively, a 20% interest and an 80% interest in PRS1, an upper-tier domestic partnership. PRS1 owns a 40% interest in PRS2, a lower-tier domestic partnership. The remaining 60% of PRS2 is owned by Z Corp, a controlled foreign corporation. PRS2 is not a controlled domestic partnership within the meaning of § 1.951-1(h)(2) (because no United States shareholder of Z Corp (or related persons) controls PRS2). PRS2 owns 80% of the single class of stock of FC, a controlled foreign corporation. X Corp, Y Corp, Z Corp, PRS1, PRS2, and FC all use the calendar year as their taxable year. In Year 1, FC has \$100x of tested income and \$50x of qualified business asset investment.

(ii) *Analysis*. (A) *Lower-tier partnership-level calculation*. PRS2 is a U.S. shareholder partnership with respect to FC, because PRS2 directly owns 80% of the single class of stock of FC. Under paragraph (b)(1) of this section, PRS2 determines its GILTI inclusion amount for its taxable year. PRS2's pro rata share of FC's tested income is \$80x ( $\$100x \times 0.80$ ). PRS2's pro rata share of FC's qualified business asset investment is \$40x ( $\$50x \times 0.80$ ). PRS2's net CFC tested income is \$80x, and its net deemed tangible income return is \$4x ( $\$40x \times 0.10$ ). PRS2's GILTI inclusion amount for Year 1 is \$76x ( $\$80x - \$4x$ ).

(B) *Non-U.S. shareholder partner calculation*. Z Corp is not a U.S. shareholder partner of FC. Therefore, under paragraph (b)(2) of this section, in Year 1, Z Corp includes in income Z Corp's distributive share of PRS2's GILTI inclusion amount, or \$45.60x ( $\$76x \times 0.60$ ). Z Corp's gross tested income in Year 1 includes this amount.

(C) *Upper-tier partnership-level calculation*. PRS1 is a U.S. shareholder partner with respect to FC because it owns (within the meaning of section 958) more than 10% of the stock of FC ( $40\% \times 100\%$  (by reason of the application of section 958(b)(2)) = 40%). Accordingly, under paragraph (c) of this section, PRS1 is treated as owning section 958(a) stock of FC proportionately as if PRS2 were a foreign

partnership. Thus, PRS1's pro rata share of FC's tested income is \$32x ( $\$100x \times 0.80 \times 0.40$ ), and its pro rata share of FC's qualified business asset investment is \$16x ( $\$50x \times 0.80 \times 0.40$ ). PRS1's net CFC tested income is \$32x, and its net deemed tangible income return is \$1.60x ( $\$16x \times 0.10$ ). PRS1's GILTI inclusion amount for Year 1 is \$30.40x ( $\$32x - \$1.60x$ ).

(D) *Upper-tier partnership partner-level calculation*—(1) *Treatment of upper-tier partnership*. For purposes of applying paragraph (c) of this section to determine X Corp and Y Corp's GILTI inclusion amount, PRS1 is treated as owning section 958(a) stock of FC.

(2) *X Corp*. X Corp is not a U.S. shareholder partner with respect to FC because it owns (within the meaning of section 958) less than 10% ( $20\% \times 40\% \times 100\%$  (by reason of the application of section 958(b)(2)) = 8%) of the stock of FC. Accordingly, under paragraph (b)(2) of this section, X Corp includes its distributive share of PRS1's GILTI inclusion amount in Year 1, which is \$6.08x ( $\$30.40x \times 0.20$ ).

(3) *Y Corp*. Y Corp is a U.S. shareholder partner with respect to FC because it owns (within the meaning of section 958) more than 10% ( $80\% \times 40\% \times 100\%$  (by reason of the application of section 958(b)(2)) = 32%) of the stock of FC. Accordingly, under paragraphs (c) and (d) of this section, Y Corp is treated as owning section 958(a) stock of FC proportionately as if PRS1 and PRS2 were foreign partnerships. Thus, Y Corp's pro rata share of FC's tested income is \$25.60x ( $\$100x \times 0.80 \times 0.40 \times 0.80$ ), and its pro rata share of FC's qualified business asset investment is \$12.80x ( $\$50x \times 0.80 \times 0.40 \times 0.80$ ). Y Corp's net CFC tested income is \$25.60x, its net deemed tangible income return is \$1.28x ( $\$12.80x \times 0.10$ ), and its GILTI inclusion amount is \$24.32x ( $\$25.60x - \$1.28x$ ). Because Y Corp is a U.S. shareholder partner with respect to FC, the only partnership CFC of PRS1, Y Corp has no distributive share of the GILTI inclusion amount of PRS1 under paragraph (c) of this section.

(5) *Example 5: S corporation and its shareholders*—(i) *Facts*. Individual A, a U.S. citizen, and Grantor Trust, a trust all of which is treated under sections 671 through 679 as owned by Individual B, a U.S. citizen, respectively own 5% and 95% of the single class of stock of Corporation X, an S corporation. Corporation X owns 100% of the single class of stock of FC, a controlled foreign corporation. Individual A, Grantor Trust, Individual B, Corporation X, and FC all use the calendar year as their taxable year. In Year 1, FC has \$200x of tested income and \$100x of qualified business asset investment.

(ii) *Analysis*—(A) *S corporation-level calculation*. An S corporation is treated as a partnership for purposes of sections 951 through 965 under section 1373. Corporation X is a U.S. shareholder partnership with respect to FC, a partnership CFC. Accordingly, under paragraph (b)(1) of this section, Corporation X determines its GILTI inclusion amount for Year 1. Corporation X's pro rata share of FC's tested income is \$200x, and its pro rata share of FC's qualified business asset investment is \$100x. Corporation X's net CFC tested income is

\$200x, and its net deemed tangible income return is \$10x ( $\$100x \times 0.10$ ). Corporation X's GILTI inclusion amount for Year 1 is \$190x ( $\$200x - \$10x$ ).

(B) *S corporation shareholder-level calculation*—(1) *Individual A*. Individual A is not a U.S. shareholder partner with respect to FC because it owns (within the meaning of section 958) less than 10% ( $5\% \times 100\% = 5\%$ ) of the FC stock. Accordingly, under paragraph (b)(2) of this section, Individual A includes in gross income its proportionate share of Corporation X's GILTI inclusion amount, which is \$9.50x ( $\$190x \times 0.05$ ).

(2) *Grantor Trust*. Because Individual B is treated as owning all of Grantor Trust under sections 671 through 679, Individual B is treated as if it directly owns the shares of stock in Corporation X owned by Grantor Trust. As a result, Individual B is treated as a U.S. shareholder partner with respect to FC because it owns (within the meaning of section 958) more than 10% ( $95\% \times 100\% = 95\%$ ) of the FC stock. Accordingly, under paragraph (c) of this section, Individual B is treated as owning section 958(a) stock of FC proportionately as if Corporation X were a foreign partnership. Thus, Individual B's pro rata share of FC's tested income is \$190x ( $\$200x \times 0.95$ ) and its pro rata share of FC's qualified business asset investment is \$95x ( $\$100x \times 0.95$ ). Individual B's net CFC tested income is \$190x, and its net deemed tangible income return is \$9.50x ( $\$95x \times 0.10$ ). Individual B's GILTI inclusion amount for Year 1 is \$180.5x ( $\$190x - \$9.50x$ ). Because Individual B is a U.S. shareholder partner with respect to FC, the only partnership CFC of Corporation X, Individual B has no distributive share of the GILTI inclusion amount of Corporation X under paragraph (c) of this section.

(6) *Example 6: Domestic partnership with no GILTI inclusion amount*—(i) *Facts*. X Corp is a domestic corporation that owns a 90% interest in PRS, a domestic partnership. The remaining 10% of PRS is owned by Y, a foreign individual. PRS owns 100% of the single class of stock of FC1, a controlled foreign corporation, and 100% of the single class of stock of FC2, a controlled foreign corporation. X Corp owns 100% of the single class of stock of FC3, a controlled foreign corporation. X Corp, PRS, FC1, FC2, and FC3 all use the calendar year as their taxable year. In Year 1, FC1 has \$100x of tested loss and \$80x of tested interest expense, FC2 has \$50x of tested income, and FC3 has \$150x of tested income and \$500x of qualified business asset investment in Year 1.

(ii) *Analysis*—(A) *Partnership-level calculation*. PRS is a U.S. shareholder partnership with respect to FC1 and FC2. Under paragraph (b)(1) of this section, PRS determines its GILTI inclusion amount for Year 1. PRS's pro rata share of FC1's tested loss is \$100x, and PRS's pro rata share of FC2's tested income is \$50x. PRS's net CFC tested income is \$0 ( $\$50x - 100x$ ), and therefore PRS has no GILTI inclusion amount for Year 1.

(B) *Partner-level calculation*. X Corp is a U.S. shareholder partner with respect to FC1 and FC2 because X Corp owns (within the meaning of section 958) at least 10% of each ( $90\% \times 100\% = 90\%$ ). Accordingly, under



paragraph (c) of this section, X Corp is treated as owning section 958(a) stock of FC1 and FC2 proportionately as if PRS were a foreign partnership. X Corp's pro rata share of FC1's tested loss is \$90x (\$100x × 0.90), and X Corp's pro rata share of FC1's tested interest expense is \$72x (\$80 × 0.90). X Corp's pro rata share of FC2's tested income is \$45x (\$50x × 0.90). X Corp's pro rata share of FC3's tested income is \$150x, and its pro rata share of FC3's qualified business asset investment is \$500x. X Corp's net CFC tested income is \$105x (\$45x + \$150x – \$90x). X Corp's deemed tangible income return is \$50x (\$500x × 0.10), but its net deemed tangible income return is \$0 (\$50x – \$72x). X Corp has a GILTI inclusion amount of \$105x (\$105x – \$0) for Year 1.

■ **Par. 9.** Section 1.951A–6 is added to read as follows:

**§ 1.951A–6 Treatment of GILTI inclusion amount and adjustments to earnings and profits and basis related to tested loss CFCs.**

(a) *Scope.* This section provides rules relating to the treatment of GILTI inclusion amounts and adjustments to earnings and profits and basis to account for tested losses. Paragraph (b) of this section provides that a GILTI inclusion amount is treated in the same manner as an amount included under section 951(a)(1)(A) for purposes of applying certain sections of the Code. Paragraph (c) of this section provides rules for the treatment of amounts taken into account in determining the net CFC tested income when applying sections 163(e)(3)(B)(i) and 267(a)(3)(B). Paragraph (d) of this section provides rules that increase the earnings and profits of a tested loss CFC for purposes of section 952(c)(1)(A). Paragraph (e) of this section provides rules for certain basis adjustments to the stock of a controlled foreign corporation by reason of tested losses used to reduce a domestic corporation's net CFC tested income upon the disposition of the stock of the controlled foreign corporation.

(b) *Treatment as subpart F income for certain purposes—(1) In general.* A GILTI inclusion amount is treated in the same manner as an amount included under section 951(a)(1)(A) for purposes of applying sections 168(h)(2)(B), 535(b)(10), 851(b), 904(h)(1), 959, 961, 962, 993(a)(1)(E), 996(f)(1), 1248(b)(1), 1248(d)(1), 1411, 6501(e)(1)(C), 6654(d)(2)(D), and 6655(e)(4), and with respect to other sections of the Internal Revenue Code as provided in other guidance published in the Internal Revenue Bulletin.

(2) *Allocation of GILTI inclusion amount to tested income CFCs—(i) In general.* For purposes of the sections referred to in paragraph (b)(1) of this section, the portion of the GILTI

inclusion amount of a United States shareholder treated as being with respect to each controlled foreign corporation of the United States shareholder for the U.S. shareholder inclusion year is—

(A) In the case of a tested loss CFC, zero, and

(B) In the case of a tested income CFC, the portion of the GILTI inclusion amount of the United States shareholder which bears the same ratio to such inclusion amount as the United States shareholder's pro rata share of the tested income of the tested income CFC for the U.S. shareholder inclusion year bears to the aggregate amount of the United States shareholder's pro rata share of the tested income of each tested income CFC for the U.S. shareholder inclusion year.

(ii) *Example—(A) Facts.* USP, a domestic corporation, owns all of the stock of three controlled foreign corporations, CFC1, CFC2, and CFC3. USP, CFC1, CFC2, and CFC3 all use the calendar year as their taxable year. In Year 1, CFC1 has tested income of \$100x, CFC2 has tested income of \$300x, and CFC3 has tested loss of \$50x. Neither CFC1 nor CFC2 has qualified business asset investment.

(B) *Analysis.* In Year 1, USP has a GILTI inclusion amount of \$350x (\$100x + \$300x – \$50x). The aggregate amount of USP's pro rata share of tested income from CFC1 and CFC2 is \$400x (\$100x + \$300x). The portion of USP's GILTI inclusion amount treated as being with respect to CFC1 is \$87.50x (\$350x × \$100x/\$400x). The portion of USP's GILTI inclusion amount treated as being with respect to CFC2 is \$262.50x (\$350x × \$300x/\$400x). The portion of USP's GILTI inclusion amount treated as being with respect to CFC3 is \$0 because CFC3 is a tested loss CFC.

(iii) *Translation of portion of GILTI inclusion amount allocated to tested income CFC.* The portion of the GILTI inclusion amount of a United States shareholder allocated to a tested income CFC under section 951A(f)(2) and paragraph (b)(2)(i) of this section is translated into the functional currency of the tested income CFC using the average exchange rate for the CFC inclusion year of the tested income CFC.

(c) *Treatment as an amount includible in the gross income of a United States person—(1) In general.* For purposes of sections 163(e)(3)(B)(i) and 267(a)(3)(B), an item (including original issue discount) is treated as includible in the gross income of a United States person to the extent that such item increases a United States shareholder's pro rata share of tested income of a controlled foreign corporation for a U.S. shareholder inclusion year, reduces the shareholder's pro rata share of tested loss of a controlled foreign corporation

for the U.S. shareholder inclusion year, or both.

(2) *Special rule for a United States shareholder that is a domestic partnership.* In the case of a United States shareholder that is a domestic partnership (within the meaning of section 7701(a)(4)), an item is described in paragraph (c)(1) of this section only to the extent one or more United States persons (other than domestic partnerships) that are direct or indirect partners of the domestic partnership include in gross income their distributive share of the GILTI inclusion amount (if any) of the domestic partnership for the U.S. shareholder inclusion year of the domestic partnership in which such item accrues or such item is taken into account under paragraph (c)(1) of this section by a U.S. shareholder partner (within the meaning of § 1.951A–5(e)(3)) of the domestic partnership by reason of § 1.951A–5(c).

(d) *Increase of earnings and profits of tested loss CFC for purposes of section 952(c)(1)(A).* For purposes of section 952(c)(1)(A) with respect to a CFC inclusion year, the earnings and profits of a tested loss CFC are increased by an amount equal to the tested loss of the tested loss CFC for the CFC inclusion year.

(e) *Adjustments to basis related to net used tested loss—(1) In general—(i) Disposition of stock of a controlled foreign corporation.* In the case of a disposition of section 958(a) stock of a controlled foreign corporation owned (directly or indirectly) by a domestic corporation (*specified stock*), the adjusted basis of the specified stock is reduced immediately before the disposition by the domestic corporation's net used tested loss amount with respect to the controlled foreign corporation (if any) attributable to the specified stock. If the reduction described in the preceding sentence exceeds the adjusted basis in the specified stock immediately before the disposition, such excess is treated as gain from the sale or exchange of the stock for the taxable year in which the disposition occurs.

(ii) *Disposition of stock of an upper-tier controlled foreign corporation.* In the case of a disposition of specified stock of a controlled foreign corporation (*upper-tier CFC*) by reason of which a domestic corporation owns, or has owned, section 958(a) stock of any other controlled foreign corporation (*lower-tier CFC*), for purposes of determining the reduction under paragraph (e)(1)(i) of this section, the domestic corporation's net used tested loss amount (if any) with respect to the

upper-tier CFC attributable to the specified stock is—

(A) Increased by the sum of the domestic corporation's net used tested loss amounts with respect to each lower-tier CFC attributable to the specified stock; and

(B) Reduced (but not below zero) by the sum of the domestic corporation's net offset tested income amounts with respect to the upper-tier CFC and each lower-tier CFC attributable to the specified stock.

(iii) *Disposition of an interest in a foreign entity other than a controlled foreign corporation.* In the case of a disposition of an interest in a foreign entity other than a controlled foreign corporation through which entity a domestic corporation owns section 958(a) stock of a controlled foreign corporation, for purposes of paragraph (e)(1)(i) and (ii) of this section, the controlled foreign corporation is treated as a lower-tier CFC, the interest in the entity is treated as specified stock of a controlled foreign corporation, and the entity is treated as an upper-tier CFC with respect to which the domestic corporation has neither a net used tested loss amount nor a net offset tested income amount.

(iv) *Order of application of basis reductions.* In the event of an indirect disposition described in paragraph (e)(6)(ii)(B) of this section, the basis reduction described in paragraph (e)(1)(i) of this section is deemed to occur at the lowest-tier CFC first and, thereafter, up the chain of ownership until adjustments are made to the specified stock directly owned by the person making the disposition described in paragraph (e)(6)(ii)(A) of this section.

(v) *No duplicative adjustments.* No item is taken into account under this paragraph (e)(1) to adjust the basis of specified stock of a controlled foreign corporation to the extent that such amount has previously been taken into account with respect to a prior basis adjustment with respect to such stock under this paragraph (e)(1). Moreover, the basis of specified stock is not reduced to the extent a taxpayer can demonstrate to the satisfaction of the Secretary that such adjustments would duplicate prior reductions to the basis of such stock under section 362(e)(2).

(2) *Net used tested loss amount—(i) In general.* The term *net used tested loss amount* means, with respect to a domestic corporation and a controlled foreign corporation, the excess (if any) of—

(A) The aggregate of the domestic corporation's used tested loss amount with respect to the controlled foreign

corporation for each U.S. shareholder inclusion year, over

(B) The aggregate of the domestic corporation's offset tested income amount with respect to the controlled foreign corporation for each U.S. shareholder inclusion year.

(ii) *Used tested loss amount.* The term *used tested loss amount* means, with respect to a domestic corporation and a tested loss CFC for a U.S. shareholder inclusion year—

(A) In the case of a domestic corporation that has net CFC tested income for the U.S. shareholder inclusion year, the domestic corporation's pro rata share of the tested loss of the tested loss CFC for the U.S. shareholder inclusion year, or

(B) In the case of a domestic corporation without net CFC tested income for the U.S. shareholder inclusion year, the amount that bears the same ratio to the domestic corporation's pro rata share of the tested loss of the tested loss CFC for the U.S. shareholder inclusion year as the aggregate of the domestic corporation's pro rata share of the tested income of each tested income CFC for the U.S. shareholder inclusion year bears to the aggregate of the domestic corporation's pro rata share of the tested loss of each tested loss CFC for the U.S. shareholder inclusion year.

(3) *Net offset tested income amount—(i) In general.* The term *net offset tested income amount* means, with respect to a domestic corporation and a controlled foreign corporation, the excess (if any) of the amount described in paragraph (e)(2)(i)(B) of this section over the amount described in paragraph (e)(2)(i)(A) of this section.

(ii) *Offset tested income amount.* The term *offset tested income amount* means, with respect to a domestic corporation and a tested income CFC for a U.S. shareholder inclusion year—

(A) In the case of a domestic corporation that has net CFC tested income for the U.S. shareholder inclusion year, the amount that bears the same ratio to the domestic corporation's pro rata share of the tested income of the tested income CFC for the U.S. shareholder inclusion year as the aggregate of the domestic corporation's pro rata share of the tested loss of each tested loss CFC for the U.S. shareholder inclusion year bears to the aggregate of the domestic corporation's pro rata share of the tested income of each tested income CFC for the U.S. shareholder inclusion year, or

(B) In the case of a domestic corporation without net CFC tested income for the U.S. shareholder inclusion year, the domestic

corporation's pro rata share of the tested income of the tested income CFC for the U.S. shareholder inclusion year.

(4) *Attribution to stock—(i) In general.* The portion of a domestic corporation's net used tested loss amount or net offset tested income amount with respect to a controlled foreign corporation (including a lower-tier CFC) attributable to specified stock for purposes of paragraph (e)(1) of this section is determined based on the domestic corporation's pro rata share of the tested loss and tested income, as applicable, of the controlled foreign corporation for each U.S. shareholder inclusion year with respect to such specified stock. See § 1.951A-1(d)(1), (2), and (4) for rules regarding the determination of pro rata share amounts of tested income and tested loss.

(ii) *Nonrecognition transactions.* In the case of specified stock acquired by a domestic corporation in a nonrecognition transaction (as defined in section 7701(a)(45)), the principles of § 1.1248-8 apply to determine the domestic corporation's net used tested loss amount or net offset tested income amount with respect to a controlled foreign corporation attributable to specified stock. For purposes of applying the principles of § 1.1248-8, tested income is treated as earnings and profits and tested loss is treated as a deficit in earnings and profits.

(5) *Section 381 transactions.* If a controlled foreign corporation with respect to which a United States shareholder has a net used tested loss amount or net offset tested income amount is a distributor or transferor corporation in a transaction described in section 381(a) (*acquired CFC*) in which a controlled foreign corporation is the acquiring corporation (*acquiring CFC*), 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 paragraph (e)(5) does not apply to the extent that the acquiring CFC is an upper-tier CFC and such amounts would be taken into account under paragraph (e)(1)(ii) of this paragraph if the stock of the acquiring CFC were disposed of.

(6) *Other definitions.* The following additional definitions apply for purposes of this paragraph (e):

(i) *Domestic corporation.* The term *domestic corporation* means a domestic corporation other than a real estate investment trust (as defined in section 856) or a regulated investment company (as defined in section 851).

(ii) *Disposition*. The term *disposition* means—

(A) Any transfer of specified stock that is taxable, in whole or in part, including a sale or exchange, contribution, or distribution of the stock, including a deemed sale or exchange by reason of the specified stock becoming worthless within the meaning of section 165(g), or

(B) Any indirect disposition of specified stock of a lower-tier CFC as a result of a disposition described in paragraph (e)(6)(ii)(A) of this section of specified stock of an upper-tier CFC.

(7) *Special rule for disposition by controlled foreign corporation less than 100 percent owned by a single domestic corporation*. In the case of a disposition by a controlled foreign corporation that is not 100 percent owned, within the meaning of section 958(a), by a single domestic corporation, if a reduction to basis described in paragraph (e)(1) of this section by reason of a domestic corporation's net used tested loss amount results in an increase to the controlled foreign corporation's foreign personal holding company income (as defined in section 954(c)(1)), the domestic corporation's pro rata share of the subpart F income of the controlled foreign corporation, as otherwise determined under section 951(a)(2) and § 1.951-1(b) and (e), is increased by the amount of such increase, and no other shareholder takes such subpart F income into account under section 951(a)(1)(A).

(8) *Special rules for members of a consolidated group*. For purposes of the section 951A regulations, a member determines its net used tested loss amount and the adjustments made as a result of the amount under the rules provided in § 1.1502-51(c).

(9) *Examples*. The following examples illustrate the application of the rules in this paragraph (e).

(i) *Example 1—(A) Facts*. USP, a domestic corporation, owns 100% of the single class of stock of CFC1 and CFC2. USP1, CFC1, and CFC2 all use the calendar year as their taxable year. In Year 1, CFC2 has \$90x of tested loss and CFC1 has \$100x of tested income. At the beginning of Year 2, USP sells all of the stock of CFC2 to an unrelated buyer for cash. USP has no used tested loss amount or offset tested income amount with respect to CFC2 in any year prior to Year 1. USP has not owned stock in any other CFC by reason of owning stock of CFC1 and CFC2.

(B) *Analysis*. At the time of the disposition, USP has a net used tested loss amount of \$90x with respect to CFC2 attributable to the CFC2 stock, which is the specified stock. Because USP does not own (and has not owned), within the meaning of section 958(a)(2), stock in any lower-tier CFCs by reason of the CFC2 stock, there is no

adjustment to the net used tested loss amount of \$90x pursuant to paragraph (e)(1)(ii) of this section. Accordingly, immediately before the disposition of the CFC2 stock, the basis of the CFC2 stock is reduced by \$90x under paragraph (e)(1)(i) of this section.

(ii) *Example 2—(A) Facts*. The facts are the same as in paragraph (A) of *Example 1*, except that USP sells only 90% of the shares of CFC2.

(B) *Analysis*. The analysis is the same as in paragraph (B) of *Example 1*, except that USP's net used tested loss amount attributable to the CFC2 stock that was disposed of is only \$81x (90% x \$90x) under paragraph (e)(4)(i) of this section.

Accordingly, immediately before the disposition of such stock, the basis in the CFC2 stock disposed of is reduced by \$81x under paragraph (e)(1)(i) of this section.

(iii) *Example 3—(A) Facts*. The facts are the same as in paragraph (A) of *Example 1*, except that USP sells the CFC2 stock at the beginning of Year 3 and during Year 2 CFC1 has \$10x of tested loss that offsets Year 2 tested income of CFC2.

(B) *Analysis*. USP has a net used tested loss amount of \$80x with respect to CFC2 attributable to the CFC2 stock, the amount of USP's used tested loss amount with respect to CFC2 attributable to the CFC2 stock in Year 1 of \$90x reduced by USP's offset tested income amount with respect to CFC2 attributable to the CFC2 stock in Year 2 of \$10x. Accordingly, immediately before the disposition of the CFC2 stock, the basis of the CFC2 stock is reduced by \$80x under paragraph (e)(1)(i) of this section.

(iv) *Example 4—(A) Facts*. USP, a domestic corporation, owns 100% of the single class of stock of CFC1, and CFC1 owns 100% of the single class of stock of CFC2. USP1, CFC1, and CFC2 all use the calendar year as their taxable year. In Year 1, CFC1 has \$100x of tested loss that offsets CFC2's \$100x of tested income. USP sells the stock of CFC1 at the beginning of Year 2. USP has no used tested loss amount or offset tested income amount with respect to CFC1 or CFC2 in any year prior to Year 1. USP has not owned stock in any other CFC by reason of owning stock of CFC1 and CFC2.

(B) *Analysis—(1) Direct disposition*. At the time of the disposition, USP has a net used tested loss amount of \$100x with respect to CFC1 attributable to the CFC1 stock.

However, because USP owns, within the meaning of section 958(a)(2), CFC2 stock by reason of the CFC1 stock, USP's \$100x net used tested loss amount with respect to CFC1 attributable to the CFC1 stock is reduced by USP's \$100x net offset tested income amount with respect to CFC2 attributable to the CFC1 stock. Accordingly, there is no adjustment to the basis of the CFC1 stock under paragraph (e)(1)(i) of this section.

(2) *Indirect disposition*. Under paragraph (e)(6)(ii)(B) of this section, USP's disposition of the CFC1 stock also constitutes an indirect disposition of the CFC2 stock because CFC1 is an upper-tier CFC and CFC2 is a lower-tier CFC within the meaning of paragraph (e)(1)(ii) of this section. However, USP has no net used tested loss amount with respect to CFC2 attributable to the CFC2 stock.

Accordingly, there is no adjustment to the

basis of the CFC2 stock under paragraph (e)(1) of this section.

(v) *Example 5—(A) Facts*. The facts are the same as in paragraph (A) of *Example 4*, except that in Year 1 CFC2 has \$100x of tested loss that offsets CFC1's \$100x of tested income. CFC1 sells the stock of CFC2 at the beginning of Year 2.

(B) *Analysis*. USP, a domestic corporation, owns within the meaning of section 958(a) stock of CFC2. Accordingly, immediately before the disposition, CFC1's basis in the CFC2 stock is reduced by USP's net used tested loss amount with respect to CFC2 attributable to the CFC2 stock of \$100x under paragraph (e)(1)(i) of this section.

(2) *Indirect disposition*.

(vi) *Example 6—(A) Facts*. The facts are the same as in paragraph (A) of *Example 5*, except that instead of CFC1 selling the stock of CFC2, USP sells the stock of CFC1.

(B) *Analysis—(1) Direct disposition*. USP has no net used tested loss amount with respect to CFC1 attributable to the stock of CFC1. However, because USP owns, within the meaning of section 958(a)(2), stock of CFC2 by reason of owning stock of CFC1, under paragraph (e)(1)(ii) of this section, USP's net used tested loss amount attributable to the stock of CFC1 (\$0) is increased by USP's net used tested loss amount with respect to CFC2 attributable to the CFC1 stock (\$100x), and reduced by USP's net offset tested income amount with respect to CFC1 attributable to the CFC1 stock (\$100x). Accordingly, there is no adjustment to the basis of the CFC1 stock under paragraph (e)(1) of this section.

(2) *Indirect disposition*. Under paragraph (e)(6)(ii)(B) of this section, USP's disposition of CFC1 stock also constitutes an indirect disposition of the CFC2 stock because CFC1 is an upper-tier CFC and CFC2 is a lower-tier CFC within the meaning of paragraph (e)(1)(ii) of this section. Accordingly, immediately before the disposition, CFC1's basis in the CFC2 stock is reduced by USP's net used tested loss amount with respect to CFC2 attributable to the CFC2 stock of \$100x under paragraph (e)(1)(i) of this section. Under paragraph (e)(1)(iv) of this section, the basis reduction to CFC2's shares is deemed to occur immediately before any reductions occur with respect to the stock of CFC1, of which there are none.

(vii) *Example 7—(A) Facts*. USP1, a domestic corporation, owns 90% of the single class of stock of CFC1, and CFC1 owns 100% of the single class of stock of CFC2. USP1 also owns 100% of the single class of stock of CFC3. The remaining 10% of the stock of CFC1 is owned by USP2, a person unrelated to USP1. USP2 owns no other CFCs. USP1, USP2, CFC1, CFC2, and CFC3 all use the calendar year as their taxable year. In Year 1, CFC1 has no tested income or tested loss, CFC2 has tested loss of \$100x, and CFC3 has tested income of \$100x. CFC1 has no other earnings or income in Year 1. At the beginning of Year 2, CFC1 sells CFC2. Without regard to this paragraph (e), CFC1 would recognize no gain or loss with respect to the CFC2 stock. USP1 has not owned stock in any other controlled foreign corporation by reason of owning stock of CFC1, CFC2, and CFC3.

(B) *Analysis.* At the time of the disposition, USP2 has no net used tested loss amount with respect to CFC2. At the time of the disposition, USP1 has a net used tested loss amount of \$90x with respect to CFC2 attributable to the CFC2 stock, which is the specified stock. Because USP1 does not own (and has not owned), within the meaning of section 958(a)(2), stock in any lower-tier CFCs by reason of the CFC2 stock, there is no adjustment to the net used tested loss amount of \$90x pursuant to paragraph (e)(1)(ii) of this section. Accordingly, immediately before the disposition of the CFC2 stock, the basis of the CFC2 stock is reduced by \$90x under paragraph (e)(1)(i) of this section. As a result, CFC1 recognizes gain of \$90x on the disposition of the CFC2 stock, which results in \$90x of foreign personal holding company income and \$90x of earnings and profits. Under paragraph (e)(7) of this section, USP1's pro rata share of the subpart F income of CFC1 is increased by \$90x, and USP2 does not take such subpart F income into account under section 951(a)(1)(A).

(viii) *Example 8—(A) Facts.* USP, a domestic corporation, owns 100% of the single class of stock of CFC1 and CFC2, and CFC1 owns 100% of the single class of stock of CFC3 and CFC4. USP, CFC1, CFC2, CFC3, and CFC4 all use the calendar year as their taxable year. In Year 1, CFC1 has no tested income or tested loss, CFC2 has \$200x of tested income, and CFC3 and CFC4 each have tested loss of \$100x. During Year 2, CFC3 liquidates into CFC1 in a nontaxable transaction described under section 332, and CFC1 sells the stock of CFC4 to an unrelated third party for cash. During Year 2, none of CFC1, CFC2, CFC3, or CFC4 earn tested income or tested loss. At the beginning of Year 3, USP sells the stock of CFC1 to an unrelated third party for cash. USP has not owned stock in any other CFC by reason of owning stock in CFC1, CFC2, CFC3, or CFC4.

(B) *Analysis.* (1) CFC3's liquidation into CFC1 is not a disposition within the meaning of paragraph (e)(6)(ii)(A) of this section because CFC1 does not recognize gain or loss in whole or in part with respect to the stock of CFC3 under section 332. Furthermore, CFC1 does not inherit CFC3's net used tested loss amount under paragraph (e)(5) of this section because CFC1 is an upper-tier CFC with respect to CFC3 and would take such amounts into account under paragraph (e)(1)(ii) of this section at the time of a future disposition. That is, the CFC3 stock is section 958(a) stock that USP has owned by reason of its ownership of CFC1 within the meaning of paragraph (e)(1)(ii) of this section.

(2) At the time of CFC1's sale of the stock of CFC4, USP has a \$100x net used tested loss amount with respect to CFC4 attributable to the CFC4 stock, which is the specified stock. Because USP has not owned, within the meaning of section 958(a)(2), stock in any lower-tier CFCs by reason of the CFC4 stock, there is no adjustment to the net used tested loss amount of \$100x pursuant to paragraph (e)(1)(ii) of this section. Accordingly, immediately before the disposition of the CFC4 stock, the basis of the CFC4 stock is reduced by \$100x under paragraph (e)(1)(i) of this section.

(3) At the time of USP's sale of CFC1, USP has no net used tested loss amount with respect to CFC1 attributable to the CFC1 stock. However, USP has owned, within the meaning of section 958(a)(2), stock of lower-tier CFCs (CFC3 and CFC4) by reason of its ownership of CFC1. Thus, USP's net used tested loss amount attributable to the stock of CFC1 (\$0) is increased by USP's net used tested loss amounts with respect to CFC3 and CFC4 attributable to the CFC1 stock (\$200x). Accordingly, immediately before the disposition of the CFC1 stock, the basis of the CFC1 stock is reduced by \$200x under paragraph (e)(1)(i) of this section. The rule prohibiting duplicative adjustments under paragraph (e)(1)(v) of this section does not prevent this basis reduction because the net used tested loss amounts with respect to the CFC3 and CFC4 stock were not previously taken into account to reduce the basis of CFC1 stock.

■ **Par. 10.** Section 1.951A-7 is added to read as follows:

**§ 1.951A-7 Applicability dates.**

Sections 1.951A-1 through 1.951A-6 apply to taxable years of foreign corporations beginning after December 31, 2017, and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end.

■ **Par. 11.** Section 1.1502-12 is amended by adding paragraph (s) to read as follows:

**§ 1.1502-12 Separate taxable income.**

\* \* \* \* \*

(s) See § 1.1502-51 for rules relating to the computation of a member's GILTI inclusion amount under section 951A and related basis adjustments.

■ **Par. 12.** Section 1.1502-13 is amended by adding paragraph (c) to *Example 4* in paragraph (f)(7).

The addition reads as follows:

**§ 1.1502-13 Intercompany transactions.**

\* \* \* \* \*

(f) \* \* \*

(7) \* \* \*

*Example 4.* \* \* \*

(c) *Application of § 1.1502-51(c)(5) to all cash intercompany reorganization under section 368(a)(1)(D).* The facts are the same as in paragraph (a) of this *Example 4*, except that S's sole asset is stock of a controlled foreign corporation, within the meaning of section 957, with respect to which S has a net used tested loss amount (within the meaning of § 1.1502-51(e)(15)) of \$15. As in paragraph (b) of this *Example 4*, S is treated as receiving additional B stock with a fair market value of \$100 (in lieu of the \$100) and, under section 358, a basis of \$25 which S distributes to M in liquidation. Immediately after the sale, pursuant to § 1.1502-51(c)(5), the basis in the B stock received by M is reduced by \$15 (the amount of the net used tested loss amount with respect to the controlled foreign corporation) to \$10. Following the basis reduction

pursuant to § 1.1502-51(c)(5), the B stock (with the exception of the nominal share which is still held by M) received by M is treated as redeemed for \$100, and the redemption is treated under section 302(d) as a distribution to which section 301 applies. M's basis of \$10 in the B stock is reduced under § 1.1502-32(b)(3)(v), resulting in an excess loss account of \$90 in the nominal share. (See § 1.302-2(c).) M's deemed distribution of the nominal share of B stock to P under § 1.368-2(l) will result in M generating an intercompany gain under section 311(b) of \$90, to be subsequently taken into account under the matching and acceleration rules.

\* \* \* \* \*

■ **Par. 13.** Section 1.1502-32 is amended by:

■ 1. Adding paragraphs (b)(3)(ii)(E), (b)(3)(ii)(F), and (b)(3)(iii)(C).

■ 2. Revising paragraph (j).

The revision and additions read as follows:

**§ 1.1502-32 Investment adjustments.**

\* \* \* \* \*

(b) \* \* \*

(3) \* \* \*

(ii) \* \* \*

(E) *Adjustment for the offset tested income amount of a controlled foreign corporation in relation to section 951A.* S's tax-exempt income for a taxable year includes the aggregate of S's offset tested income amounts (within the meaning of § 1.1502-51(c)(3)) with respect to a controlled foreign corporation (within the meaning of section 957) for all of its U.S. shareholder inclusion years (within the meaning of § 1.951A-1(e)(4)), to the extent such aggregate does not exceed the excess (if any) of—

(1) The aggregate of S's used tested loss amounts (within the meaning of § 1.1502-51(c)(2)) with respect to the controlled foreign corporation for all of its U.S. shareholder inclusion years, over

(2) The aggregate of S's offset tested income amounts with respect to the controlled foreign corporation for all of its U.S. shareholder inclusion years previously treated as tax-exempt income pursuant to this paragraph.

(F) *Adjustment for the net offset tested income amount of a controlled foreign corporation in relation to section 951A.* S will be treated as having tax-exempt income immediately prior to a transaction (*recognition event*) in which another member of the group recognizes income, gain, deduction, or loss with respect to a share of S's stock to the extent provided in this paragraph (b)(3)(ii)(F). S's tax-exempt income is equal to the portion of the allocable amount that would have been characterized as a dividend to which

section 245A, but not section 1059, would have applied if the allocable amount had been distributed by a controlled foreign corporation to the owner of the transferred shares immediately before the recognition event. For purposes of this paragraph—

(1) The term *transferred shares* means the shares of a controlled foreign corporation that S owns within the meaning of section 958(a) or is considered to own by applying the rules of ownership of section 958(b) and that are indirectly transferred as part of the recognition event; and

(2) The term *allocable amount* means the net offset tested income amount (within the meaning of § 1.1502–51(e)(14)) allocable to the transferred shares.

(iii) \* \* \*

(C) *Adjustment for the used tested loss amount of a controlled foreign corporation in relation to section 951A.* S's noncapital, nondeductible expense includes its amount of used tested loss amount (within the meaning of § 1.1502–51(c)(2)) with respect to a controlled foreign corporation (within the meaning of section 957) for a U.S. shareholder inclusion year (within the meaning of § 1.951A–1(e)(4)).

\* \* \* \* \*

(j) *Applicability date*—(1) *In general.* Paragraph (b)(4)(iv) of this section applies to any original consolidated Federal income tax return due (without extensions) after June 14, 2007. For original consolidated Federal income tax returns due (without extensions) after May 30, 2006, and on or before June 14, 2007, see § 1.1502–32T as contained in 26 CFR part 1 in effect on April 1, 2007. For original consolidated Federal income tax returns due (without extensions) on or before May 30, 2006, see § 1.1502–32 as contained in 26 CFR part 1 in effect on April 1, 2006.

(2) *Adjustment for the offset tested income amount, net offset tested income amount, and used tested loss amount of a controlled foreign corporation.* Paragraphs (b)(3)(ii)(E), (b)(3)(ii)(F), and (b)(3)(iii)(C) of this section apply to any consolidated Federal income tax return for a taxable year in which or with which the taxable year of a controlled foreign corporation beginning after December 31, 2017, ends.

\* \* \* \* \*

■ **Par. 14.** Section 1.1502–51 is added to read as follows:

**§ 1.1502–51 Consolidated section 951A.**

(a) *In general.* This section provides rules for applying section 951A and §§ 1.951A–1 through 1.951A–7 (the *section 951A regulations*) to each

member of a consolidated group (each, a *member*) that is a United States shareholder of any controlled foreign corporation. Paragraph (b) describes the inclusion of the GILTI inclusion amount by a member of a consolidated group. Paragraph (c) modifies the rules provided in § 1.951A–6(e) for adjustments to basis related to used tested loss amount. Paragraph (d) provides rules governing basis adjustments to member stock resulting from the application of § 1.951A–6(e) and paragraph (c) of this section. Paragraph (e) provides definitions for purposes of this section. Paragraph (f) provides examples illustrating the rules of this section. Paragraph (g) provides an applicability date.

(b) *Calculation of the GILTI inclusion amount for a member of a consolidated group.* Each member who is a United States shareholder of any controlled foreign corporation includes in gross income in the U.S. shareholder inclusion year the member's GILTI inclusion amount, if any, for the U.S. shareholder inclusion year. See section 951A(a) and § 1.951A–1(b). The GILTI inclusion amount of a member for a U.S. shareholder inclusion year is the excess (if any) of the member's net CFC tested income for the U.S. shareholder inclusion year, over the member's net deemed tangible income return for the U.S. shareholder inclusion year, determined using the definitions provided in paragraph (e) of this section.

(c) *Adjustments to basis related to used tested loss amount*—(1) *In general.* The adjusted basis of the section 958(a) stock of a controlled foreign corporation that is owned (directly or indirectly) by a member (*specified stock*) or an interest in a foreign entity other than a controlled foreign corporation by reason of which a domestic corporation owns (within the meaning of section 958(a)(2)) stock of a controlled foreign corporation is adjusted immediately before its disposition pursuant to § 1.951A–6(e). The amount of the adjustment is determined using the rules provided in paragraphs (c)(2), (3), and (4) of this section.

(2) *Determination of used tested loss amount.* For purposes of the section 951A regulations and this section, the term *used tested loss amount* means, with respect to a member and a tested loss CFC for a U.S. shareholder inclusion year—

(i) In the case of the consolidated group tested income equaling or exceeding the consolidated group tested loss for a U.S. shareholder inclusion year, the member's pro rata share (determined under § 1.951A–1(d)(4)) of

the tested loss of the tested loss CFC for the U.S. shareholder inclusion year.

(ii) In the case of the consolidated group tested income being less than the consolidated group tested loss for a U.S. shareholder inclusion year, the amount that bears the same ratio to the member's pro rata share (determined under § 1.951A–1(d)(4)) of the tested loss of the tested loss CFC for the U.S. shareholder inclusion year as the consolidated group tested income for the U.S. shareholder inclusion year bears to the consolidated group tested loss for the U.S. shareholder inclusion year.

(3) *Determination of offset tested income amount.* For purposes of the section 951A regulations and this section, the term *offset tested income amount* means, with respect to a member and a tested income CFC for a U.S. shareholder inclusion year—

(i) In the case of the consolidated group tested income exceeding the consolidated group tested loss for a U.S. shareholder inclusion year, the amount that bears the same ratio to the member's pro rata share (determined under § 1.951A–1(d)(2)) of the tested income of the tested income CFC for the U.S. shareholder inclusion year as the consolidated group tested loss for the U.S. shareholder inclusion year bears to the consolidated group tested income for the U.S. shareholder inclusion year.

(ii) In the case of the consolidated group tested income equaling or being less than the consolidated group tested loss for a U.S. shareholder inclusion year, the member's pro rata share (determined under § 1.951A–1(d)(2)) of the tested income of the tested income CFC for the U.S. shareholder inclusion year.

(4) *Special rule for disposition by a controlled foreign corporation less than 100 percent owned by a single domestic corporation.* For purposes of determining the application of § 1.951A–6(e)(7), the amount of stock in the controlled foreign corporation a member owns, within the meaning of section 958(a), includes any stock that the member is considered as owning by applying the rules of ownership of section 958(b).

(5) *Special rule for intercompany nonrecognition transactions.* If a member engages in a nonrecognition transaction (within the meaning of section 7701(a)(45)), with another member in which stock of a controlled foreign corporation that has a net used tested loss amount is directly transferred, the adjusted basis of the nonrecognition property (within the meaning of section 358) received in the nonrecognition transaction is

immediately reduced by the amount of the net used tested loss amount. In cases of intercompany transactions that are governed by § 1.368–2(l), the reduction in basis pursuant to this paragraph (c)(5) is made prior to the application of § 1.1502–13(f)(3). See § 1.1502–13(f)(7), Example 4(c).

(d) *Adjustments to the basis of a member.* For adjustments to the basis of a member related to paragraph (c) of this section, see § 1.1502–32(b)(3)(ii)(E), (b)(3)(ii)(F), and (b)(3)(iii)(C).

(e) *Definitions.* The following definitions apply for purposes of the section—

(1) *Aggregate tested income.* With respect to a member, the term *aggregate tested income* means the aggregate of the member's pro rata share (determined under § 1.951A–1(d)(2)) of the tested income of each tested income CFC for a U.S. shareholder inclusion year.

(2) *Aggregate tested loss.* With respect to a member, the term *aggregate tested loss* means the aggregate of the member's pro rata share (determined under § 1.951A–1(d)(4)) of the tested loss of each tested loss CFC for a U.S. shareholder inclusion year.

(3) *Allocable share.* The term *allocable share* means, with respect to a member that is a United States shareholder and a U.S. shareholder inclusion year—

(i) With respect to consolidated group QBAI, the product of the consolidated group QBAI of the member's consolidated group and the member's GILTI allocation ratio.

(ii) With respect to consolidated group specified interest expense, the product of the consolidated group specified interest expense of the member's consolidated group and the member's GILTI allocation ratio.

(iii) With respect to consolidated group tested loss, the product of the consolidated group tested loss of the member's consolidated group and the member's GILTI allocation ratio.

(4) *Consolidated group QBAI.* With respect to a consolidated group, the term *consolidated group QBAI* means the sum of each member's pro rata share (determined under § 1.951A–1(d)(3)) of the qualified business asset investment of each tested income CFC for a U.S. shareholder inclusion year.

(5) *Consolidated group specified interest expense.* With respect to a consolidated group, the term *consolidated group specified interest expense* means the excess (if any) of—

(i) The sum of each member's pro rata share (determined under § 1.951A–1(d)(5)) of the tested interest expense of each controlled foreign corporation for

the U.S. shareholder inclusion year, over

(ii) The sum of each member's pro rata share (determined under § 1.951A–1(d)(6)) of the tested interest income of each controlled foreign corporation for the U.S. shareholder inclusion year.

(6) *Consolidated group tested income.* With respect to a consolidated group, the term *consolidated group tested income* means the sum of each member's aggregate tested income for a U.S. shareholder inclusion year.

(7) *Consolidated group tested loss.* With respect to a consolidated group, the term *consolidated group tested loss* means the sum of each member's aggregate tested loss for a U.S. shareholder inclusion year.

(8) *Controlled foreign corporation.* The term *controlled foreign corporation* means a controlled foreign corporation as defined in section 957.

(9) *Deemed tangible income return.* With respect to a member, the term *deemed tangible income return* means 10 percent of the member's allocable share of the consolidated group QBAI.

(10) *GILTI allocation ratio.* With respect to a member, the term *GILTI allocation ratio* means the ratio of—

(i) The aggregate tested income of the member for a U.S. shareholder inclusion year, to

(ii) The consolidated group tested income of the consolidated group of which the member is a member for the U.S. shareholder inclusion year.

(11) *GILTI inclusion amount.* With respect to a member, the term *GILTI inclusion amount* has the meaning provided in paragraph (b) of this section.

(12) *Net CFC tested income.* With respect to a member, the term *net CFC tested income* means the excess (if any) of—

(i) The member's aggregate tested income, over

(ii) The member's allocable share of the consolidated group tested loss.

(13) *Net deemed tangible income return.* With respect to a member, the term *net deemed tangible income return* means the excess (if any) of the member's deemed tangible income return over the member's allocable share of the consolidated group specified interest expense.

(14) *Net offset tested income amount.* The term *net offset tested income amount* means, with respect to a member and a controlled foreign corporation, the excess (if any) of the amount described in paragraph (e)(15)(ii) of this section over the amount described in paragraph (e)(15)(i) of this section.

(15) *Net used tested loss amount.* The term *net used tested loss amount* means, with respect to a member and a controlled foreign corporation, the excess (if any) of—

(i) The aggregate of the member's pro rata share of each used tested loss amount of the controlled foreign corporation for each U.S. shareholder inclusion year over

(ii) The aggregate of the member's pro rata share of each offset tested income amount of the controlled foreign corporation for each U.S. shareholder inclusion year.

(16) *Offset tested income amount.* The term *offset tested income amount* has the meaning provided in paragraph (c)(3) of this section.

(17) *Qualified business asset investment.* The term *qualified business asset investment* has the meaning provided in § 1.951A–3(b).

(18) *Tested income.* The term *tested income* has the meaning provided in § 1.951A–2(b)(1).

(19) *Tested income CFC.* The term *tested income CFC* has the meaning provided in § 1.951A–2(b)(1).

(20) *Tested interest expense.* The term *tested interest expense* has the meaning provided in § 1.951A–4(b)(1).

(21) *Tested interest income.* The term *tested interest income* has the meaning provided in § 1.951A–4(b)(2).

(22) *Tested loss.* The term *tested loss* has the meaning provided in § 1.951A–2(b)(2).

(23) *Tested loss CFC.* The term *tested loss CFC* has the meaning provided in § 1.951A–2(b)(2).

(24) *United States shareholder.* The term *United States shareholder* has the meaning provided in § 1.951–1(g)(1).

(25) *U.S. shareholder inclusion year.* The term *U.S. shareholder inclusion year* has the meaning provided in § 1.951A–1(e)(4).

(26) *Used tested loss amount.* The term *used tested loss amount* has the meaning provided in paragraph (c)(2) of this section.

(f) *Examples.* The following examples illustrate the rules of this section. For purposes of the examples in this section, unless otherwise stated: P is the common parent of the P consolidated group; P owns all of the single class of stock of subsidiaries USS1, USS2, and USS3, all of whom are members of the P consolidated group; CFC1, CFC2, CFC3, and CFC4 are all controlled foreign corporations (within the meaning of paragraph (e)(8) of this section); and the taxable year of all persons is the calendar year.

(1) *Example 1: Calculation of net CFC tested income within a consolidated group*

when all CFCs are wholly owned by a member— (i) *Facts*. USS1 owns all of the single class of stock of CFC1. USS2 owns all of the single class of stock of each of CFC2 and CFC3. USS3 owns all of the single class of stock of CFC4. In Year 1, CFC1 has tested loss of \$100, CFC2 has tested income of \$200x, CFC3 has tested loss of \$200x, and CFC4 has tested income of \$600x. Neither CFC2 nor CFC4 has qualified business asset investment in Year 1.

(ii) *Analysis*—(A) *Consolidated group tested income and GILTI allocation ratio*. USS1 has no aggregate tested income; USS2's aggregate tested income is \$200x, its pro rata share (within the meaning of § 1.951A-1(d)(2)) of CFC2's tested income; and USS3's aggregate tested income is \$600x, its pro rata share (within the meaning of § 1.951A-1(d)(2)) of CFC4's tested income. Therefore, under paragraph (e)(6) of this section, the P consolidated group's consolidated group tested income is \$800x (\$200x + \$600x). As a result, the GILTI allocation ratios of USS1, USS2, and USS3 are 0 (\$0/\$800x), 0.25 (\$200x/\$800x), and 0.75 (\$600x/\$800x), respectively.

(B) *Consolidated group tested loss*. Under paragraph (e)(7) of this section, the P consolidated group's consolidated group tested loss is \$300x (\$100x + \$200x), the aggregate of USS1's aggregate tested loss, which is equal to its pro rata share (within the meaning of § 1.951A-1(d)(4)) of CFC1's tested loss (\$100x), and USS2's aggregate tested loss, which is equal to its pro rata share (within the meaning of § 1.951A-1(d)(4)) of CFC3's tested loss (\$200x). Under paragraph (e)(3)(iii) of this section, a member's allocable share of the consolidated group tested loss is the product of the consolidated group tested loss of the member's consolidated group and the member's GILTI allocation ratio. Therefore, the allocable shares of the consolidated group tested loss of USS1, USS2, and USS3 are \$0 (0 × \$300x), \$75x (0.25 × \$300x), and \$225x (0.75 × \$300x), respectively.

(C) *Calculation of net CFC tested income*. Under paragraph (e)(12) of this section, a member's net CFC tested income is the excess (if any) of the member's aggregate tested income over the member's allocable share of the consolidated group tested loss. As a result, USS1's, USS2's, and USS3's net CFC tested income amounts are \$0 (\$0 - \$0), \$125x (\$200x - \$75x), and \$375x (\$600x - \$225x), respectively.

(2) *Example 2: Calculation of net CFC tested income within a consolidated group when ownership of a tested loss CFC is split between members*— (i) *Facts*. The facts are the same as in paragraph (i) of *Example 1*, except that USS2 and USS3 each own 50% of the single class of stock of CFC3.

(ii) *Analysis*. As in paragraph (ii) of *Example 1*, USS1 has no aggregate tested income and a GILTI allocation ratio of 0, USS2 has \$200x of aggregate tested income and a GILTI allocation ratio of 0.25, and USS3 has \$600x of aggregate tested income and a GILTI allocation ratio of 0.75. Additionally, the P consolidated group's consolidated group tested loss is \$300x (the aggregate of USS1's aggregate tested loss, which is equal to its pro rata share (within

the meaning of § 1.951A-1(d)(4)) of CFC1's tested loss (\$100x); USS2's aggregate tested loss, which is equal to its pro rata share (within the meaning of § 1.951A-1(d)(4)) of CFC3's tested loss (\$100x); and USS3's aggregate tested loss, which is equal to its pro rata share (within the meaning of § 1.951A-1(d)(4)) of CFC3's tested loss (\$100x). As a result, under paragraph (e)(12) of this section, as in paragraph (ii)(C) of *Example 1*, USS1's, USS2's, and USS3's net CFC tested income amounts are \$0 (\$0 - \$0), \$125x (\$200x - \$75x), and \$375x (\$600x - \$225x), respectively.

(3) *Example 3: Calculation of GILTI inclusion amount*— (i) *Facts*. The facts are the same as in paragraph (i) of *Example 1*, except that CFC2 and CFC4 have qualified business asset investment of \$500x and \$2000x, respectively, for Year 1. In Year 1, CFC1 and CFC4 each have tested interest expense (within the meaning of § 1.951A-4(b)(1)) of \$25x, and CFC1, CFC2, CFC3, and CFC4 have \$0 of tested interest income (within the meaning of § 1.951A-4(b)(2)). CFC1's tested loss of \$100x and CFC4's tested income of \$600x take into account the interest paid.

(ii) *Analysis*—(A) *GILTI allocation ratio*. As in paragraph (ii) of *Example 1*, the GILTI allocation ratios of USS1, USS2, and USS3 are 0 (\$0/\$800x), 0.25 (\$200x/\$800x), and 0.75 (\$600x/\$800x), respectively.

(B) *Consolidated group QBAI*. Under paragraph (e)(4) of this section, the P consolidated group's consolidated group QBAI is \$2,500x (\$500x + \$2,000x), the aggregate of USS2's pro rata share (determined under § 1.951A-1(d)(3)) of the qualified business asset investment of CFC2 and USS3's pro rata share (determined under § 1.951A-1(d)(3)) of the qualified business asset investment of CFC4. Under paragraph (e)(3)(i) of this section, a member's allocable share of consolidated group QBAI is the product of the consolidated group QBAI of the member's consolidated group and the member's GILTI allocation ratio. Therefore, the allocable shares of the consolidated group QBAI of each of USS1, USS2, and USS3 are \$0 (0 × \$2,500x), \$625x (0.25 × \$2,500x), and \$1,875x (0.75 × \$2,500x), respectively.

(C) *Consolidated group specified interest expense*—(1) *Pro rata share of tested interest expense*. USS1's pro rata share of the tested interest expense of CFC1 is \$25x, the amount by which the tested interest expense increases USS1's pro rata share of CFC1's tested loss (from \$75x to \$100x) for Year 1. USS3's pro rata share of the tested interest expense of CFC4 is also \$25x, the amount by which the tested interest expense decreases USS1's pro rata share of CFC4's tested income (from \$625x to \$600x). See § 1.951A-1(d)(5).

(2) *Consolidated group specified interest expense*. Under paragraph (e)(5) of this section, the P consolidated group's consolidated group specified interest expense is \$50x, the excess of the sum of each member's pro rata share of the tested interest expense of each controlled foreign corporation (\$50x, \$25x from USS1 + \$25x from USS3), over the sum of each member's pro rata share of tested interest income (\$0). Under paragraph (e)(3)(ii) of this section, a

member's allocable share of consolidated group specified interest expense is the product of the consolidated group specified interest expense of the member's consolidated group and the member's GILTI allocation ratio. Therefore, the allocable shares of consolidated group specified interest expense of USS1, USS2, and USS3 are \$0 (0 × \$50x), \$12.50x (0.25 × \$50x), and \$37.50x (0.75 × \$50x), respectively.

(D) *Calculation of deemed tangible income return*. Under paragraph (e)(9) of this section, a member's deemed tangible income return means 10 percent of the member's allocable share of the consolidated group QBAI. As a result, USS1's, USS2's, and USS3's deemed tangible income returns are \$0 (0 - \$0), \$62.50x (0.1 × \$625x), and \$187.50x (0.1 × \$1,875x), respectively.

(E) *Calculation of net deemed tangible income return*. Under paragraph (e)(13) of this section, a member's net deemed tangible income return means the excess (if any) of a member's deemed tangible income return over the member's allocable share of the consolidated group specified interest. As a result, USS1's, USS2's, and USS3's net deemed tangible income returns are \$0 (\$0 - \$0), \$50x (\$62.50x - \$12.50x), and \$150x (\$187.50x - \$37.50x), respectively.

(F) *Calculation of GILTI inclusion amount*. Under paragraph (b) of this section, a member's GILTI inclusion amount for a U.S. shareholder inclusion year is the excess (if any) of the member's net CFC tested income for the U.S. shareholder inclusion year, over the shareholder's net deemed tangible income return for the U.S. shareholder inclusion year. As described in paragraph (ii)(C) of *Example 1*, the amounts of USS1's, USS2's, and USS3's net CFC tested income are \$0, \$125x, and \$375x, respectively. As described in paragraph (ii)(E) of this *Example 3*, the amounts of USS1's, USS2's, and USS3's net deemed tangible income return are \$0, \$50x, and \$150x, respectively. As a result, under paragraph (b) of this section, USS1's, USS2's, and USS3's GILTI inclusion amounts are \$0 (\$0 - \$0), \$75x (\$125x - \$50x), and \$225x (\$375x - \$150x), respectively.

(G) *Calculation of used tested loss amount and offset tested income amount*. As described in paragraph (ii)(A) of *Example 1*, P consolidated group's consolidated group tested income is \$800x. As described in paragraph (ii)(B) of *Example 1*, P consolidated group's consolidated group tested loss is \$300x. Therefore, the P consolidated group's consolidated group tested income exceeds its consolidated group tested loss. As a result, USS1 has a \$100x used tested loss amount with respect to CFC1 and USS2 has a \$200x used tested loss amount with respect to CFC3. Additionally, USS2 has a \$75x offset tested income amount with respect to CFC2 (\$200x × \$300x/\$800x) and USS3 has a \$225x offset tested income amount with respect to CFC3 (\$600x × \$300x/\$800x). See paragraph (c) of this section. P will adjust its basis in USS1 and USS2 pursuant to the rule in § 1.1502-32(b)(3)(iii)(C).

(g) *Applicability date*. This section applies to taxable years of foreign corporations beginning after December

31, 2017, and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end.

■ **Par. 15.** Section 1.6038–2 is amended by:

- 1. Revising the section heading.
- 2. Revising the first sentence in paragraph (a).
- 3. Revising paragraph (m).

The revisions read as follows:

**§ 1.6038–2 Information returns required of United States persons with respect to annual accounting periods of certain foreign corporations.**

(a) *Requirement of return.* Every U.S. person shall make a separate annual information return with respect to each annual accounting period (described in paragraph (e) of this section) of each foreign corporation which that person controls (as defined in paragraph (b) of this section) at any time during such annual accounting period. \* \* \*

\* \* \* \* \*

(m) *Applicability dates.* This section applies to taxable years of foreign corporations beginning on or after October 3, 2018. See 26 CFR 1.6038–2 (revised as of April 1, 2018) for rules applicable to taxable years of foreign corporations beginning before such date.

■ **Par. 16.** Section 1.6038–5 is added to read as follows:

**§ 1.6038–5 Information returns required of certain United States persons to report amounts determined with respect to certain foreign corporations for global intangible low-taxed income (GILTI) purposes.**

(a) *Requirement of return.* Except as provided in paragraph (d) of this section, each United States person who is a United States shareholder (as defined in section 951(b)) of any controlled foreign corporation must make an annual return on Form 8992, “U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI),” (or successor form) for each U.S. shareholder inclusion year (as defined

in § 1.951A–1(e)(4)) setting forth the information with respect to each such controlled foreign corporation, in such form and manner, as Form 8992 (or successor form) prescribes.

(b) *Time and manner for filing.*

Returns on Form 8992 (or successor form) required under paragraph (a) of this section for a taxable year must be filed with the United States person’s income tax return on or before the due date (taking into account extensions) for filing that person’s income tax return.

(c) *Failure to furnish information—(1) Penalties.* If any person required to file Form 8992 (or successor form) under section 6038 and this section fails to furnish the information prescribed on Form 8992 within the time prescribed by paragraph (b) of this section, the penalties imposed by section 6038(b) and (c) may apply.

(2) *Increase in penalty.* If a failure described in paragraph (c)(1) of this section continues for more than 90 days after the date on which the Director of Field Operations, Area Director, or Director of Compliance Campus Operations mails notice of such failure to the person required to file Form 8992, such person shall pay a penalty of \$10,000, in addition to the penalty imposed by section 6038(b)(1), for each 30-day period (or a fraction of) during which such failure continues after such 90-day period has expired. The additional penalty imposed by section 6038(b)(2) and this paragraph (c)(2) shall be limited to a maximum of \$50,000 for each failure.

(3) *Reasonable cause—(i)* For purposes of section 6038(b) and (c) and this section, the time prescribed for furnishing information under paragraph (b) of this section, and the beginning of the 90-day period after mailing of notice by the director under paragraph (c)(2) of this section, shall be treated as being not earlier than the last day on which reasonable cause existed for failure to furnish the information.

(ii) To show that reasonable cause existed for failure to furnish information as required by section 6038 and this section, the person required to report such information must make an affirmative showing of all facts alleged as reasonable cause for such failure in a written statement containing a declaration that it is made under the penalties of perjury. The statement must be filed with the director where the return is required to be filed. The director shall determine whether the failure to furnish information was due to reasonable cause, and if so, the period of time for which such reasonable cause existed. In the case of a return that has been filed as required by this section except for an omission of, or error with respect to, some of the information required, if the person who filed the return establishes to the satisfaction of the director that the person has substantially complied with this section, then the omission or error shall not constitute a failure under this section.

(d) *Exception from filing requirement.* Any United States person that does not own, within the meaning of section 958(a), stock of a controlled foreign corporation in which the United States person is a United States shareholder for a taxable year is not required to file Form 8992. For this purpose, a U.S. shareholder partner (as defined in § 1.951A–5(e)(3)) with respect to a partnership CFC (as defined in § 1.951A–5(e)(2)) is treated as owning, within the meaning of section 958(a), stock of the partnership CFC.

(e) *Applicability date.* This section applies to taxable years of controlled foreign corporations beginning on or after October 3, 2018.

**Kirsten Wielobob,**

*Deputy Commissioner for Services and Enforcement.*

[FR Doc. 2018–20304 Filed 10–3–18; 4:15 pm]

**BILLING CODE 4830–01–P**









# 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

### KAREN GILBREATH SOWELL

Chair  
Ernst & Young LLP  
1101 New York Ave. N.W.  
Washington, DC 20005  
202/327-8747

### DEBORAH L. PAUL

First Vice-Chair  
212/403-1300

### ANDREW H. BRAITERMAN

Second Vice-Chair  
212/837-6315

### GORDON E. WARNKE

Secretary  
212/997-0500

### COMMITTEE CHAIRS:

#### Bankruptcy and Operating Losses

Stuart J. Goldring  
David W. Mayo

#### Compliance, Practice & Procedure

Elliot Pisem  
Bryan C. Skarlatos

#### Consolidated Returns

William Alexander  
Richard Nugent

#### Corporations

Michael T. Mollerus  
Linda Z. Swartz

#### Cross-Border Capital Markets

David M. Schizer  
Andrew R. Walker

#### Cross-Border M&A

Yaron Z. Reich  
Ansgar A. Simon

#### Employee Benefits

Robert C. Fleder  
Andrea K. Wahlquist

#### Estates and Trusts

Alan S. Halperin  
Joseph Septimus

#### Financial Instruments

Lucy W. Farr  
Jeffrey Maddrey

#### "Inbound" U.S. Activities of Foreign

#### Taxpayers

Peter J. Connors  
Peter F. G. Schuur

#### Individuals

Megan L. Brackney  
Steven A. Dean

#### Investment Funds

John C. Hart  
Amanda H. Nussbaum

#### Multistate Taxation

Arthur R. Rosen  
Jack Trachtenberg

#### New York City Taxes

Sherry S. Kraus  
Irwin M. Slomka

#### New York State Taxes

Paul R. Comeau  
Joshua E. Gewolb

#### "Outbound" Foreign Activities of

#### U.S. Taxpayers

Andrew P. Solomon  
Philip R. Wagman

#### Partnerships

Phillip J. Gall  
Eric B. Sloan

#### Pass-Through Entities

James R. Brown  
Edward E. Gonzalez

#### Real Property

Robert Cassanos  
Marcy Geller

#### Reorganizations

Neil J. Barr  
Peter A. Furci

#### Securitized and Structured

#### Finance

Daniel M. Dunn  
John T. Lutz

#### Spin Offs

Lawrence M. Garrett  
Joshua M. Holmes

#### Tax Exempt Entities

Stuart Rosow  
Richard R. Upton

#### Treaties and Intergovernmental

#### Agreements

Lee E. Allison  
David R. Hardy

## MEMBERS-AT-LARGE OF EXECUTIVE COMMITTEE:

Daniel Z. Altman  
William A. Curran  
Tijana J. Dvornic  
Pamela L. Endreny  
Jason R. Factor

Kathleen L. Ferrell  
Elizabeth T. Kessenides  
Shane J. Kiggen  
Stuart E. Leblang  
William L. McRae

Kara L. Mungovan  
Joel Scharfstein  
Stephen E. Shay  
Michael B. Shulman  
Eric Solomon

Jonathan R. Talansky  
Eric Wang  
Sara B. Zablotny

Report No. 1393  
March 28, 2018

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

The Honorable David J. Kautter  
Acting 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. 1393 on Section 163(j)*

Dear Messrs. Kautter and Paul:

I am pleased to submit Report No. 1393 addressing Section 163(j) of the Internal Revenue Code of 1986, as amended (the "Code"), which was amended by P.L. 115-97 (the "Act"), enacted on December 22, 2017. Under Section 163(j), a taxpayer's annual deduction for business interest expense is generally limited to the sum, for the relevant taxable year, of (A) the taxpayer's business interest income, (B) 30% of the taxpayer's adjusted taxable income, and (C) any floor plan financing interest of the taxpayer.

As discussed in the Report, we recommend that guidance be issued under Section 163(j) addressing several technical and interpretive questions, including: (1) the definitions of "interest," "business interest expense," "business interest income," and "adjusted taxable income" as used in 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. Handier  
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

provision; (2) in the case of a taxpayer that conducts both one or more trades or businesses subject to Section 163(j) and one or more trades or businesses excluded from the scope of the provision pursuant to Section 163(j)(7), rules for allocating interest expense among those trades or businesses; (3) guidance concerning the application of Section 163(j) to consolidated groups, including where a member enters or leaves a group; (4) clarification of the rules in Section 163(j)(4) regarding the application of the statute to partners and partnerships; and (5) guidance as to the interaction of Section 163(j) with international tax rules in the Code, including the rules concerning controlled foreign corporations and U.S. shareholders and the rules concerning effectively connected income of a foreign corporation. In addition to providing specific recommendations in the Report concerning these and other issues, we also set forth in the concluding section of the Report a list of additional questions as to which it may be appropriate to issue guidance.

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  
Chair

Enclosure

Cc:

Thomas C. West  
Tax Legislative Counsel  
Department of the Treasury

Krishna P. Vallabhaneni  
Deputy Tax Legislative Counsel  
Department of the Treasury

Brett York  
Associate International Tax Counsel  
Department of the Treasury

Bryan A. Rimmke  
Attorney-Advisor  
Department of the Treasury

Ellen Martin  
Tax Policy Advisor  
Department of the Treasury

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

Robert H. Wellen  
Associate Chief Counsel (CORP)  
Internal Revenue Service

Holly Porter  
Associate Chief Counsel (PSI)  
Internal Revenue Service

Scott K. Dinwiddie  
Associate Chief Counsel (ITA)  
Internal Revenue Service

Bridget E. Tombul  
Branch Chief, Branch 2  
Office of Associate Chief Counsel (ITA)  
Internal Revenue Service

Charles W. Gorham  
Office of Associate Chief Counsel (ITA)  
Internal Revenue Service



**NEW YORK STATE BAR ASSOCIATION TAX SECTION**

**REPORT ON SECTION 163(j)**

**March 28, 2018**

## TABLE OF CONTENTS

	<b>Page</b>
I. SUMMARY OF RECOMMENDATIONS .....	1
A. General Recommendations .....	1
B. Corporate Recommendations.....	3
C. Partnership Recommendations.....	4
D. International Recommendations .....	5
II. OVERVIEW OF SECTION 163(J) .....	6
A. Section 163(j) Prior to the Act .....	6
B. Section 163(j) as amended by the Act .....	7
III. DISCUSSION .....	11
A. Interest.....	11
B. Business Interest Expense; Business Interest Income .....	13
C. Adjusted Taxable Income .....	14
D. Allocation of Interest Expense Among a Taxpayer's Activities .....	15
E. Coordination of Section 163(j) With Other Limits in the Code on Interest Deductions and Non-Interest Deductions .....	20
F. Impact on Earnings and Profits.....	23
G. Consolidated Groups.....	24
H. Partnership Issues.....	33
I. International Issues .....	48
IV. ADDITIONAL ISSUES UNDER SECTION 163(J) .....	51



## **REPORT OF THE TAX SECTION OF THE NEW YORK STATE BAR ASSOCIATION ON AMENDMENTS TO SECTION 163(j)**

This report (“**Report**”) of the New York State Bar Association Tax Section comments on Section 163(j)<sup>1</sup> 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**”)<sup>2</sup>.

We thank the Department of the Treasury (“**Treasury**”) and the Internal Revenue Service (the “**IRS**”) for considering our comments on Section 163(j). In this Report, we recommend that Treasury and the IRS issue guidance to address some uncertainties surrounding the application of the statute.

This Report is divided into four parts. Part I summarizes our recommendations for future guidance. Part II describes Section 163(j) as in effect before and after the Act. Part III provides a detailed discussion of our recommendations. Part IV sets forth some additional issues that we have identified, but regarding which we have not yet developed a formal recommendation.

### **I. Summary of Recommendations**

We recommend that Treasury and the IRS issue guidance providing for the following:

#### **A. General Recommendations**

1. It should be confirmed that “interest” for purposes of Section 163(j) includes any item of income or expense that is treated as interest under the Code. In addition, it should be considered whether administrative guidance (or a statutory amendment) should provide that items economically equivalent to interest will be treated as such for purposes of Section 163(j). Particularly if the government seeks to address this issue through administrative guidance, we recommend that the guidance apply only to a limited set of specifically identified types of transactions (in all of which one party secures the use of funds for a period of time and makes payments that are determined solely or almost solely by reference to the time value of money). Such guidance also should take a symmetrical approach for

---

<sup>1</sup> Unless otherwise indicated, all Section references are to the Internal Revenue Code of 1986, as amended (the “**Code**”) and the Treasury Regulations promulgated thereunder.

<sup>2</sup> The principal drafters of this report are John T. Lutz and Philip Wagman with contributions from William Alexander, Daniel Z. Altman, Kimberly S. Blanchard, Peter H. Blessing, Andrew H. Braiterman, James R. Brown, Robert Cassanos, Peter Connors, Daniel M. Dunn, Timothy J. Devetski, Lucy W. Farr, Phillip J. Gall, Marcy G. Geller, Kevin Glenn, Edward E. Gonzalez, David Hardy, Andrew M. Herman, Monte A. Jackel, Robert Kantowitz, Shane J. Kiggen, Stephen B. Land, John P. MacMaster, Jeffrey Maddrey, Michael T. Mollerus, Richard M. Nugent, Deborah L. Paul, James M. Peaslee, Elliot Pisem, Michael L. Schler, David Schnabel, Peter F. G. Schuur, Michael B. Shulman, David R. Sicular, Eric B. Sloan, Andrew P. Solomon, Karen G. Sowell, Shun Tosaka, Adina T. Wagman, Gordon E. Warnke and Sara B. Zablotney. This report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or House of Delegates.

purposes of identifying income and expenses equivalent to interest under Section 163(j).

2. All interest income of a corporation (other than interest income attributable to a business exempt from Section 163(j)) should be treated as "business interest income" under Section 163(j)(5), and all interest expense of a corporation (other than interest expense attributable to an exempt business) should be treated as "business interest" under Section 163(j)(6). In the case of a noncorporate taxpayer, all interest income other than investment income as defined in Section 163(d) (and interest income attributable to an exempt business) should be treated as "business interest income," and all interest expense other than investment interest under Section 163(d) and personal interest under Section 163(h) (and interest expense attributable to an exempt business) should be treated as "business interest."
3. "Adjusted taxable income" of a corporation should include all items of income and expense that are included in its taxable income, other than those specifically excluded by Section 163(j)(8)(A)(ii), (iii) and (v) (i.e., business interest income, business interest, the net operating loss deduction and, beginning in 2022, deductions for depreciation and amortization) or that are attributable to exempt businesses. In the case of a non-corporate taxpayer, adjusted taxable income should include (a) all of the taxpayer's non-interest income, other than items that are investment income under Section 163(d), are attributable to exempt businesses or (for a taxpayer that is not a business entity) are clearly personal in nature (such as interest income imputed under Section 7872 on a gift loan), and (b) all of the taxpayer's non-interest deductible expenses, other than investment expenses under Section 163(d), expenses attributable to exempt businesses and (for a taxpayer that is not a business entity) specifically enumerated non-business deductions.
4. A framework should be provided for a corporation to allocate interest expense between businesses it conducts that are exempt from Section 163(j), and businesses that are not exempt. Allocation methods based on the relative assets, or the relative income, of these businesses should be considered. If an asset-based or income-based allocation method is adopted, then the government should consider also providing some exceptions from that allocation method, in order to address limited, specific cases where a particular indebtedness is clearly tied to a particular business: for example, where particular debt is taken into account by a regulatory authority that has oversight over a specific business; or where nonrecourse debt is used to finance the acquisition or construction of property that is used in a particular business.
5. Individuals should allocate interest expense between exempt and non-exempt businesses using tracing principles that are consistent with Treasury Regulation Section 1.163-8T.

6. Tracing principles also should generally apply to partnerships, for purposes of allocating a partnership's interest expense between exempt and non-exempt businesses. However, in the case of a partnership whose partners are solely or mainly corporations, it should be considered whether an allocation method should be used which corresponds to the method required for businesses that are directly owned by a corporation.
7. Section 163(j) should be applied to interest expense for which a deduction otherwise would be allowed to the taxpayer in a given year, after having taken into account all the other statutory and regulatory rules that would disallow or defer such deductions.
8. If a loss is allowed under Sections 465 and 469 which consists in part of interest expense, and a deduction for part or all of that interest expense is then disallowed for the year under Section 163(j), then Sections 465 and 469 should be re-applied after Section 163(j), so that the taxpayer is allowed to deduct additional amounts of other items and claim the full amount of loss permitted under Sections 465 and 469.
9. Interest expense that was disallowed under Section 163(j) as in effect before the Act should be carried forward and treated as interest paid or accrued by the taxpayer in the first year new Section 163(j) is effective. However, a corporation that had a carryforward of excess limitation under old Section 163(j) should lose that limitation carryforward, under the new statute.
10. It should be confirmed how the rules for computing a corporation's "adjusted taxable income" under Section 163(j) interact with Section 246(b) and Section 250(a)(2) (both of which limit specific deductions of a corporation by using formulas that are based on the amount of the corporation's taxable income).

**B. Corporate Recommendations**

1. Interest expense disallowed by reason of Section 163(j) should reduce a corporation's earnings and profits in the year that the interest expense was paid or accrued in accordance with the corporation's method of accounting.
2. All members of the same consolidated group should be treated as a single taxpayer for Section 163(j) purposes.
3. There should be rules that deal with disallowed business interest expense carryforwards of a corporation that joins a consolidated group, as well as apportionment of a consolidated group's disallowed business interest carryforwards to a corporation that leaves a consolidated group. These rules should generally be similar to the rules that deal with similar issues in the case of net operating loss carryforwards. However, some special rules may be appropriate, in order to deal with issues that could arise when a member

that has operations that generate applicable taxable income but little or no debt (or vice versa) leaves a group.

4. Section 163(j) should not be applied on a group basis to a Section 1504(a) affiliated group that does not file a consolidated return, or to an expanded affiliated group of the type described in the proposed regulations under old Section 163(j). In addition, a partnership among members of a consolidated group should not be treated as a single taxpayer together with the members of the consolidated group, for purposes of applying Section 163(j).

### **C. Partnership Recommendations**

1. The character of a partnership's interest income and expense as business interest income and business interest expense should be determined at partnership level.
2. A partnership generally should use tracing principles to divide its interest expense between investment interest and business interest expense (and, as noted in A.6 above, between exempt and non-exempt businesses). Such allocation should not be dependent on whether the partnership distributes the borrowed funds to its partners. As indicated in A.6 above, in the case of a partnership whose partners are solely or mainly corporations, it should be considered whether an allocation method should be used that corresponds to the method required for businesses that are directly owned by a corporation.
3. A partnership's deductible business interest expense that is taken into account in the partnership's non-separately stated income for purposes of Section 163(j) should retain its character as interest for all other purposes of the Code.
4. To the extent that a partnership's business interest income is taken into account in determining the amount of interest expense allowable under Section 163(j) at the partnership level, such business interest income should be included in the partnership's non-separately stated income for Section 163(j) purposes, so that a partner cannot utilize such business interest income to support an additional interest expense deduction at the partner level.
5. It should be clarified that if a partner has excess business interest expense carryforwards, and the partner is allocated a share of the partnership's "excess taxable income" for a subsequent year, then the partner can only deduct carried forward interest equal to at most 30% (not 100%) of the allocable excess taxable income.
6. A partner should be permitted to utilize its excess business interest expense carryforwards against such partner's share of the partnership's business

interest income (net of such partnership's business interest expense) for a subsequent taxable year.

7. If a partnership has interest expense characterized at the partnership level as investment interest, a corporate partner should treat its share of that interest expense as business interest expense that is subject to Section 163(j) at the partner level; and a non-corporate partner should treat its share of the interest expense as subject to Section 163(d).
8. The statutory exemptions of certain businesses from Section 163(j), including the electing real property trade or business exemption, the electing farming business exemption, the utilities business exemption and small business exemption, should be determined at the partnership level. Elections for the first two of these exemptions should be made at the partnership level.
9. If a partner incurs interest expense at the partner level that is allocable, under the allocation principles described above in A.4 and A.5, to the partner's interest in a partnership that conducts an exempt trade or business, then such interest expense should be exempt from Section 163(j).
10. It should be clarified how Section 163(j) applies in the case of a partnership that has special allocations, as well as how Section 743 adjustments and Section 704(c) allocations impact the application of Section 163(j) to partnerships and partners.

#### **D. International Recommendations**

1. Guidance should confirm whether Section 163(j) applies to business interest expense of controlled foreign corporations and passive foreign investment companies, and, if it does, the manner in which it applies. If Section 163(j) applies to CFCs then, when calculating the Section 163(j) limit in connection with determining the amount of a CFC's Subpart F income, the CFC's adjusted taxable income and business interest income should be computed taking into account only items that are Subpart F income, and its business interest expense should be computed taking into account only interest expense which is allocable to Subpart F income.
2. In the case of a foreign corporation that has a U.S. trade or business, Section 163(j) should be applied in order to compute the corporation's liability for corporate net income and branch profits taxes by taking into account only adjusted taxable income and business interest income that are included in the corporation's effectively connected income, and business interest expense that is allocated to effectively connected income pursuant to the regulations under Sections 882 and 884.

## II. Overview of Section 163(j)

### A. Section 163(j) Prior to the Act

In general terms, prior to the Act, Section 163(j) limited the deductibility of interest paid or accrued by a corporate taxpayer<sup>3</sup> to a related person<sup>4</sup> where such interest was exempt (in whole or in part) from U.S. tax.<sup>5</sup> Old Section 163(j) did not apply unless the corporation's debt to equity ratio exceeded 1.5 to 1.<sup>6</sup> Assuming a corporate taxpayer's debt-to-equity ratio exceeded 1.5:1 as of the end of such corporate taxpayer's taxable year, old Section 163(j) denied an interest deduction for amounts paid or accrued to a related tax-exempt (generally, foreign) person<sup>7</sup> to the extent that the corporation's net interest expense<sup>8</sup> exceeded 50% of its adjusted taxable income (i.e., taxable income computed without regard to deductions for net interest expense, net operating losses, net interest expense, domestic production activities under Section 199, depreciation, amortization and depletion).<sup>9</sup> Net interest expense in excess of 50% of the corporation's adjusted taxable income was defined as "excess interest expense."<sup>10</sup> Any interest deduction disallowed under Section 163(j) was treated as interest paid or accrued in the succeeding taxable year.<sup>11</sup>

Under old Section 163(j), all members of the same affiliated group (within the meaning of Section 1504(a)) were treated as a single taxpayer.<sup>12</sup> Pursuant to proposed regulations issued under old Section 163(j), all members of an affiliated group are treated as one taxpayer for Section 163(j) purposes without regard to whether the affiliated group files a consolidated return.<sup>13</sup>

Old Section 163(j) was applied at the partner level. A corporate partner's distributive share of interest income paid or accrued to the partnership was treated as interest income paid or accrued

---

<sup>3</sup> Prior to the Act, Section 163(j) applied to domestic "C" corporations and foreign corporations with income, gain or loss that was effectively connected to a U.S. trade or business, but did not apply to "S" corporations. Proposed Regulation Section 1.163(j)-1(a)(1).

<sup>4</sup> For convenience, we sometimes refer to "**old Section 163(j)**" rather than Section 163(j) prior to the Act. Old Section 163(j) also applied to interest paid or accrued to an unrelated person if the debt was guaranteed by a related person and certain additional requirements were met. See old Section 163(j)(3)(B).

<sup>5</sup> Exempt related party interest referred to interest expense that was exempt in whole or in part from U.S. tax in the hands of the recipient, taking into account treaty benefits.

<sup>6</sup> Section 163(j)(2)(A)(ii) prior to the Act.

<sup>7</sup> Theoretically, old Section 163(j) could apply to interest paid by a taxable subsidiary to a tax-exempt parent corporation, although amendments to Section 512(b)(13) effectively limited the application of old Section 163(j) to interest paid or accrued to foreign persons.

<sup>8</sup> Net interest expense is the amount by which all interest paid or accrued during the taxable year exceeds the amount of interest includible by the taxpayer in gross income for taxable such year. Proposed Regulation Section 1.163(j)-2(d).

<sup>9</sup> Section 163(j)(1)(A), (2)(B)(i) prior to the Act.

<sup>10</sup> Section 163(j)(2)(B)(i) prior to the Act.

<sup>11</sup> Section 163(j)(1)(B) prior to the Act.

<sup>12</sup> Section 163(j)(6)(C) prior to the Act.

<sup>13</sup> Proposed Regulation Section 1.163(j)-5(a)(2). In addition, the proposed regulations would have expanded the definition of affiliated group beyond that provided in Section 1504(a).

to a corporate partner; a corporate partner's distributive share of interest paid or accrued by the partnership was treated as interest paid or accrued by a corporate partner; and a corporate partner's share of the partnership's liabilities was treated as liabilities of a corporate partner.<sup>14</sup>

## **B. Section 163(j) as amended by the Act**

### **1. General**

The Act amended Section 163(j) in several material ways. Section 163(j), as amended, applies to both corporate and noncorporate taxpayers. The debt-to-equity ratio test was removed, and Section 163(j) now applies at the partnership level rather than the partner level. Finally, new exceptions were added for electing real property businesses, electing farming businesses, utilities, certain small businesses and floor plan financing interest. The statutory provisions are described in greater detail below.

Section 163(j) provides, in pertinent part, that a taxpayer cannot deduct business interest expense for a taxable year to the extent that such interest exceeds the sum of (a) the business interest income of such taxpayer for such taxable year, and (b) 30 percent of the taxpayer's adjusted taxable income for such taxable year.<sup>15</sup> The statute defines "business interest expense," "business interest income," and "adjusted taxable income."

For Section 163(j) purposes, "business interest expense" means any interest paid or accrued on indebtedness properly allocable to a trade or business. It does not include investment interest (within the meaning of Section 163(d)).<sup>16</sup> (In this Report, we refer to business interest expense as "business interest expense," for ease of distinguishing it from "business interest income.")

The term "business interest income," for Section 163(j) purposes, means the amount of interest includible in the gross income of the taxpayer for the taxable year which is properly allocable to a trade or business. The term does not include investment income (within the meaning of Section 163(d)).<sup>17</sup>

Accordingly, the application of Section 163(j) turns on whether interest is properly allocable to a trade or business. The term "trade or business" is not defined affirmatively in Section 163(j) but the statute expressly excludes (i) the trade or business of performing services as an employee, (ii) any electing real property trade or business, (iii) any electing farming business, or (iv) the trade or business of the furnishing or sale of (a) electrical energy, water, or sewage disposal services, (b) gas or steam through a local distribution system, or (c) transportation of gas or steam by pipeline, if the rates for such furnishing or sale, as the case may be, have been established or

---

<sup>14</sup> Section 163(j)(8) prior to the Act.

<sup>15</sup> Section 163(j)(1). Although "floor plan financing interest" technically falls within the definition of business interest expense, such interest nevertheless is not subject to limitation under Section 163(j). Section 163(j)(1)(C).

<sup>16</sup> Section 163(j)(5). In very general terms, Section 163(d)(3) defines "investment interest" as interest paid or accrued on indebtedness properly allocable to property held for investment other than "qualified residence interest" under Section 163(h)(3) or interest which is taken into account under Section 469 in computing gain or loss from a passive activity of a taxpayer.

<sup>17</sup> Section 163(j)(6).

approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative.<sup>18</sup>

The term “adjusted taxable income” (“**ATI**”) means the taxable income of the taxpayer computed without regard to (i) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business, (ii) any business interest expense or business interest income, (iii) the amount of any net operating loss deduction under Section 172, (iv) the amount of any deduction allowed under Section 199A, and (v) in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion.<sup>19</sup>

Any business interest expense not allowed as a deduction for any taxable year is treated as business interest expense paid or accrued in the succeeding taxable year.<sup>20</sup>

## 2. Partnerships

In the case of any partnership,<sup>21</sup> (a) Section 163(j) is applied at the partnership level and any deduction for business interest expense is taken into account in determining the non-separately stated taxable income or loss of the partnership, and (b) the adjusted taxable income of each partner of such partnership, (i) is determined without regard to such partner’s distributive share of any items of income, gain, deduction, or loss of such partnership, and (ii) is increased by such partner’s distributive share of such partnership’s excess taxable income.<sup>22</sup> For this purpose, a partner’s distributive share of partnership excess taxable income shall be determined in the same manner as the partner’s distributive share of non-separately stated taxable income or loss of the partnership.<sup>23</sup>

The amount of any business interest expense not allowed as a deduction to a partnership for any taxable year is not treated as business interest expense paid or accrued by the partnership in the succeeding taxable year, but, subject to the rules in the next paragraph, is treated as excess business interest expense which is allocated to each partner in the same manner as the non-separately stated taxable income or loss of the partnership.<sup>24</sup>

If a partner is allocated any excess business interest expense from a partnership for any taxable year (a) such excess business interest expense is treated as business interest expense paid or accrued by the partner in the next succeeding taxable year in which the partner is allocated excess taxable income (defined below) from such partnership, but only to the extent of such excess taxable income, and (b) any portion of such excess business interest expense remaining after

---

<sup>18</sup> Section 163(j)(7)(A).

<sup>19</sup> The Treasury is granted the authority to make other adjustments to ATI.

<sup>20</sup> Section 163(j)(2).

<sup>21</sup> Rules similar to the special Section 163(j) partnership rules also apply to any ‘S’ corporation and its shareholders. See Section 163(j)(4)(D).

<sup>22</sup> Section 163(j)(4)(A).

<sup>23</sup> Id.

<sup>24</sup> Section 163(j)(4)(B)(i).



applying the excess taxable income limitation, is treated as business interest expense paid or accrued in succeeding taxable years.<sup>25</sup> In addition, once all such excess business interest expense for all preceding taxable years has been treated as paid or accrued by a partner as a result of allocations of excess taxable income to the partner a partner by the partnership for any taxable year, any remaining excess taxable income that has been allocated to the partner will be taken into account when computing the partner's own Section 163(j) limitation with respect to any business interest expense the partner has incurred at the partner level.

The term “excess taxable income” (“**ETI**”) means, with respect to any partnership, the amount which bears the same ratio to the partnership’s adjusted taxable income as the excess (if any) of (a) 30% of the adjusted taxable income of the partnership for the taxable year, over (b) the amount (if any) by which the business interest expense of the partnership exceeds the business interest income of the partnership, bears to 30% of the partnership’s adjusted taxable income for the taxable year.<sup>26</sup>

The adjusted basis of a partner in a partnership interest is reduced (but not below zero) by the amount of excess business interest expense allocated to the partner.<sup>27</sup> If a partner disposes of a partnership interest, the adjusted basis of the partner in the partnership interest is increased immediately before the disposition by the amount of the excess (if any) of the amount of such basis reduction over the portion of any excess business interest expense allocated to the partner which has previously been treated as business interest expense paid or accrued by the partner. This provision also applies to transfers of a partnership interest (including by reason of death) in a transaction in which gain is not recognized in whole or in part. No deduction is allowed to the transferor or transferee for any excess business interest expense resulting in a basis increase.<sup>28</sup>

### 3. **Exceptions to Section 163(j)**

Section 163(j) does not apply to certain activities and certain small businesses. Each of these exceptions will be described below.

#### a. **Electing Real Property Businesses**

Section 163(j) does not apply to an “electing real property trade or business” because that phrase is carved out of the Section 163(j) definition of trade or business. The term ‘electing real property trade or business’ means any trade or business which is described in Section 469(c)(7)(C) that elects to be excluded from Section 163(j). Section 469(c)(7)(C) defines “real property trade or business” as “any real property development redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.”

---

<sup>25</sup> Section 163(j)(4)(B)(ii).

<sup>26</sup> Section 163(j)(4)(C).

<sup>27</sup> Section 163(j)(4)(B)(iii)(I).

<sup>28</sup> Section 163(j)(4)(B)(iii)(II).

The statute grants authority to Treasury to determine the time and manner of the election. Once made, the election is irrevocable.<sup>29</sup>

**b. Electing Farming Businesses**

Similarly, Section 163(j) does not apply to an electing farm business because that term is excluded from the Section 163(j) definition of trade or business. The term “electing farming business” means a farming business (as defined in Section 263A(e)(4)) or any trade or business of a specified agricultural or horticultural cooperative (as defined in Section 199A(g)(2)) that elect to be excluded from Section 163(j).<sup>30</sup> The statute grants authority to the Treasury to determine the time and manner of the election. Once made, the election is irrevocable.<sup>31</sup>

**c. Small Business Exception**

There is an exemption for certain small businesses. In the case of any taxpayer<sup>32</sup> which meets the gross receipts test of Section 448(c) for any taxable year, Section 163(j) does not apply to such taxpayer for such taxable year. In general, a corporation or partnership meets the gross receipts test of Section 448(c) for any taxable year if the average annual gross receipts of such entity for the 3 taxable year period ending with the immediately prior taxable year does not exceed \$25 million.<sup>33</sup> In the case of any taxpayer which is not a corporation or a partnership, the gross receipts test of Section 448(c) shall be applied in the same manner as if such taxpayer were a corporation or partnership.<sup>34</sup>

**d. Employees**

The trade or business of performing services as an employee is not treated as a trade or business for purposes of the Section 163(j) limitation.<sup>35</sup> As a result, the wages of an employee are not counted in the ATI of the taxpayer for purposes of determining the interest expense limitation.<sup>36</sup>

**e. Utilities Exception**

The trade or business of the furnishing or sale of (a) electrical energy, water, or sewage disposal services, (b) gas or steam through a local distribution system, or (c) transportation of gas or steam by pipeline, if the rates for such furnishing or sale, as the case may be, have been

---

<sup>29</sup> Section 163(j)(7)(B).

<sup>30</sup> Section 163(j)(7)(C).

<sup>31</sup> Section 163(j)(7)(C).

<sup>32</sup> Other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting under Section 448(a)(3). Section 163(j)(3).

<sup>33</sup> All persons treated as a single employer under Section 52(a) or (b) or Section 414(m) or (o) are treated as one person for purposes of the \$25 million gross receipts test. Section 448(c)(2).

<sup>34</sup> Section 163(j)(3).

<sup>35</sup> Section 163(j)(7)(A)(i).

<sup>36</sup> Section 163(j)(7)(A)(i).

established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative (a "**utilities business**") is not a trade or business for purposes of Section 163(j).<sup>37</sup>

#### f. **Floor Plan Financing Interest**

Interest paid or accrued on "floor plan financing indebtedness" is not subject to limitation under Section 163(j).<sup>38</sup> The term "floor plan financing interest" means indebtedness used to finance the acquisition of motor vehicles<sup>39</sup> held for sale or lease, and secured by the inventory so acquired.<sup>40</sup>

#### 4. **Effective Date**

The amendments to Section 163(j) apply to taxable years beginning after December 31, 2017.

#### 5. **Conforming Amendments**

The Act amended Section 381(c) to include the carryover of disallowed business interest expense to taxable years ending after the date of distribution and transfer. Section 382(d) was amended to include disallowed interest expense within the definition of "pre-change loss."<sup>41</sup>

### III. **Discussion**

#### A. **Interest**

Section 163(j) contains no special rules defining interest. The Conference Report, however, states that "any amount treated as interest for purposes of the Code is treated as interest for purposes of Section 163(j)." The Conference Report appears to indicate a Congressional decision to apply Section 163(j) more narrowly than old Section 163(j). Old Section 163(j), for example, took a more expansive view of interest by including substitute payments made under a

---

<sup>37</sup> Section 163(j)(7)(A).

<sup>38</sup> Section 163(j)(1)(C) and (j)(9). Section 163(j)(1). The Conference report to the Act states "by including business interest income and floor plan financing interest in the limitation, the rule operates to allow floor plan financing interest to be fully deductible and to limit the deduction for net interest expense (less floor plan financing interest) to 30% of adjusted taxable income." H.R. Rep. 115-466, at 387.

In this Report, references to business interest expense are to interest that qualifies as such under Section 163(j)(5) and is not floor plan financing interest; and in all examples, the interest expense is not floor plan financing interest.

<sup>39</sup> The term "motor vehicle" means any (a) self-propelled vehicle designed for transporting persons or property on a public street, highway, or road, (b) a boat, or (c) farm machinery or equipment. Section 163(j)(a)(C).

<sup>40</sup> Section 163(j)(9)(B).

<sup>41</sup> Section 382(d)(3). Section 382(k)(1) was amended to include any corporation entitled to use a carry forward of disallowed interest.

securities loan that met the requirements of Section 1058(a) as interest for Section 163(j) purposes.<sup>42</sup>

We recommend that the Treasury and Service issue guidance confirming that Section 163(j) applies to all amounts treated as interest under the Code. Accordingly, under our recommendation for Section 163(j) purposes, interest would include:

- original issue discount, adjusted for any acquisition premium;
- acquisition discount;
- amounts treated as interest under Section 1286 (related to stripped bonds);
- gain treated as ordinary income on the disposition of a market discount bond;
- amounts treated as interest under Treas. Reg. Sec. 1.446-3T (related to notional principal contracts with nonperiodic payments);
- payments treated as interest under Section 483;
- amounts treated as interest under a Section 467 rental agreement;
- redeemable ground rent treated as interest under Section 163(c);
- amounts treated as interest under Section 988; and
- foregone interest treated as interest under Section 7872.

There is a reasonable policy argument that deductions for expenses that are the functional equivalent of interest ought to be limited in the same manner as interest deductions under Section 163(j). For example, if a taxpayer borrows a debt security in a Section 1058(a) transaction, substitute payments it makes on account of interest on that security logically should be subject to Section 163(j); otherwise the taxpayer could use that securities loan to generate cash which it uses to purchase a separate debt security, with interest income on the purchased debt security increasing the taxpayer's Section 163(j) limitation and substitute payments on the borrowed security not be subject to the limitation. As a similar example, if a taxpayer holds a fixed-rate debt instrument and a derivative swapping fixed for floating rate interest, then the taxpayer again may receive interest income that increases its Section 163(j) limitation and make interest-like payments under the swap that are not subject to the limitation. By comparison, if the taxpayer integrated the debt instrument with the hedge, all of the payments would be taken into account in applying Section 163(j). However, while the right answer in these examples may seem clear, we believe it becomes more difficult fairly quickly to determine where to draw the line, if a broader range of transactions

---

<sup>42</sup> The legislative history to old Section 163(j), by comparison, indicated that Congress contemplated Treasury could issue guidance, if it wished, regarding "expense items not denominated interest but appropriately characterized as equivalent to interest expense." H.R. Rep. 101-386 at 566-567 (1989).

(having some time-value element, but not solely or predominantly providing for payments that are determined by reference to the time value of money) is considered.

To the extent that certain deductible payments should be treated as interest expense for purposes of applying the statute, it would seem logical that receipt or accrual of the same types of payments should be treated as interest income for that purpose. There does not seem to be a principled justification for adopting an asymmetrical approach.

In view of the statutory language ("interest paid or accrued on indebtedness"), the legislative history, and the fact that Congress did not give any indication of following the long-established approach that was taken under old Section 163(j), it seems questionable whether there would be authority for guidance applying new Section 163(j) to interest equivalents, absent a statutory amendment. However, we note that to the extent guidance applies only to a limited set of specifically identified types of transactions, in all of which one party secures the use of funds for a period of time and makes payments that are determined solely or almost solely by reference to the time value of money (including making net payments determined taking into account a hedge of the cost of borrowing, as in the example above), such guidance would appear to be more easily defensible, as an antiabuse measure designed to protect the intended operation of the statute rather than to materially expand it. Similarly, guidance takes a symmetrical approach for purposes of identifying income and expenses equivalent to interest under Section 163(j) would seem more likely to be upheld, as applying in a relatively neutral way that is not intended to disadvantage taxpayers.

#### **B. Business Interest Expense; Business Interest Income**

Guidance should confirm that all interest expense of a corporation is business interest expense, and all interest expense of a non-corporate taxpayer, other than personal interest and Section 163(d) investment interest, is business interest expense. The goal of Section 163(j) is to limit a taxpayer's ability to use interest deductions to increase its after-tax rate of return from its activities, and thereby to curb the tax law's tendency to encourage excessive levels of debt in taxpayers' capital structures.<sup>43</sup> It is consistent with that goal for the concept of business interest expense to have a broad scope, with Section 163(j)(5)'s references to "trade or business" and "properly allocable" not being interpreted as imposing significant limitations. For example, a corporation should not be able to claim that, to the extent its interest expense is attributable to investment activities that do not rise to the level of a trade or business under general tax principles, or is not closely connected to a particular activity that constitutes a trade or business but instead has been incurred on debt borrowed for general corporate purposes, the interest is not subject to limitation Section 163(j). Similarly, a non-corporate taxpayer should not be able to successfully

---

<sup>43</sup> See H.R. Rep. 115-409, at 247-248 ("The Committee believes that the general deductibility of interest payments on debt may result in companies undertaking more leverage than they would in the absence of the tax system. The effective marginal tax rate on debt-financed investment is lower than that on equity-financed investment. Limiting the deductibility of interest along with reducing the corporate tax rate narrows the disparity in the effective marginal tax rates based on different sources of financing. This leads to a more efficient capital structure for firms.").

argue that it has interest expense that falls into an area uncovered by any of Sections 163(j), 163(d) or 163(h). The statute's legislative history provides direct support for such an approach.<sup>44</sup>

Logically, business interest income for purposes of Section 163(j) would be determined under a rule symmetrical to the one just described for business interest expense; that is, all interest income of a corporation, and all interest income of a non-corporate taxpayer other than investment income as defined in Section 163(d), would be business interest income. (In the case of a non-corporate taxpayer that is not a business entity, Treasury and the IRS could consider also excluding interest income on loans clearly made for personal reasons, such as interest income imputed under Section 7872 on a gift loan to a friend or relative of the taxpayer.) The legislative history just referenced supports such an approach.<sup>45</sup>

### C. Adjusted Taxable Income

In our view, it logically follows from our recommended approach to defining the business interest income and business interest expense of a corporation, that all of its other items of income and expense (exclusive of items attributable to a business exempt from Section 163(j)) should be included in the corporation's ATI. The legislative history discussed above suggests that for purposes of Section 163(j), all activities of a corporation constitute a trade or business, with the result that all its income and expense is "properly allocable" to a trade or business. In addition, assuming that (as recommended) all of the corporation's interest expense (not allocated to an exempt business) is treated as business interest expense, it seems fair to treat all of its non-interest income (other than from exempt businesses) as ATI; otherwise, there would be the potential for arbitrary mismatches, in which a taxpayer's interest expense is subject to the Section 163(j) limitation, while the taxpayer's income from an activity financed by the relevant borrowing is not taken into account as ATI to increase the amount of the limitation under Section 163(j)(1)(B). There is no apparent policy reason for applying the statute in a manner that creates such mismatches, and the text of the statute readily lends itself to a more symmetrical approach. Moreover, our recommended approach is relatively easily administrable, as compared to an

---

<sup>44</sup> See H.R. Rep. 115-409, at page 248 note 444 ("Section 163(d) applies in the case of a taxpayer other than a corporation. Thus, a corporation has neither investment interest nor investment income within the meaning of section 163(d). Thus, interest income and interest expense of a corporation is properly allocable to a trade or business, unless such trade or business is otherwise explicitly excluded from the application of the provision."); H.R. Rep. 115-466, at 386 n. 688 ("a corporation has neither investment interest nor investment income within Section 163(d). Thus, interest income and interest expense of a corporation's properly allocable to a trade or business, unless such trade or business is otherwise explicitly excluded from the application of [Section 163(j)].").

In Part III of this report, except where specifically stated, all references to a "corporation" are to a C corporation (as defined in Section 1361(a)(2)) that is not a real estate investment trust, a regulated investment company.

<sup>45</sup> As noted in the legislative history, if a taxpayer conducts a business that is explicitly exempted from Section 163(j), then interest income and interest expense allocable to that business is excluded from the definitions of business interest income and business interest expense, pursuant to Section 163(j)(7). We discuss further in Part III.D below recommendations for the method to be used to allocate interest expense, and other items of income and expense, to an exempt business conducted by a taxpayer.

approach that requires a fact-intensive inquiry into the connection between items of income and a trade or business of the corporation.

Similar logic should apply to a non-corporate taxpayer. As proposed above, all of a non-corporate taxpayer's interest income and interest expense, other than investment income and investment interest under Section 163(d), interest income and expense from exempt businesses, and personal interest under Section 163(h) (and, possibly, interest income on loans clearly made for personal reasons, such as interest imputed under Section 7872 on gift loans), would be treated as business interest income and business interest expense under Section 163(j). It thus seems reasonable to treat all of a non-corporate taxpayer's non-interest income as being included in the taxpayer's ATI, other than items that are investment income under Section 163(d), or that are attributable to exempt businesses or (in the case of a taxpayer that is not a business entity) are specifically enumerated items of income that are personal in nature, such as gain on the sale of the taxpayer's home. In addition, all of the taxpayer's non-interest deductible expenses, other than investment expenses under Section 163(d), expenses attributable to exempt businesses, and (in the case of a taxpayer that is not a business entity) specifically enumerated non-business deductions including for charitable contributions, state or local property taxes not related to a business, and medical or dental expenses, should be taken into account in ATI.

#### **D. Allocation of Interest Expense Among a Taxpayer's Activities**

Application of Section 163(j) requires that interest expense be allocated among different activities of a taxpayer. Under Section 163(j)(5) and 163(j)(7)(A), interest expense allocable to a trade or business of acting as an employee, an electing real property trade or business, an electing farming business, or a utilities business is exempted from the Section 163(j) limitation. Other provisions of the Code adopt a range of different approaches to allocating interest expense to different assets or activities: tracing based on the taxpayer's use of the borrowed funds;<sup>46</sup> tracing based on the purpose for the borrowing;<sup>47</sup> and allocation rules based on the relative amounts of assets used in different activities of the taxpayer.<sup>48</sup>

On balance, we recommend that guidance be issued under Section 163(j) allocating interest expense of a corporation based on the relative amounts of assets used in the corporation's exempt and non-exempt businesses, or based on the relative amounts of income the businesses generate, rather than an approach based on tracing or the purpose of a borrowing. We believe that an asset- or income-based approach to allocating interest expense would be more difficult for corporate taxpayers to manipulate, and would lead to significantly less litigation based on factual disputes, than a system based on tracing or the taxpayer's purpose would. However, we recognize that the

---

<sup>46</sup> See Treasury Regulation Section 1.163-8T; see also Treasury Regulation Section 1.108(i)-2(d)(1) (adopting certain safe harbors based on the use of borrowed funds, for purposes of determining whether debt was issued by a partnership or S corporation "in connection with the conduct of a trade or business").

<sup>47</sup> See Section 265(a)(2) (denying a deduction for interest on debt incurred or continued to purchase or carry tax-exempt securities; was issued by a partnership or S corporation "in connection with the conduct of a trade or business"); Treasury Regulation Section 1.265-1(c); Rev. Proc. 72-18 (describing standards, including based on objective factors, for determining whether debt incurred for the purpose of purchasing or carrying tax-exempt securities).

<sup>48</sup> See Treasury Regulation Sections 1.861-9 – 1.861-12T, 1.882-5, 1.884-4.

considerations for corporate and non-corporate taxpayers are somewhat different relating to the choice of a Section 163(j) allocation method, and we acknowledge that, as a practical matter, it may be necessary to adopt a method for non-corporate taxpayers that is based largely or entirely on tracing principles.

Although we outline below multiple possible approaches to allocation for the government's consideration, we believe that guidance should provide mandatory rules, rather than taxpayer elections between allocation methods, in order to maximize the likelihood of consistent outcomes that do not unduly disadvantage the government.

## 1. Corporations

### a. Asset-Based Allocation Method

Corporate taxpayers in many cases may find an asset-based approach familiar, from their calculations under Section 861 for foreign tax credit purposes. The basic principles of the Section 861 rules are well-understood and have been fairly stable over a long period of time, and it would appear those principles could be applied under Section 163(j) without undue difficulty in the case of a corporation with exempt and non-exempt businesses. A system based on tracing the use of funds or based on the purpose of a borrowing, by comparison, would be a relatively new exercise for many corporate taxpayers, and could be a complex one for large corporate groups.

Either fair market value or tax basis could be used to measure a taxpayer's assets. Fair market value could be seen as a less arbitrary metric for measuring the assets used in different businesses, than tax basis would be (for example, valuable self-developed intangibles may have a low or no tax basis); and the Code and regulations provide several other examples of determinations made based on the relative fair market values of different groups of assets.<sup>49</sup> However, fair market values often can be difficult to determine, thus increasing opportunities for disagreements between taxpayers and the IRS. Possibly for that reason, the Act adopted Section 864(e)(2), which eliminated taxpayers' right under prior law to allocate interest expense between domestic and foreign assets for sourcing purposes based on fair market value, and instead mandated the use of tax basis.<sup>50</sup>

If tax basis is used to measure a corporation's assets, there would be a natural tendency for exempt businesses to attract a relatively large share of interest expense, because those businesses tend to be capital-intensive and to involve assets with longer depreciation schedules (or non-depreciable assets). However, as a practical matter, it often would be relatively easy for taxpayers to use basis, as it would be computed for other purposes; and it would generally be difficult to manipulate basis for purposes of skewing the apportionment.<sup>51</sup> In addition, a number of businesses of the types that are exempted from Section 163(j) may be relatively heavily levered, for reasons

---

<sup>49</sup> See, e.g., Section 856(c)(4) (asset tests for REIT status); Section 897(c)(2) and Treasury Regulation Section 1.897-2 (determination of a corporation's status as a U.S. real property holding corporation).

<sup>50</sup> See Treasury Regulation Section 1.861-9T(g) (which historically permitted taxpayers to choose to use fair market value).

<sup>51</sup> Congress has used basis as a way of measuring capital investment in assets in multiple other places in the Act (see new Sections 199A, 951A, and 250).



unrelated to tax; indeed, that might have been one of the reasons Congress had for exempting them from Section 163(j).

Regardless of whether basis or fair market value is used, Treasury and the IRS should consider adopting special rules that allow interest expense on a particular debt obligation to be allocated to a business, in specific cases where there is a relatively clear economic link between the business and that debt. For example, in the case of a utilities business, the regulatory authority that approves the rates the business is entitled to charge customers may have taken into account particular debt incurred by the business in the ratemaking process, permitting the business to charge rates that cover the expected debt service. This would be an objective measure of the debt attributable to the utilities business. Similarly, if a non-exempt business is subject to regulatory oversight that involves a review of particular debt owed by the taxpayer, then interest expense on that debt could be treated as allocable entirely to the non-exempt business. In addition, a taxpayer often may incur nonrecourse debt to finance the construction, improvement or purchase of real property. In a case where the lenders are looking exclusively to the property built or purchased with the borrowed funds and the cashflows generated by that property for repayment, there would seem to be reasonable grounds for allocating the interest expense on the debt to the business in which the property is used. This traditional type of financing arrangement has been taken into account in other contexts when allocating interest expense.<sup>52</sup> Such a rule could also apply to a future refinancing of a construction or acquisition loan; in such a case, we would propose that the rule apply only to the extent the amount of the new debt does not exceed the amount of debt being refinanced.

#### **b. Income-Based Allocation Method**

In our view, it is worth considering an income-based approach to allocation of interest expense as an alternative to an asset-based approach. We are not aware of an existing statutory or regulatory regime that provides for taxpayers to allocate interest expense on the basis of income (or cash flow) from different activities.<sup>53</sup> The Act has amended Section 864(e)(2), in a manner that prohibits such an allocation methodology. Nevertheless, we believe such an approach may have merit under Section 163(j). Debt capacity often is determined by lenders using income-based metrics, rather than asset values. In addition, and more importantly, an income-based approach can be seen as fitting well with the basic design of Section 163(j). As noted above, the legislative history indicates that the goal of the statute is to prevent a taxpayer from making excessive use of interest deductions to increase its after-tax rate of return from its activities.<sup>54</sup> The statute accomplishes this goal by limiting the extent to which each dollar of net interest expense can shield the ATI of a non-exempt business from tax. Allocating a taxpayer's interest expense between exempt and non-exempt businesses based on those businesses' relative contributions to the

---

<sup>52</sup> See Treasury Regulations Sections 1.861-10(e), 1.861-10T(b), 1.882-5(a)(2).

<sup>53</sup> Prior to the Act, it was permissible to compute a controlled foreign corporation's Subpart F income, by allocating its interest expense among different activities based on the relative amounts of gross income generated by each activity. See Treasury Regulation Section 1.861-9T(j).

<sup>54</sup> See H.R. Rep. 115-409, at 247-248.

taxpayer's overall net income<sup>55</sup> fits well with the basic proposition that a dollar of interest expense is meant to shield from tax at most \$0.30 of the ATI generated by a non-exempt business.<sup>56</sup>

## 2. Non-Corporate Taxpayers

For non-corporate taxpayers, the considerations relating to the choice of a Section 163(j) allocation method are somewhat different than described above. In particular, individuals have long characterized their interest expense as personal interest under Section 163(h), investment interest under Section 163(d), an expense of passive activities under Section 469, or an expense of non-passive businesses in which they materially participate, using the tracing rules of Treasury Regulation Section 1.163-8T. The most straightforward way to apply new Section 163(j) to individuals, which would require the least administrative guidance in the near term, would be for individuals simply to continue to trace interest expense under Treasury Regulation Section 1.163-8T to each of their business and non-business activities; and interest that is traced to an exempt business under these principles would not be subject to Section 163(j), while interest traced to a non-exempt business would be subject to limitation.

Treasury and the IRS might consider applying a set of rules to individuals that is based only in part on tracing. For example, as a first step, tracing could be used to divide an individual's interest expense between personal interest and other interest.<sup>57</sup> Then, asset-based or income-based rules like the ones described above for corporations could be applied, to allocate the other interest expense between the individual's investments and businesses, and between exempt and non-exempt businesses. This would reduce, at least to some extent, the potential for an individual to manipulate the allocation of business interest expense between exempt and non-exempt businesses, for purposes of applying Section 163(j). However, it is questionable whether such an approach would be fair, if it applied to allocate interest expense on existing indebtedness among an individual's business and investment activities for purposes other than just applying Section 163(j) – for example, for purposes of determining how much interest is allocable to a particular activity of an individual for purposes of applying Section 469. Treasury Regulation Section 1.163-8T has long been a part of the framework of rules that individuals have taken into account when planning business transactions; and many of those transactions may extend well into future periods. It appears that such an approach also would apply to a relatively limited population of individual taxpayers, in view of the exception in Section 163(j)(2) for taxpayers that have average annual gross receipts under \$25 million. As a result, at least in the near term, it is questionable whether individuals should be subject to rules that depart from a tracing approach.

---

<sup>55</sup> For this purpose, the taxpayer's overall net income would be computed taking into account income and expenses from its exempt businesses, in the same manner as ATI is computed under the statute for non-exempt businesses.

<sup>56</sup> By comparison, if a taxpayer's interest expense is allocated based on the relative amounts of assets used in different businesses, then the result could be that each dollar of the taxpayer's interest expense ends up sheltering more than \$0.30 of income from a non-exempt business. For instance, that would be the case if a taxpayer's debt, and interest expense, was allocated largely to an asset-intensive exempt business carried on by the corporation that generated little net income, resulting in a net loss attributable to that business. That loss could be used to shelter ATI generated by the taxpayer's non-exempt businesses without the 30% limitation applying.

<sup>57</sup> It appears it would be difficult to use an approach other than tracing, to identify an individual's personal interest.

By comparison, in the case of a partnership, an approach not based purely on tracing principles may make more sense. In particular, if a partnership used rules based purely on tracing, then opportunities could arise for a corporation to avoid the rules described in Part III.D.1 above providing for asset-based or income-based allocation of business interest expense, simply by investing in those businesses through a partnership rather than directly. We discuss issues relating to the application of Section 163(j) to a partnership and its partners in detail in Part III.H below.

### **3. Additional Issues Related to the Choice of Allocation Method**

#### **a. Allocation of Income and Expenses (Other than Interest Expense) to Exempt Businesses**

In order to apply Section 163(j) to a taxpayer that conducts both exempt and non-exempt businesses, it will be necessary to determine not only the amount of the taxpayer's interest expense, but also the amounts of its other items of income and expense, that are attributable to the taxpayer's exempt businesses (and thus excluded from ATI). We believe that, in general, it should be more straightforward to allocate these items than to allocate interest expense, and that such determinations are generally best made based on a practical review of the facts that link an item to an exempt business. In cases where the appropriate allocation of an item of income is not entirely clear, principles that are similar to those in Section 864(c) could be applied.<sup>58</sup> A reasonable rule could be developed to identify investment assets held for the reasonable present and anticipated future needs of an exempt business, income from which would be part of that business's income.<sup>59</sup> In addition, principles can be used to allocate a taxpayer's expenses (other than interest) to an exempt business that are similar to those used in Treasury Regulation Section 1.861-8 and Treasury Regulation Section 1.954-1(c).

#### **b. Grouping of Taxpayers for Purposes of Allocating Interest Expense to Exempt and Non-Exempt Businesses**

An additional point related to the choice of allocation method, is whether guidance will provide for grouping of different taxpayers or entities. As discussed further below, we believe grouping is appropriate for members of a consolidated group. On the whole, however, the basic approach taken by Congress in drafting Section 163(j) suggests it did not contemplate broad grouping or aggregation rules. For example, if a partner owns interests in two partnerships, one of which conducts an exempt electric power business and the other of which conducts a non-exempt trade or business, it does not appear that the assets and interest expense of those two partnerships ought to be aggregated, for purposes of determining how much of the interest expense should be viewed as allocable to the exempt electric power business; as discussed in more detail

---

<sup>58</sup> This would be consistent with the approach taken in Section 199A, a provision that could be expected to be applied in tandem with Section 163(j). See Section 199A(c)(3)(A)(i). The Tax Section intends to submit separately recommendations for guidance under Section 199A.

<sup>59</sup> See Treasury Regulation Section 1.897-1(f) (amount of cash and investment assets considered to be business assets for purposes of applying Section 897(c)); Treasury Regulation Section 1.537-1 (principles for determining whether a corporation has accumulated earnings and profits that exceed the reasonable needs of its business).

later in this Report, Section 163(j)(4) contemplates fairly clearly that the statutory limitation (or lack thereof) will be computed separately, partnership by partnership.

## **E. Coordination of Section 163(j) With Other Limits in the Code on Interest Deductions and Non-Interest Deductions**

### **1. Coordination with Other Limits on Interest Deductions**

A straightforward reading of Section 163(j) indicates that it places a cap on the amount of interest for which a deduction otherwise would be allowed to a taxpayer in a given year, after having taken into account all the other statutory and regulatory rules that would disallow or defer such deductions. ("The amount allowed as a deduction under this chapter for business interest expense shall not exceed...").<sup>60</sup> This application of the statute is justified as a policy matter: as noted above, the statute is intended to prevent taxpayers from relying excessively on interest deductions to increase their after-tax returns;<sup>61</sup> and that purpose is achieved in a simple, effective manner by applying the formula for the annual Section 163(j) limit to interest expense that would otherwise be currently deductible. Consistent with that logic, the Congressional reports state that: "It is generally intended that, similar to present law, section 163(j) apply after the application of provisions that subject interest to deferral, capitalization, or other limitation. Thus, section 163(j) applies to interest deductions that are deferred, for example under section 163(e) or section 267(a)(3)(B) in the taxable year to which such deductions are deferred. Section 163(j) applies after section 263A is applied to capitalize interest and after, for example, section 265 or section 279 is applied to disallow interest."<sup>62</sup>

New Section 59A contains a special ordering rule, for application of the "Base Erosion and Anti-Abuse Tax" ("BEAT"). Section 59A generally requires that a U.S. corporation that (together with affiliates) has average annual gross receipts of at least \$500 million to pay a minimum tax, equal to 10% of its "modified taxable income"; and modified taxable income, in turn, is generally defined as taxable income computed without regard to any deductible payment to a foreign related party (including interest) (a "base erosion payment"). Section 59A(c)(3) provides that for purposes of computing a taxpayer's modified taxable income, "in the case of a taxpayer to which section 163(j) applies for the taxable year, the reduction in the amount of interest for which a deduction is allowed by reason of such subsection shall be treated as allocable first to interest paid or accrued to persons who are not related parties with respect to the taxpayer and then to such related parties." Thus, in effect, Section 163(j) is applied before BEAT, so that there is the maximum possible disallowance of interest under the former, and the imposition of the greatest possible amount of tax under the latter. Although the BEAT statute is not drafted as a limitation on the deductibility of base erosion payments, it does function in a somewhat similar manner, in effect limiting the maximum reduction in a U.S. corporation's tax liability that can be achieved through such payments; and it can be asked whether Section 59A(c)(3) should be seen as suggesting a broader approach to how Section 163(j) should be coordinated with other limits on deductibility of interest

---

<sup>60</sup> Section 163(j)(1).

<sup>61</sup> See H.R. Rep. 115-409, at 247-248.

<sup>62</sup> H.R. Rep. 115-409, at 249; H.R. Rep. 115-466, at 228-229 (repeating this statement, in describing the House bill, and then going on to describe changes to the House bill made by the Senate and in the Conference Committee that do not impact this point).

payments (i.e., in a manner that maximizes the effect of each limit). In our view, the fact that Congress added a specific rule in the Code to achieve this result, and did so in the BEAT statute instead of in Section 163(j), indicates that Congress viewed BEAT as a special case that required a unique, and relatively harsh, rule, rather than an indication more broadly of how Section 163(j) is meant to interact with other limits in the Code.<sup>63</sup> Except in the case of BEAT, the approach described in the preceding paragraph – applying other limits before applying Section 163(j), and thus applying its formula only to interest otherwise allowable as a current deduction – appears preferable.

We recommend that guidance be issued confirming these conclusions.

In the case of Sections 465 and 469, if Section 163(j) is applied to a taxpayer's interest expense after those provisions, the effect may be that the taxpayer's income from a passive or limited-risk activity is not sheltered to the full extent permitted by those provisions even though the taxpayer has substantial non-interest expenses from the activity. It would seem in keeping with the purposes of Section 465 and 469 to remove the possibility for such results, by having the taxpayer re-apply the limits these provisions impose, after taking into account the Section 163(j) limitation on interest expense from the relevant activity. In addition, such an approach would not undercut the goals of Section 163(j). In this connection, we note that proposed regulations under old Section 163(j) took a contrary approach, and Congress opted to overrule those proposed regulations.<sup>64</sup>

The Tax Section plans to submit comments on whether Treasury Regulation Section 1.385-3 should be withdrawn or modified as a result of various changes made pursuant to Act, including the enactment of Section 163(j).

## 2. **Carryforwards of Disallowed Interest Under Old Section 163(j)**

Interest expense that was disallowed by reason of Section 163(j) as in effect prior to the Act should be treated as interest paid or accrued by the taxpayer in the first year new Section 163(j) is effective. Old Section 163(j)(1)(B) expressly provided for the carryforward of such interest to that year: such interest would be treated as "paid or accrued within" that year for purposes of Section 163(a), as well as for purposes of the annual limitation on the Section 163(a) interest deduction set forth in Section 163(j).

The new statute and its legislative history do not expressly state whether this carryforward will be recognized in the period following the statute's enactment. However, the Act did not amend Section 163(a); and there would seem to be no reason why Treasury and the IRS cannot simply continue to interpret the reference in Section 163(a) to "interest paid or accrued within" 2018, as including disallowed interest carried forward from 2017. Doing so would be fully consistent with the policy of the new provision, as the carried forward interest would simply become subject to

---

<sup>63</sup> We note that the BEAT, unlike Section 163(j), also applies to a corporation's gross, rather than net, interest expense.

<sup>64</sup> See Section 163(j)(7).

the same formulaic limitation as interest paid or accrued after the effective date of the amendments to Section 163(j).

Old Section 163(j) also provided that if a corporation's Section 163(j) limit for a taxable year exceeded its interest expense, the corporation was entitled to carry forward that excess to increase its Section 163(j) limit in the next three taxable years.<sup>65</sup> We recommend that guidance confirm that a corporation with such a carryforward from the last year old Section 163(j) was in effect, will simply lose the benefit of that carryforward under the new provision. The new provision includes no concept of carrying forward an unused limitation to future years. In addition, the old Section 163(j) limit was considerably different than the new one, reaching only interest paid to a related party not subject to U.S. tax on that amount, and only to the extent interest expense exceeded 50% of EBITDA; it would seem to give taxpayers a significant advantage to be able to use a carryforward designed to provide leniency under the relatively narrowly targeted former provision, in order to lessen the impact of the new, broader restriction.

### 3. **Interaction Between Section 163(j), and Sections 246(b) and 250(a)**

Under our recommendation in Part III.C above, a corporation's ATI would include dividends received by it, Subpart F income, global intangible low-taxed income ("**GILTI**") as defined in Section 951A and "foreign-derived intangible income" ("**FDII**") as defined in Section 250. The corporation's ATI also would take into account the dividends-received deductions provided by Sections 243, 245 and 245A, as well as the deductions in respect of GILTI and FDII provided in Section 250(a)(1).

Section 246(b) provides that, in general, the total of a corporation's dividends-received deductions under Sections 243(a)(1) and 245 and its deduction under Section 250 cannot exceed 50% of the corporation's taxable income, determined without regard to any Section 172 deduction for a net operating loss carryover and with certain other adjustments. It is not entirely clear how this limitation interacts with the one in Section 163(j)(1)(B), generally restricting interest deductions to 30% of ATI. If one of these limits is applied before the other (i.e., by simply disregarding the other), then a taxpayer may end up with a result that is not in literal compliance with the latter Code provision. In similar circumstances, the IRS and the courts have approved of the use of simultaneous linear equations.<sup>66</sup> We recommend that guidance confirm whether such an approach also applies when applying the two limits in the present case.<sup>67</sup>

---

<sup>65</sup> Old Section 163(j)(2)(B)(ii).

<sup>66</sup> See Rev. Rul. 79-347, 1979-2 C.B. 122 (corporation had (i) a Section 243(a)(1) dividends received deduction, subject to the limitation in Section 246(b), and (ii) depletion deductions under Section 613A, subject to the limitation in Section 613A(d)(1) based on 65% of the corporation's taxable income; the IRS approved the use of simultaneous equations to apply these two limits); *Shell Oil Co. v. Comm'r*, 89 T.C. 371, 419-421 (1987) (describing situations under the Code in which use of simultaneous equations has been necessary), rev'd. in part and remanded in part, 952 F.2d 885 (5th Cir. 1992).

<sup>67</sup> Under Section 246A, if a corporation owns "debt-financed portfolio stock," then the corporation's dividends received deduction with respect to a dividend paid on that stock generally is limited to (a) the portion of the dividend that is attributable to the part of the stock that has not been financed with debt plus (b) the excess (if any) of the portion of the dividend that is attributable to the debt-financed part of the stock over the interest

The interaction between Sections 163(j) and 250(a)(2) raises similar ordering questions. In general, Section 250(a)(1) provides that a U.S. corporation is entitled to a deduction equal to the sum of (a) 37.5% of its FDII for the taxable year and (b) 50% of (i) the GILTI amount included in its gross income under Section 951A for the taxable year. However, Section 250(a)(2) adds the limitation that, if the sum of the corporation's FDII and GILTI amounts exceeds its taxable income (computed without regard to the deduction provided in Section 250), then the corporation's deduction under Section 250(a)(1) must be reduced under a formula. Again, Treasury and the IRS should confirm whether simultaneous equations need to be used in order to apply Sections 163(j) and 250(a)(2) in tandem.

The FDII rules also require the resolution of one additional ordering question related to Section 163(j). In general, FDII is defined as a portion of the excess of a U.S. corporation's "deduction eligible income" over a deemed return on its investment in tangible assets – specifically, the portion of such excess income that is attributable to selling property or services to foreign persons.<sup>68</sup> "Deduction eligible income" is defined as the excess of the corporation's gross income (computed without regard to specified items) over "the deductions (including taxes) properly allocable to such gross income."<sup>69</sup> Guidance should be provided regarding whether, for this purpose, "the deduction" for interest takes into account the limitation on deductibility imposed by Section 163(j).

#### F. **Impact on Earnings and Profits**

We recommend that Treasury and the IRS confirm that disallowance of a corporation's interest expense under Section 163(j) should not have an effect on the year in which the expense reduces the corporation's earnings and profits ("**E&P**"). Caselaw and rulings have established a principle that, generally, E&P should be determined in a manner that is consistent with the economic reality of a corporation's ability to make distributions in excess of a return of capital.<sup>70</sup> Consistent with that principle, Treasury and the IRS have concluded that when a corporation has an economic outlay in a particular year and the tax deduction or loss associated with that outlay is disallowed for the year and carried forward, the corporation reduces its E&P in the year the outlay

---

deduction allocable to the dividend. Generally, debt financed portfolio stock is a minority stockholding in a corporation, to the extent there is debt that is "directly attributable" to the corporation's investment in that stock. Section 246A does not present the same kind of issue that Section 246(b) does, regarding the order of applying Section 163(j)(1)(B) and a separate deduction limitation in the Code that uses a formula based on taxable income. However, depending on what method is used to allocate a corporation's interest expense between exempt and non-exempt businesses for purposes of Section 163(j), it is possible that a different allocation method will need to be used under Section 246A to determine whether any portion of the corporation's investment in stock is considered to be debt-financed portfolio stock under Section 246A (Section 246A generally requires that debt be incurred for the purpose of investing in the portfolio stock or is otherwise directly traceable to the purchase of the stock). In addition, the portion of the interest on such debt that is deductible under Section 163(j) will need to be determined.

<sup>68</sup> See Section 250(b).

<sup>69</sup> See Section 250(b)(3)(A)(ii).

<sup>70</sup> See *Beck v. Comm'r*, 52 T.C. 1 (1969) (E&P is "an economic concept which the tax law has utilized 'to approximate a corporation's power to make distributions which are more than just a return of investment.'), *aff'd*, 433 F.2d 309 (5th Cir. 1970); Bittker & Eustice, Federal Income Taxation of Corporations & Shareholders ¶8.04.

is made notwithstanding the disallowance.<sup>71</sup> Treasury and the IRS adopted that approach in proposed regulations under old Section 163(j);<sup>72</sup> and we believe it would be appropriate to do the same under new Section 163(j).

## **G. Consolidated Groups**

### **1. Single Taxpayer Approach**

The statute applies Section 163(j) to a "taxpayer." It appears appropriate to view a consolidated group as a single "taxpayer" for this purpose, in keeping with the consolidated group regulations' basic approach of computing a single consolidated taxable income for a group's members, which is reduced by the aggregate amount of interest expense incurred by the group's members.<sup>73</sup> Such an approach would make sense as a policy matter, and is consistent with Section 163(j)'s legislative history. The House report states: "In the case of a group of affiliated corporations that file a consolidated return, the limitation applies at the consolidated tax return filing level."<sup>74</sup> In addition, a similar statement appears in the Joint Committee's description of the Senate's version of the legislation; and the Conference Committee report notes this would have been the approach under the House's proposal, and then goes on to describe changes to the House's proposal made by the Senate and Conference Committee, none of which impact this point.<sup>75</sup>

Under a "single taxpayer" approach, a consolidated group's ATI, business interest income, and business interest expense all would be computed at the group level, by reference to items included each year in consolidated taxable income.<sup>76</sup> One refinement to this basic approach, is that interest on intercompany loans could be disregarded for purposes of determining the amount

---

<sup>71</sup> See Treasury Regulation Section 1.312-7(b)(1) (corporation's capital loss reduces E&P in the year recognized, even if disallowed under Section 1211, not the year to which carried forward under Section 1212); Rev. Rul. 75-515, 1975-2 C.B. 117 ("In general, the computation of earnings and profits of a corporation for dividend purposes is based upon reasonable accounting concepts that take into account the economic realities of corporate transactions as well as those resulting from the application of tax law. Thus, losses and expenses that are disallowed as a deduction for Federal income tax purposes, charitable contributions in excess of the limitations provided therefore, and other items that have actually depleted the assets of the corporation, even though not reflected in the income computation, are allowed as deductions in computing earnings and profits."); see also Field Service Advice 1993-540 (noting that a corporation's E&P is reduced by a net operating loss in the year the loss is incurred, rather than the year to which it is carried forward under Section 172).

<sup>72</sup> See Proposed Regulation Section 1.163(j)-1(e), 1.163(j)-8(g).

<sup>73</sup> See Treasury Regulation Section 1.1502-11.

<sup>74</sup> H.R. Rep. 115-409 at 248.

<sup>75</sup> See JCT Description of Senate Finance Committee Chairman's Mark of the Tax Cuts and Jobs Act, at 71 (same statement); H. Rep. 115-466, at 228.

<sup>76</sup> Compare Treasury Regulation Section 1.1502-24 (computing Section 170(b)(2) limit on charitable contribution deduction at the consolidated group level); Treasury Regulation Section 1.1502-26 (same for Section 246 limit on dividends received deduction); Treasury Regulation Section 1.1502-44 (same for Section 613A(d) limit on percentage depletion deductions); proposed Treasury Regulation Section 1.163(j)-5(b) (same for old Section 163(j) limit).



of the consolidated Section 163(j) limitation. This would be consistent with the basic principle here that a group is a single economic unit for purposes of Section 163(j).<sup>77</sup>

**Example 1.** Parent, S1 and S2 are the members of a consolidated group. In 2018, Parent has no income or deductions; S1 has 100 of business interest expense on loans from non-group members and 10 of ATI; and S2 has 20 of business interest expense on loans from non-group members and 290 of ATI.

In Example 1, the consolidated group's ATI is 300 (= 290 + 10), and its Section 163(j) limit should be 90 (90 = 30% x 300). Thus, the group should be entitled to deduct 90 of its 120 of business interest expense for 2018, with the remaining 30 being a carryforward.<sup>78</sup>

For years prior to 2022, ATI is computed without reference to the taxpayer's depreciation and amortization deductions. However, gain from a sale of a depreciable or amortizable asset is included in ATI. In a case where one consolidated group member sells a depreciable or amortizable asset to another in an intercompany transaction, it is not entirely clear how these rules should apply. It would appear that, since the selling member's gain is generally taken into account under the "matching rule" in a manner designed to produce the same effect as a transaction between divisions (i.e., the character and timing of the selling member's gain will match the purchasing member's deductions), and since the purchasing member's deductions are disregarded in computing ATI, the gain also logically should be disregarded.<sup>79</sup> This result would be consistent with the basic principle recommended, to treat the consolidated group as a single taxpayer for purposes of Section 163(j).

More broadly, we note that in general, items from intercompany transactions either could be disregarded when computing a consolidated group's ATI, or included in the calculation. Because intercompany transactions normally should result in items of offsetting amount and the same character in a particular year under the matching rule, it appears such items normally would not result in a net change in the amount of the group's consolidated ATI, whether such items are disregarded when computing consolidated ATI or not.<sup>80</sup>

## 2. Exempt Businesses of a Consolidated Group

A logical corollary of the single taxpayer approach, and of the allocation principles recommended above, is that a consolidated group would allocate its interest expense between a trade or business that is exempt from Section 163(j), and another one that is not, based on the relative assets or income of each business – regardless of the location of each business, or of the interest expense, within the consolidated group.

---

<sup>77</sup> Compare Treasury Regulation Section 1.385-4T (taking a similar approach for purposes of applying the debt recharacterization rules in Treasury Regulation Section 1.385-3 to consolidated groups).

<sup>78</sup> In Part III.G.4 below, we consider the appropriate treatment of intragroup loans when applying Section 163(j) to a consolidated group.

<sup>79</sup> See Treasury Regulation Section 1.1502-13(c).

<sup>80</sup> We discuss in the next section, however, a case where Section 163(j) might be applied differently to a consolidated group, depending on whether items from intercompany transactions are taken into account.

**Example 2.** Parent, S1 and S2, are the members of a consolidated group. Parent has incurred no debt, and owns no assets other than the shares of S1 and S2. S1 owns 1,000 of assets, which it uses in a non-exempt trade or business, and has 200 of ATI and 50 of interest expense on loans from non-group members in 2018. S2 owns 500 of assets, which it uses in a real property trade or business for which S2 has made an election under Section 163(j)(6)(B), and has 50 of income from that trade or business and 100 of third-party interest expense on loans from non-group members in 2018.

In Example 2, assuming that an asset-based approach is used to allocate interest expense to the consolidated group's exempt and non-exempt businesses, it appears that the consolidated group should disregard members' stock when making that allocation.<sup>81</sup> The group should compute a consolidated ratio of assets used in an exempt business (500) to total assets (1,500), and thus should treat 1/3 of the group's 150 of total interest expense as being allocated to S2's real property trade or business and not being subject to Section 163(j), notwithstanding that S2 has actually incurred 100 of interest expense. All of the group's remaining 100 of interest expense should be treated as being allocated to S1's trade or business and being subject to Section 163(j). For purposes of computing the group's limitation, only S1's 200 of ATI from its non-exempt business should be taken into account. Thus, the consolidated group should be limited to a deduction of 60 under Section 163(j) with respect to the group's 100 of non-exempt business interest expense, resulting in a disallowance of 40.

Alternatively, if an income-based method is used to allocate interest expense in Example 2, then the group's ratio of exempt income (50) to total group income (250) is computed, with the result that 20% of the group's 150 of interest expense (30) should be treated as not subject to Section 163(j). The Section 163(j) limitation would apply to the remaining 120 of interest expense, resulting in a disallowance of 60.

We note that, consistent with the basic approach described in Part III.G.1 above, the income that is taken into account for purposes of making an income-based allocation of interest expense between exempt and non-exempt businesses conducted by a consolidated group should take into account all items that are included in consolidated taxable income. Generally speaking, it appears that it should not make a difference whether items from intercompany transactions are taken into account. However, this may not always be the case, as when a subsidiary that conducts an exempt business has intercompany items from transactions with a subsidiary that conducts a non-exempt business. In such a case, it seems that either taking into account those intercompany items (or else, possibly, seeking to allocate income and non-interest expenses from transactions with non-group members in some fashion between the exempt and non-exempt businesses) may be appropriate.

In Example 2, if S2's business consists solely or predominantly of leasing real property to (or conducting other activities described in Section 469(c)(7)(C) for) other members of the consolidated group, it can be asked whether it is consistent with a single taxpayer approach to view S2 as conducting a real property trade or business for which a Section 163(j)(6)(B) election can be made. In other contexts, the separate existence of a trade or business that principally serves

---

<sup>81</sup> Compare Treasury Regulation Section 1.1502-91(g)(1) and 1.1502-93(b)(1) (member stock and intercompany debt is disregarded for purposes of certain consolidated group Section 382 computations).

affiliates is respected.<sup>82</sup> However, the basic consolidated return principle of treating members as divisions of a single corporation, and the application of that principle in the Section 163(j) context to treat a group as a single "taxpayer," suggest that S2's activities should be viewed as an indivisible part of the group's overall (non-exempt) business activity.<sup>83</sup> (This view has particular force, if it is the case that items from intercompany transactions are not taken into account in allocating interest expense among the group's businesses.)

### **3. Corporations Joining a Consolidated Group**

When a corporation joins a consolidated group, in a transaction that results in a Section 382 ownership change for the corporation, the corporation's carryforward of disallowed business interest expense from a separate return year would be subject to the resulting Section 382 limitation. It would appear consistent with the treatment of other Section 382-limited attributes to allow the consolidated group to take into account the portion of the corporation's business interest expense carryforward permitted under Section 382 to be treated as incurred in a consolidated return year, and to subject that amount of interest of such corporation to the consolidated Section 163(j) limitation for the consolidated return year in the same manner as any other interest expense incurred by a group member in that year – without any special treatment or limitation as a result of the fact the interest has been carried forward from a separate return year.<sup>84</sup>

### **4. Corporations Leaving a Consolidated Group; Apportionment of Consolidated Group's Carryforwards**

Although Section 163(j) generally should be applied to a consolidated group as if it were a single taxpayer, in the manner described above, it nevertheless may be appropriate to apportion among the members the effects of any disallowance and carryforward of the group's business interest expense. In particular, such apportionment may be appropriate in order to determine how

---

<sup>82</sup> Cf. Proposed Regulation Section 1.355-3(d)(2), Example 16 (manufacturing corporation has an R&D department that develops new products for the corporation to manufacture; R&D department's activity can be transferred to a separate corporation and used to satisfy the Section 355(b) active trade or business requirement), Example 17 (corporation that sells meat products carries on activity of processing meat, which it sells to customers; meat processing activity can be held in a separate corporation from the sales function and used to satisfy the active trade or business requirement).

In addition, as noted above in the text, our basic recommended methodology recognizes intercompany transactions and takes into account items from those transactions for purposes of applying Section 163(j), rather than simply disregarding such items.

<sup>83</sup> Support for this approach can be found in Treasury Regulation Section 1.1502-13(c)(7)(ii), Example 2. S, a member of a group that holds land for investment, sells the land to B, a member of the group that develops the land as residential real estate and sells the developed lots to customers. In the example, the character of S's gain from its sale of land must be determined by treating S and B as a single corporation and assessing whether, based on their combined activities, the land is described in Section 1221(a)(1). By analogy, in the case described in the text above, the character of S2's rental income and activities giving rise to that income, would be determined by treating S2 and the subsidiaries to which it leases property as a single corporation.

<sup>84</sup> We do not analyze in this Report the proper result in a case where a corporation joins a consolidated group in a transaction not resulting in an ownership change under Section 382.

much of the group's business interest expense carryforward a member should take with it, if it leaves the group. We consider several different potential apportionment methods below.<sup>85</sup>

**a. Method One: Apportionment Based on Each Member's Business Interest Expense on Debt Owed to Non-Group Members**

One relatively simple method would be to treat each member that has business interest expense on debt owed to non-group members in the year a carryforward is generated, as having a portion of that business interest expense disallowed and carried forward, corresponding to the portion of the group's total business interest expense owed to non-group members that is disallowed and carried forward.

Under this method, if the group has any business interest expense on intercompany debt for the year in which the carryforward is generated, none of that interest expense would be considered to have been disallowed and carried forward; rather, only business interest expense on debt owed to lenders outside the group would be so treated. The rationale is that each dollar of intercompany business interest expense is matched by a dollar of intercompany business interest income and, thus, should not be viewed as causing or contributing to any disallowance and carryforward of business interest expense by the group under Section 163(j).

**Example 3.** Parent, S1 and S2 are members of a consolidated group. Parent is a holding company that has borrowed from third parties and lent to S1 and S2, which are both operating subsidiaries. In 2018, Parent's only items of income and expense are 150 of business interest expense on a loan from an unrelated lender, 100 of business interest income from S1 and 50 of business interest income from S2. S1 has 100 of business interest expense and 200 of ATI. S2 has 50 of business interest expense and 100 of ATI. At the end of the year, Parent sells S1 to an unrelated buyer.

In this example, the consolidated group's Section 163(j) limit for 2018 would be 90 ( $90 = 30\% \times 300$ ). Under Method One, S1's 100 of business interest expense, S2's 50 of business interest expense, and Parent's 150 of business interest income, would be disregarded for purposes of applying Section 163(j) to the group. Parent's 150 of business interest expense owed to the unrelated lender would be limited, with 60 of that interest expense being disallowed and carried forward. When Parent sells S1, none of that carryforward would go with S1; rather, the entire carryforward would remain with Parent.

Method One would be generally similar to the principles for apportionment of other group attributes to a departing member.<sup>86</sup>

---

<sup>85</sup> As discussed below, each of the apportionment methods that we have considered may lead to what can be seen as distortions in some cases, and involve potential complexity. A possible alternative that could be considered, is for none of a group's business interest expense carryforwards to be apportioned to a member that leaves the consolidated group. Instead, the entire disallowed business interest expense carryforward would simply remain with the group. Cf. Treasury Regulation Section 1.1502-36(d).

<sup>86</sup> See Treas. Regulation Sections. 1.1502-21(b) (apportioning a consolidated net operating loss carryover based on the approach that the consolidated loss consists of a ratable portion of each loss-making member's separate

**b. Method Two: Apportionment Based on Each Member's Net Business Interest Expense (Determined Taking into Account Interest on Intragroup Debt)**

A second possible method would be to apportion the disallowance and carryforward of business interest expense based on each member's net business interest expense (i.e., the excess, if any, for each member of its business interest expense over its business interest income) for the year in which the Section 163(j) carryforward is generated. Under this method, a member's net business interest expense would be determined by taking into account not only interest on debt that the member has borrowed from or loaned to non-members, but also interest on intragroup debt.

Under Method Two, the consolidated group would be treated as a single taxpayer, and loans between members would be disregarded, when computing the amount of the group's consolidated Section 163(j) limit, and the total amount of business interest expense to be disallowed. However, unlike Method One, that disallowed interest would not all be apportioned to the members with external business interest expense, but instead would be spread among the members in a manner that takes into account intercompany debt.

The rationale for this approach is that often, external borrowing may be done by only one or a few holding companies in the consolidated group, which members then on-lend the funds to other group members that are operating companies (as in Example 3). If one of these operating subsidiaries ultimately leaves the consolidated group, it is that subsidiary which could generate ATI that would provide capacity to use carryforwards of disallowed business interest expense; thus, it would seem logical to choose an apportionment methodology that is relatively likely to apportion carryforwards to the operating subsidiary.

For instance, in Example 3, the consolidated group's Section 163(j) limit continues to be 90, and the total amount of interest disallowed continues to be 60, as was the case under Method One. However, the manner in which the disallowed interest expense is apportioned to the various group members would be different. In 2018 Parent's net business interest expense is 0; S1's is 100; and S2's is 50. As a result, of the 60 of business interest expense disallowed in 2018, 40 would be apportioned to S1 ( $40 = 60 \times 100/150$ ). When Parent sells S1, S1 would take 40 of the carryforward with it; and the remaining 20 would stay with the consolidated group.

Under Method Two, S1 would be entitled to deduct only 60 of its 100 of business interest expense on its loan from Parent in 2018. Parent, however, would have 100 of business interest income and 100 of currently deductible business interest expense. This result represents an (arguably anomalous) departure from the matching principles that would normally apply to Parent's and S1's interest income and expense on their intercompany loan.<sup>87</sup> However, an advantage of this method is that when S1, which (at least in 2018) possesses most of the group's

---

net operating loss for the year), 1.1502-79 (applying a similar approach to apportion a consolidated group's investment tax credit carryforwards, foreign tax credit carryforwards, and excess charitable contribution carryforwards to a departing group member).

<sup>87</sup> See Treasury Regulation Section 1.1502-13(c).

capacity to generate ATI, leaves the group, S1 will take most of the business interest expense carryforward.<sup>88</sup>

An additional advantage of Method Two, is that it appears to lead to more appropriate results than Method One in cases where the group conducts both businesses that are exempt from Section 163(j), and non-exempt businesses.

**Example 4.** Parent, S1 and S2 are members of a consolidated group. In 2018, Parent, a holding company, borrows from third parties and on-lends the funds to S1, which conducts a non-exempt business, and S2, which conducts an exempt business. Parent's interest income on these loans matches its interest expense on its third-party debt. At the end of the year, P sells S1 to a third party.

In Example 4, any carryforward of disallowed business interest expense that the consolidated group generates in 2018 logically should be attributed to S1. However, under Method One, when Parent sells S1, the entire carryforward would remain with the consolidated group – which at that point will own only an exempt business. Presumably, in 2019, the consolidated group would be entitled under Section 163(j) to deduct the full amount of the carried-forward interest assuming sufficient pre-deduction taxable income.

By comparison, under Method Two, S2 could logically be treated as not having any business interest expense in 2018, since its sole activity is an exempt business. Under that approach, none of the carryforward would be apportioned to it. In addition, Parent would have no net business interest expense. Thus, the entire amount of disallowed interest, and carryforward, would be apportioned to S1.

#### **c. Method Three: Apportionment Based on Members' Relative Assets or Income**

A third possibility would be to apportion a group's disallowed interest expense among its members using one of the asset-based or income-based methodologies described above in Part III.D. Similar to Method Two, this approach is intended to achieve suitable results in cases where the group members that have business operations (and thus have capacity to use the carryforward) are different than the ones borrowing from third parties; it also is intended to address cases where a group conducts both exempt and non-exempt businesses. This approach is also designed to eliminate a potential weakness of Method Two – that outcomes can differ depending on whether a particular group member has net business interest expense, or not.

**Example 5.** The facts are the same as in Example 4, except that Parent does not on-lend any funds to S1 and S2. Instead, Parent makes capital contributions to S1 and S2.

---

<sup>88</sup> Such an approach can be seen as consistent, at a practical level, with the rules for apportioning a group's NOLs to a departing member. The rules governing that issue generally have the effect of apportioning the NOLs to a group member that carries on revenue-generating activities, which activities might in the future become profitable and utilize the NOLs.

Under both Method One and Method Two, none of the group's disallowed interest expense would be apportioned to S1 when it is sold by Parent. By comparison, in Method Three, rules would be established to apportion the disallowed interest expense to the members of the group that conduct non-exempt businesses, based on the relative assets they use, or income they generate, in those businesses. Thus, in the example, the carryforward of disallowed interest expense is apportioned to S1.

As Example 5 indicates, Method Three often would impute interest expense to group members that in form have no debt. Thus, while this method achieves results that can be seen as more economically accurate, and less susceptible to manipulation, than either of the other methods, this method also would represent a substantial departure from traditional tax principles. On the other hand, this departure might be seen as appropriate given its matching of the methodology employed to determine disallowed interest during the time that S1 and S2 were members of the group.<sup>89</sup>

## 5. Captive Partnerships

It can be asked whether the single taxpayer approach discussed above should be extended to a case where a partnership that is wholly owned by members of a consolidated group incurs business interest expense. A rational argument could be made that such a partnership is part of a single economic unit to the same extent as any of the partnership's partners are, and that to refrain from subjecting the partnership's business interest expense to the consolidated group's Section 163(j) limit is at odds with economic reality. It also could be asserted that treating group members as a single taxpayer for purposes of Section 163(j) is conceptually consistent with treating a partnership wholly owned by the group as (for purposes of Section 163(j)) a disregarded entity with a single owner, rather than as a partnership with separate existence. A minority of us would propose to take this position.

However, while there may be reasonable policy arguments for such a position, it nevertheless appears it would be difficult to reconcile any guidance applying the group's Section 163(j) limit to the partnership's interest expense, with the terms of the statute. As discussed in Part III.H below, Congress clearly intended that Section 163(j) would apply at the partnership level, and that a partnership's business interest expense for which it is allowed a deduction would not then be subject to a further Section 163(j) limitation in a partner's hands.<sup>90</sup> See Section

---

<sup>89</sup> If Method Three were adopted, then additional rules addressing adjustments to basis of member stock and other attributes might be required in order to explain the migration of interest expense to a non-borrower member.

In a related point, it also would be appropriate to consider whether, in a case where a departing member's business tends to be relatively heavily leveraged for non-tax reasons (e.g., a financial institution), it would be reasonable for carryforwards of interest expense attributable to debt incurred by that member to be apportioned only to that member, rather than being apportioned at least in part to non-borrower members remaining in the group. Method Three appears potentially to raise this question to a greater extent than either Method One or Method Two above.

<sup>90</sup> Section 163(j)(4)(A)(i) and (j)(7)(A). When it decided to apply Section 163(j) at the partnership level, it appears Congress may have been motivated, at least in part, by a belief that a business organized in the form of a partnership is as likely to try to generate large interest deductions to shelter its profits, as is a business organized in the form of a corporation. See H.R. Rep. 115-409 at 247 ("The Committee believes that it is necessary to apply the limitation on the deductibility of interest to businesses regardless of the form in which such businesses

163(j)(4)(A)(i). If a partnership had one partner that was a member of a consolidated group, and another that was not, it would seem highly difficult as a technical matter to take a bifurcated approach, computing ATI, business interest income and business interest expense at the partnership level for the non-member partner, as mandated by the statutory text, and computing these items under an aggregate approach for the partner that was a member of the consolidated group. In view of this, it appears questionable whether a special aggregate approach should be adopted for a partnership all of whose partners, in a given period, are members of a consolidated group. Such a partnership is treated as a separate entity for purposes of other provisions of the tax law; and Section 163(j)(4) gives no indication that, notwithstanding those other provisions, the Section 163(j) limit is not meant to be applied at the partnership level when the partners are all members of a group, or otherwise closely related.

While Treasury and the IRS might have authority for such an approach under Section 1502, it would appear to create significant potential for complexity, and also would entail a novel decision to disregard a partnership (at least for a limited purpose) merely because its owners are group members.<sup>91</sup> An approach more consistent with precedent would be to conclude that, if the partnership passes muster under economic substance, business purpose, and similar doctrines, its existence as a partnership should be respected and the normal rules applicable to partnerships should govern.<sup>92</sup>

## 6. Application to Affiliated (Rather than Consolidated) Group

Old Section 163(j)(6)(C) provided that the members of an affiliated group, as defined in Section 1504(a), would be treated as a single taxpayer for purposes of the interest limitation formula. The regulations that were proposed in 1991 under old Section 163(j) would have determined whether the ownership requirements of Section 1504(a) were met based not only on actual ownership, but also on constructive ownership under Section 318. Thus, for example, two

---

are organized so as not to create distortions in the choice of entity."'). That rationale would seem to be as relevant in a case where a partnership's owners are members of a consolidated group, as in a case where they are not.

<sup>91</sup> In the proposed version of the anti-avoidance rule relating to intercompany transactions, Treasury and the IRS included an example in which a bona fide partnership is owned solely by members of a consolidated group, and one of those members obtains a tax advantage by selling an asset to the partnership. (In the example, there was no subsequent transfer by the partnership, or another person, to a group member.) It was concluded in the example that the sale could be disregarded as a sale to a non-member and, instead, treated as an intercompany transaction. Proposed Regulation Section 1.1502-13(h)(2), Example 2, in 59 Fed. Reg. 18,011, 18,043 (Apr. 15, 1994). After receiving substantial criticism of this example from stakeholders, Treasury and the IRS did not include it in the final version of the regulations. Instead, they indicated in the preamble that such a transaction in an appropriate case could be attacked under other anti-avoidance rules and authorities not specifically tied to the consolidated return context. T.D. 8597, 60 Fed. Reg. 36,677 (July 12, 1995).

<sup>92</sup> See PLR 200252070 (partnership wholly owned by members of consolidated group, treated as preventing consolidation with subsidiaries owned by the partnership until it liquidated); PLR 9645015 (sale by a consolidated group member to an entirely captive partnership was not an intercompany transaction or subject to the intercompany transaction anti-avoidance rule); TAM 9644003 (deferred intercompany gain with respect to stock of a consolidated group member triggered when the member merged into a partnership wholly owned by two other members of the consolidated group); cf. Rev. Rul. 83-156 (respecting a partnership between parent and wholly owned subsidiary in a corporate group).



separate consolidated groups, owned by the same foreign parent corporation, would be considered a single group for purposes of applying old Section 163(j).<sup>93</sup>

We do not recommend that a similar approach be taken under new Section 163(j). In 2017, Congress acted with old Section 163(j) as a long-established, well-understood precedent – and did not adopt any rule similar to old Section 163(j)(6)(C) or the proposed regulations. It is difficult in such circumstances to find statutory support for application of the new interest limitation at the level of an affiliated group. Indeed, the statute provides detailed rules under which Section 163(j) must be applied separately at the partnership level, and not at the partner level using aggregate principles. That conceptual approach seems antithetical to any rule requiring aggregation of separate corporations. Even under old Section 163(j), where there was an express prompt in the statute, the affiliated group rules were viewed as highly complex; it is not warranted to attempt to duplicate those rules here.<sup>94</sup>

We note that one consequence of not treating an affiliated group as a single taxpayer under new Section 163(j), is that if such an affiliated group has a carryforward of disallowed interest under the old statute, it will need to allocate that disallowed interest expense among the consolidated groups, and/or separate U.S. corporations, that were components of that affiliated group. For simplicity, we recommend that such allocation be done using the existing rules in Proposed Regulation Section 1.163(j)-5(c)(2)(iii) for allocations to a member leaving an affiliated group. These rules generally allocate the impact of disallowance of a portion of the affiliated group's interest expense in a particular year among the members of the group, based on their relative amounts of interest paid or accrued to non-taxable related parties. We recognize that other approaches are possible (including allocation based on the relative amount of business assets of each group member), but do not believe it is necessary to create a new rule for this limited purpose.

## H. Partnership Issues

### 1. Applying the Statute at the Partnership Level

The starting point for applying Section 163(j) to a partnership and its partners, is to classify that partnership's interest income, interest expense, and other income and expense at the partnership level: “In the case of any partnership (i) this subsection shall be applied at the partnership level and any deduction for business interest expense shall be taken into account in determining the non-separately stated taxable income or loss of the partnership.”<sup>95</sup>

Generally speaking, a partnership should be treated in the same manner as other non-corporate taxpayers for purposes of identifying its business interest income, its business interest

---

<sup>93</sup> Legislative history to old Section 163(j) contemplated that, at least in some cases, the affiliated group definition might be broadened, where non-member entities had been inserted in a structure that had the effect of breaking apart what otherwise would be a single affiliated group. It was viewed as questionable, however, whether the general statutory grant of authority in Section 163(j)(7) to issue regulations under old Section 163(j) contemplated an approach as broad as that taken in the proposed regulations. See NYSBA Tax Section Report No. 701, Report on Proposed Regulations under Section 163(j), at 20 - 22 (Oct. 23, 1991).

<sup>94</sup> See *id.*

<sup>95</sup> Section 163(j)(4)(A)(i).

expense, and its ATI.<sup>96</sup> Thus, a partnership's interest income should not be treated as business interest income to the extent such interest income is treated as “investment income” under Section 163(d) (e.g., interest income from passive investment in debt securities). In addition, as discussed further below, a partnership can have interest expense that is not treated as business interest expense because such interest expense qualifies as “investment interest” under Section 163(d).

Once a partnership has computed its business interest income, business interest expense, and ATI, the partnership should first apply its business interest expense against its business interest income under Section 163(j)(1)(A).<sup>97</sup> The partnership will be entitled to a deduction for business interest expense to the extent such business interest expense does not exceed the partnership’s business interest income. Next, any remaining business interest expense should be deducted to the extent such remaining business interest expense does not exceed 30% of the partnership’s ATI.<sup>98</sup> Finally, to the extent the partnership has any business interest expense remaining after the deductions just described, the partnership will not be allowed a deduction for that excess interest; instead, the carryforward rules of Section 163(j)(4)(B) (discussed below) will apply to such excess. While the statute does not expressly mandate that a partnership’s business interest expense will be applied in the manner described in the three preceding sentences, this is the result – for example, the provisions in Section 163(j)(4)(ii)(II) and Section 163(j)(4)(C) concerning “excess taxable income” make this clear.

## 2. **Classification of a Partnership's Interest Expense As Business Interest or Investment Interest**

In the case of a partnership whose partners are solely or mainly individuals, it would seem reasonable to allocate its interest expense between business interest expense and investment interest using the tracing principles of Treasury Regulation Section 1.163-8T, consistent with the approach recommended in Part III.D.2 above for interest expense incurred directly by individuals. In addition, tracing could be used to allocate interest expense to such a partnership's businesses that are exempt from Section 163(j), and those that are not.

This approach has significant practical advantages. Under both Section 163(d) and Section 469, current law provides that a determination is made at the partnership level whether interest expense of a partnership is attributable to a particular activity pursuant to Treasury Regulation Section 1.163-8T; and then each partner makes a determination, at the partner level, whether their distributive share of the interest expense attributable to that activity is investment interest or is an expense of a passive activity of the partner. If tracing principles are also used to determine whether interest expense of a partnership should be treated as business interest expense under Section 163(j), then the framework just described can be left unchanged. By comparison, if a partnership owned largely or entirely by individuals was required to use an asset-based or income-based allocation method to determine what portion of its interest expense was business interest expense, it would seem the partnership would need to apply consistent principles to allocate interest expense

---

<sup>96</sup> See Section 703(a), providing that a partnership generally computes its taxable income in the same manner as an individual.

<sup>97</sup> If the partnership has any floor plan financing interest, this interest should be separated out from the rest of its business interest expense, and deducted in full by the partnership under Section 163(b)(1)(C).

<sup>98</sup> Section 163(j)(1)(B).

to all its activities (including investment activities and passive activities). This in turn would have an impact on how all the partners applied Sections 163(d) and 469 to their shares of interest expense; they would use different rules than would apply for interest expense attributable to activities that a partner conducted directly.<sup>99</sup> In addition, when an individual made a contribution to, or received a distribution from, a partnership, rules would need to be developed in order to coordinate between the special allocation methodology that would apply at the partnership level and the traditional tracing principles applying to individual partners. Moreover, in interest of fairness, grandfathering rules would likely need to be provided in order to exclude pre-existing partnership debt, which had already been traced to a partnership activity under Treasury Regulation Section 1.163-8T prior to the Act, from the new allocation methodology. The complexity involved in implementing such an approach, would seem to outweigh any benefits it might provide.

However, as noted in Part III.D.2, it is questionable whether the same conclusion applies, where a partnership is owned solely or mainly by corporations. In such a case, it would seem preferable for the partnership to apply an asset-based or income-based approach to allocate its interest expense between investment interest and business interest expense, and between exempt and non-exempt businesses. Such an approach would limit opportunities for a corporation to use a partnership to manipulate how much interest expense could be allocated to exempt businesses.

Whatever method is generally used by a partnership to allocate its interest expense, we believe that at least one limited departure from traditional tracing principles is appropriate. If a partnership distributes borrowed funds, we believe that for purposes of applying Section 163(j) at the partnership level (and only for that purpose), the partnership's interest expense should be allocated among the partnership's exempt and non-exempt businesses, and its investments, based on the relative assets or income attributable to each business and its investment portfolio. None of the interest should be allocated based on the distributee partners' use of funds.

By comparison, Notice 89-35 applied the principles of Treasury Regulation Section 1.163-8T to a partnership borrowing that funded a distribution, to determine how to characterize the partnership's interest expense under Section 163. In the case of the partner that received the distribution, the character of that partner's interest expense generally depended on how the partner used the borrowed funds. If a partner was allocated interest expense on a share of the debt exceeding the amount (if any) of the borrowing proceeds distributed to him, then the partner was free to allocate the interest expense on that excess debt using any reasonable method, including by reference to the nature of the partnership's expenses during the year.<sup>100</sup> It appears that a rule that is based on how a partner uses the proceeds of a debt-financed partnership distribution, does not

---

<sup>99</sup> As discussed in Part III.H.7 below, the exception in Section 163(j)(3) for small taxpayers (those with average annual gross receipts of not more than \$25 million) appears to apply at the partnership level rather than the partner level. Thus, if a partnership had gross receipts of at least \$25 million, its methodology for allocating interest expense among its activities would impact all of its partners, large and small.

<sup>100</sup> In addition to the general rules described in the text, Notice 89-35 provides an optional alternative. Under that alternative, a partnership can choose to determine the character of its interest expense on debt used to fund a distribution by allocating the debt to any one or more expenditures made by the partnership during the year of the distribution. However, the portion of the debt allocated in this manner cannot exceed the amount of the selected expenditures. Any excess portion of such debt, and the related interest expense, must be allocated under the general rules described in the text.

fit well with the statutory mandate in Section 163(j)(4) that Section 163(j) should be applied separately at the partnership level. A rule that allocates the interest expense on the debt based on the assets and activities of the partnership would more fully comport with this statutory requirement.<sup>101</sup>

### 3. Treatment of a Partnership's Business Interest Expense That Is Allowed as a Deduction

Section 163(j)(4)(A)(i) states that all business interest expense of a partnership for which a deduction is allowed under Section 163(j), is taken into account in the partnership's "non-separately stated income." Although "non-separately stated income" is not defined in Section 163(j), we understand it to mean the partnership's "taxable income or loss, exclusive of items requiring separate computation under other paragraphs of [Section 702(a)]."<sup>102</sup>

In general, an item of income or deduction that is included in the non-separately stated income of a partnership, as determined under Section 702(a)(8), loses its tax character in the hands of the partner to whom the item is allocated.<sup>103</sup> In the case of a partnership's deduction for business interest expense, it is clear such deduction loses its character as interest, when applying Section 163(j) at the partner level. As a result, such deduction is not subject to any additional Section 163(j) limit at the partner level – only the limit, if any, imposed at the partnership level applies.

However, while not entirely clear, it seems very unlikely that such interest loses its character for purposes of applying other provisions of the Code. The legislative history and structure of the statute suggest that the purpose of the rule is to help coordinate the Section 163(j) limit imposed at the partner and partnership levels; there is no suggestion the rule is intended to apply more broadly. Thus, for example, the source of a partner's share of the partnership's business interest expense deduction presumably is determined under Section 861 under the normal rules that apply to interest expense.

We recommend that Treasury and the IRS issue guidance confirming that partnership business interest expense that is deductible for Section 163(j) purposes and taken into account in determining the partnership's "non-separately stated income" nevertheless retains its character for all other Code purposes.

---

<sup>101</sup> For avoidance of doubt, this Report is not suggesting that Treasury undertake a broader re-examination of the guidance provided in Notice 89-35, for any purpose other than the application of Section 163(j) at the partnership level.

<sup>102</sup> Section 702(a)(8). See also Section 6225(a)(2)(A), referring to "non-separately stated income or....non-separately stated loss (whichever is appropriate) under section 702(a)(8).".

<sup>103</sup> See Rev. Rul. 71-278 (partnership is subject to Indiana gross receipts tax; partnership is entitled to a deduction for this tax under Section 164 when computing its taxable income and its partners' distributive shares of such taxable income; partnership's partners do not get a separate Section 164 deduction, and they are not precluded from choosing the standard deduction instead of itemized deductions); McKee, Nelson & Whitmire, Federal Taxation of Partnerships & Partners, ¶ 9.01[3][a] ("Partnership items that are not separately stated are lumped together in an undifferentiated residual hotchpot that constitutes partnership Section 702(a)(8) "bottom-line" taxable income or loss.").

Because, under our recommendation, partnership business interest expense would retain its character as interest at the partner level other than for purposes of applying Section 163(j), it could be asked whether a non-corporate partner's share of such interest expense could be subject to limitation under Section 163(d). We believe this result is not intended; rather, it would seem that under Section 702 principles a partner's share of interest expense allocable to a business of the partnership should retain that character in the partner's hands.<sup>104</sup>

#### 4. Rules Relating to a Partnership's Business Interest Income

Section 163(j) does not provide that a partnership's business interest income is treated as part of its non-separately stated income. The statute does not contain any express rule regarding how the partnership's business interest income should be treated in the hands of its partners.

**Example 6.** A owns 10% of partnership (PS) and B owns the remaining 90%. In 2018, PS has \$1,000 of business interest income, \$990 of business interest expense, and no other items of income or deduction. In the same year, A has 100 of business interest expense on debt that A has incurred outside PS, and \$0 of ATI from sources other than PS.

The statute does not provide guidance about how A should be treated in Example 6 – in particular, whether A is allowed under Section 163(j) to claim a deduction for A's 100 of business interest expense on partner-level debt, as a result of the allocation of 100 of PS's business interest income to A.

In general, if a partnership has business interest income, it appears that under Section 702, a partner's distributive share of that income would retain its character as such; and, as a result, the partner would be able to increase the partner's Section 163(j) limitation by its share of that interest income, pursuant to Section 163(j)(1)(A).

However, in a case like Example 6, it seems logical, and consistent with the statutory scheme, to provide in administrative guidance that to the extent PS's business interest income has been taken into account in determining the amount of PS's business interest expense deduction allowed under Section 163(j)(1)(A), such business interest income cannot then be taken into account a second time, in computing the limit under Section 163(j) on A's deduction for business interest expense incurred by A on partner-level debt. Such a rule would be a reasonable interpretation of the statutory requirement that Section 163(j) must be applied "at the partnership level" (i.e., 990 of PS's business interest income should be taken into account at the PS level only, in computing PS's interest deduction limit under Section 163(j)(1)(A) – and not at the partner level). This result would also be conceptually similar to the statute's express rules to ensure that, once a dollar of a partnership's ATI is used to support a deduction of the partnership's business interest expense under Section 163(j)(1)(B), that same dollar of ATI cannot then be used a second time, to support a deduction of a partner's business interest expense on partner-level debt.

---

<sup>104</sup> This result also comports with legislative history that suggests the same dollar of interest expense is not meant to be subject to limitation under both Section 163(j) and Section 163(d). See H.R. Rep. 115-409, at page 248 note 444; H.R. Rep. 115-466, at 386 n. 688.

Under the guidance proposed above, A would not be entitled to use the whole \$100 of business interest income allocated to A, to support a deduction under Section 163(j)(1)(A) of A's partner-level business interest expense. Instead, A would be entitled to use only \$1 out of the \$100 of PS's business interest income allocated to A, to deduct A's partner-level interest expense in 2018.

As a mechanical matter, a relatively straightforward way to achieve the desired results would be to require that a partnership's business interest income must be included in the partnership's non-separately stated income, to the extent such business interest income does not exceed the partnership's business interest expense for the year.

By comparison, in the absence of the proposed guidance, A would appear to have a compelling argument that the business interest income allocated to A supports a deduction of the full \$100 of A's business interest expense under Section 163(j)(1)(A). In that case, the result would be that PS's \$100 of business interest income allocated to A would have supported \$200 of deductions of business interest expense – a \$100 deduction at the PS level, allocated to A; plus a second \$100 deduction at the partner level for A. It would be difficult to justify such a result as a policy matter.

## 5. **Business Interest Expense Disallowed at the Partnership Level: Carryforward Rules**

### a. **In General**

A partnership's business interest expense for which a deduction is not allowed at the partnership level under Section 163(j) is allocated to the partners per Section 163(j)(4)(B) as "excess business interest." Any excess business interest of a partner may not be deducted until the partner is allocated "excess taxable income" ("ETI") from the partnership in futures years. When a partner is allocated ETI, it treats an equivalent amount of excess business interest as business interest expense paid or accrued by the partner in the year of the ETI allocation.

It seems clear that ETI is intended to be defined as that portion of a partnership's ATI for a given year that is not needed to support the partnership's deduction under Section 163(j)(1)(B) for business interest expense in that year.

**Example 7.** C owns 10% of PS. In Year 1, PS incurs \$1,000 of business interest expense that it is not able to deduct by reason of the partnership-level limitation under Section 163(j). PS allocates 10 percent, or \$100, of that amount to C as excess business interest expense under Section 163(j)(4)(B)(ii).

In Year 2, PS has 1,500 of ATI and 150 of business interest expense. PS allocates 150 of ATI and 15 of business interest expense to C in Year 2.

Under Section 163(j)(1)(B) and (j)(4)(i), PS uses 500 of its ATI to support PS's deduction of 150 of business interest expense for Year 2. This leaves PS with 1,000 of ETI. Because PS allocates 10% (or 150) of its ATI to C, this means 10% (or 100) of PS's ETI is allocated to C. Logically, it is appropriate for C to be able to use the 100 of ETI to deduct only 30 of its carryforward of interest expense from Year 1. That result would put C in the same position as it

would have been in had the 100 of business interest expense in Year 1 been incurred by PS and allocated to C in Year 2 – rather than being carried forward by C from Year 1.

However, Section 163(j)(4)(B)(ii) indicates that C is entitled to deduct (at least to the extent it has excess available ATI) its carried-forward 100 of interest expense “to the extent of such excess taxable income,” i.e., to the extent of the ETI that PS allocates to C in Year 2. The relevant provision reads, in full:

If a partner is allocated any excess business interest expense from a partnership under clause (i) [requiring the allocation among partners of business interest expense for which a deduction is not allowed for a taxable year] for any taxable year—

(I) such excess business interest expense shall be treated as business interest expense paid or accrued by the partner in the next succeeding taxable year in which the partner is allocated excess taxable income from such partnership, but only to the extent of such excess taxable income, and

(II) any portion of such excess business interest expense remaining after the application of subclause (I) shall, subject to the limitations of subclause (I), be treated as business interest expense paid or accrued in succeeding taxable years.

Under this provision, because C recognizes 100 of ETI in Year 2, all 100 of its carryforward is treated as business interest expense “paid or accrued by” C in Year 2.

We believe that the reference to “paid or accrued” should not be interpreted as providing that C is automatically entitled to a deduction under Section 163(a) for 100 of interest paid or accrued in Year 2, without any limitation under Section 163(j) applying. Instead, this provision should be interpreted to treat such business interest expense in a manner similar to any other business interest expense paid or accrued by C in Year 2. That is, because that business interest expense is treated as having been “paid or accrued by C” in Year 2, it should be subject to the same limitations under Section 163(j)(1) as other business interest expense incurred by C.

Under this approach, pursuant to Section 163(j)(4)(A)(ii)(II), C’s 100 of ETI is added to C’s ATI, thus supporting a deduction of 30 of the business interest expense C is deemed to have accrued in Year 2. The remaining 70 of business interest expense is treated like any other business interest expense incurred by C in Year 2; that is, C is entitled to deduct it to the extent C has sufficient ATI and/or business interest income, and C is required to carry forward to future years any portion of that business interest expense that it cannot deduct. Thus, because that business interest expense is treated as having been “paid or accrued by C” in Year 2, it ceases to be a carryforward of excess business interest that can be used only against C’s share of PS’s ETI pursuant to Section 163(j)(4)(B)(ii).

We recommend that guidance make clear that any excess business interest expense of a partner “freed up” as a result of an allocation of ETI must be treated like any other business interest expense of the partner paid or accrued in the same year (and thus potentially subject to limitation at the partner level). In the absence of such guidance, we believe taxpayers might argue that the statutory language entitles a partner to an immediate deduction for the full amount of business

interest expense that has been "freed up" and is treated as paid or accrued as a result of an allocation of ETI.

Even if such guidance is provided, however, Section 163(j)(4)(B)(ii) will lead to the apparently inappropriate result of each dollar of ETI allowing one dollar of excess business expense to be deducted by a partner (subject to such partner having sufficient excess ATI from other sources), even though one dollar of ATI recognized by a partnership only permits the deductibility of thirty cents of business interest expense. While we recommend that this issue be addressed, it is unclear that regulatory authority exists for preventing this result, in which case a technical correction would be appropriate.

In addition, guidance should provide a clear ordering rule under which a partner's share of ETI, to the extent such share exceeds the amount the partner needs in order to be entitled to deduct carryforwards of disallowed business interest expense, is added to the partner's ATI. Section 163(j)(4)(A)(ii)(II) indicates fairly clearly this result is intended. However, the last sentence of Section 163(j)(4)(B)(ii) may cause some confusion: the sentence states that "For purposes of applying this paragraph [i.e., Section 163(j)(4), which applies Section 163 in the partnership context], excess taxable income allocated to a partner from a partnership for any taxable year shall not be taken into account under paragraph (1)(A) with respect to any business interest expense other than excess business interest expense from the partnership until all such excess business interest expense for such taxable year and all preceding taxable years has been treated as paid or accrued" (emphasis added). Treasury and the IRS should clarify that such ETI in fact will be taken into account by the partner under Section 163(j)(1)(B).

**b. Use of a Partner's Share of the Partnership's Business Interest Income to Absorb a Carryforward**

We recommend providing guidance under which, if a partnership has business interest income in a particular year that exceeds the partnership's business interest expense for the year, then a partner will be permitted to use its share of that excess business interest income to absorb the partner's carryforwards of excess business interest from prior years.

**Example 8.** D owns 10% of PS. In Year 1, PS has \$1,000 of ATI and \$1,000 of business interest expense, and 10% of this ATI and business interest expense is allocated to D. In Year 2, PS has \$1,000 of business interest income and \$300 of business interest expense, and again 10% of these items are allocated to D.

In Example 8, under Section 163(j)(4)(i)(A), PS is entitled to deduct \$300 of its \$1,000 of business interest expense in Year 1. Under Section 163(j)(4)(ii)(B), \$70 out of the remaining \$700 of interest is allocated to D and treated as excess business interest expense, which is carried forward to Year 2. Section 163(j)(4)(B)(ii) allows D to apply the \$70 against D's share of any ETI that PS recognizes in future years. In Example 8, PS has no ETI in Year 2; but, it would seem logical, and justified as a policy matter, to allow D to apply the \$70 of excess business interest expense against D's share of PS's business interest income for Year 2, as reduced by PS's business interest expense for Year 2. Under this approach, PS's business interest income of \$1,000 for Year 2, net of PS's \$300 of business interest expense for the year, leaves \$700 of excess business interest



income, of which \$70 is allocable to D; D thus would be entitled to deduct the entire \$70 of disallowed interest in Year 2.

While the statute sets forth a detailed formula for the computation of a partnership's ETI, and specific rules prescribing how a partner is allowed to use its distributive share of ETI to absorb carryforwards of excess business interest expense, it does not incorporate "excess" business interest income into the formula for ETI. The statute also does not, however, expressly prohibit guidance permitting the use of excess business interest income to absorb carryforwards; and such guidance seems consistent with legislative intent. Section 163(j)'s legislative history indicates that the carryforward rules in Section 163(j) are intended to deal with the fact that, due to business cycles or other factors, a business might sometimes incur an amount of interest expense that is large, relative to the business' income.<sup>105</sup> In the partnership context, Congress dealt with the most obvious manifestation of this issue when it adopted rules allowing a partner to use the partner's share of ETI to claim deductions for excess business interest expense. Congress did not adopt specific rules for a partnership whose principal income from its trade or business in fact happens to be interest, as with a lending business, rather than (say) income from the sale of inventory or provision of personal services. Indeed, there may not be a large number of partnerships that fit this description, relative to the total number of partnerships in the United States.<sup>106</sup> However, the fact that Congress focused on providing relief for the most common cases that warranted it, logically should not be interpreted as precluding Treasury and the IRS from extending the principles of the statute to equally appropriate, if less mainstream, cases involving a partnership that has excess business income that happens to be interest, rather than ATI.

#### **6. Cases Where a Partnership Has Interest Income/Expense that is Not Treated as Business Interest Income/Expense at the Partnership Level, Or Has Other Items That Are Treated as Investment Income at the Partnership Level**

A partnership can have interest income and expense that is not treated as business interest income or business interest expense at the partnership level.

**Example 9.** E, a U.S. corporation, and F, an individual, each own 50% of PS. PS has passive investments in securities, which it finances partially by incurring debt. In 2018, PS incurs 100 of interest expense on the debt, which it allocates pro rata to E and F.

PS's 100 of interest expense would qualify in Example 9 as investment interest under Section 163(d), if PS were an individual. Thus, such interest is not business interest expense, in PS's hands.

---

<sup>105</sup> See H.R. Rep. 115-409, at 248 (Nov. 9, 2017).

<sup>106</sup> IRS data indicates that in 2011 through 2014, partnerships in the finance and insurance sector represented about 9% of all partnerships filing returns. IRS data also indicates that in 2011 through 2013, S corporations in that sector represented about 4% of S corporations filing returns. See IRS, Total Assets, Trade or Business Income and Deductions, Portfolio Income, Rental Income and Total Net Income; IRS, Returns of Active Corporations, Form 1120S - Table 7).

In E's hands, however, that interest should be treated as business interest expense.<sup>107</sup> Section 163(j)(4) does not require that such interest be included in PS's non-separately stated income. Instead, under Section 702(a)(7) and Section 702(b), the interest expense ought to be treated in E's hands in the same manner as interest on debt incurred directly by E to finance direct investments in securities by E. Such interest expense of E would be business interest expense that is subject to limitation under Section 163(j).

By comparison, if Section 163(j) did not apply to the interest expense allocated to E, that would create an opportunity for E to avoid Section 163(j) by borrowing through a partnership, rather than borrowing directly. That result appears to be contrary to the intent of the statute: the statute's drafters clearly placed emphasis on preventing the use of partnerships to avoid the Section 163(j) limit.

An approach similar to the one just described should be taken in the case of F. Thus, similar to the analysis in E's case, the 50 of interest expense allocated to F should be treated as incurred by F to finance an investment in securities. Under Section 163(d), that interest should be treated as investment interest.

In Example 9, if PS earns interest income on its securities then it seems that the same approach as described above for interest expense, should apply to that income. Thus, E's share of PS's interest income should be treated as business interest income, in E's hands. F's share of such interest should be treated as investment income as defined in Section 163(d), in F's hands.

In addition, a partnership may have items other than interest income which are treated, at the partnership level, as investment income that is not part of the partnership's ATI. For example, it would appear that dividends, Subpart F income and qualified electing fund inclusions that are included in income by a partnership should be treated as investment income at the partnership level that does not enter into its ATI.<sup>108</sup> Similarly, the partnership's ATI should not include any dividends received deduction claimed by a corporate partner, as such items are not partnership-level deductions but, instead, are tied to the corporate status of the partner.<sup>109</sup>

---

<sup>107</sup> See H.R. Rep. 115-409, at 248 note 444 (Nov. 9, 2017) ("Section 163(d) applies in the case of a taxpayer other than a corporation. Thus, a corporation has neither investment interest nor investment income within the meaning of section 163(d). Thus, interest income and interest expense of a corporation is properly allocable to a trade or business, unless such trade or business is otherwise explicitly excluded from the application of the provision.").

<sup>108</sup> See Section 163(d)(5)(A)(i), 469(e)(1)(A)(i)(I); cf. Treasury Regulation Section 1.1411-10(c)(5), (g) (for purposes of calculating net investment income, a taxpayer can elect whether to compute his Section 163(d) investment interest limitation based on different timing for inclusion of Subpart F income and QEF amounts, than applies for regular income tax purposes).

The Tax Section plans to make a separate submission on the GILTI rules that will address, among other issues, the application of Sections 250 and 951A to partners and partnerships.

<sup>109</sup> If a corporate partner borrows at the partner level to finance an investment in a partnership that owns stock, the result under Section 163(j) will be different (generally less favorable) than if the borrowing had been at the partnership level. The corporate partner's ATI will take into account both its share of the dividend income and the dividends received deduction, whereas the partnership's ATI would not take into account the dividends received deduction. It could be asked whether that difference is justifiable as a policy matter. On balance, we believe it is. The difference in treatment is a direct consequence of Congress' decision in Section 163(j)(4) that

Guidance confirming the above results would be useful.

7. **Application of Exemptions/Exclusions from Section 163(j)**

a. **Election for a Real Property Trade or Business/Electing Farming Business (Section 163(j)(7)(B) & (C))**

Guidance should provide that, where a partnership conducts a real estate business of a type that qualifies for the election under Section 163(j)(7)(B), or a farming business that qualifies for the election under Section 163(j)(7)(C), the election should be made at the partnership level, rather than at the partner level.

In general, most elections affecting the treatment of partnership items are required to be made by the partnership.<sup>110</sup> In addition, Section 163(j)(4) specifically provides that Section 163(j) must be applied at the partnership level. It would be consistent with Section 163(j)(4), and simple as a mechanical matter, to have a partnership make the elections under Sections 163(j)(7)(B) and (C) with respect to a business it conducts. By comparison, if it is desired to give each partner the option to elect out, with respect to that partner's distributive share of income and interest expense from a partnership's real estate or farming business, the necessary mechanics for the election would be significantly more complicated. Among other things, a partner that elected out would need to take into account that partner's distributive share of depreciation deductions using a slower depreciation schedule, than a partner who did not elect out would use. In addition, it would seem hard to reconcile a partner-by-partner approach with the basic principle of applying Section 163(j) at the partnership level.

b. **Impact on the Partners Where a Partnership Conducts an Exempt Business**

If a partnership conducts an electing real property or farming trade or business, or a utilities business, then the partnership's interest expense allocable to that business, as well as all the other items of income and deduction that are allocable to such business, should retain their character in the hands of the partners to whom such items are allocated. In other words, under Section 702(a), such items should be treated as received/incurred by a partner in the conduct of a business that is excluded from Section 163(j), and so should not enter into the partner's ATI, business interest income or business interest expense.

**Example 10.** PS conducts a business of renting real estate to third parties, for which PS makes an election under Section 163(j)(7)(B), as well as a non-exempt business. In 2018, G, a partner in PS, is allocated 3 of income from PS's real estate business and 7 of ETI from the non-exempt business. G has business interest expense allocable (under the allocation principles described in Part III.D above) to non-exempt activities unrelated to its investment in PS.

---

it is appropriate to apply the Section 163(j) limit at the partnership level, rather than adopting an aggregate approach to partnerships.

<sup>110</sup> See Section 703(b).

On these facts, G should add its 7 of ETI to its ATI, thus increasing its Section 163(j)(1)(B) limit for purposes of deducting its business interest expense unrelated to PS. G's 3 of income from PS's real estate business, however, should not be included in G's ATI or increase G's Section 163(j) limitation.

In a case where a partner incurs debt which is allocable to its interest in a partnership that conducts an exempt business, guidance should provide that interest on the partner-level debt is exempt from Section 163(j).

**Example 11.** PS conducts a business of renting real estate to third parties as PS's sole activity and makes an election under Section 163(j)(7)(B). H, a partner in PS, borrows and its interest expense is allocable (under the allocation principles described in Part III.D above) to H's interest in PS.

In Example 11, it is appropriate for H's interest expense to be exempted from Section 163(j), because the interest is allocable entirely to an asset (H's interest in PS) that generates income from an electing real property trade or business. Such an approach is conceptually similar to the approach taken in the statute to PS's ETI, which a partner can use to support a deduction of partner-level interest expense.

If PS in Example 11 conducts both a real estate business, and a trade or business that is not excluded from the scope of Section 163(j) (similar to Example 10), then the treatment described above would apply only for the portion of H's partner-level interest expense that is properly allocable to the real estate rental business.

#### c. **Small Businesses (Section 163(j)(3))**

**Example 12.** PS conducts a business and has business interest expense. However, PS has average annual gross receipts of less than \$25 million, as determined for purposes of Section 448(c). One or more of PS's partners has average annual gross receipts of over \$25 million.

In Example 12, it seems clear that, at the partnership level, Section 163(j) does not apply to limit PS's interest deductions, because PS qualifies for the small business exception in Section 163(j)(3). However, a question remains as to whether, at the partner level, each partner should separately determine whether that partner is below the \$25 million threshold in Section 163(j)(3).

The general principle that Section 163(j) will be applied at the partnership level indicates that, if PS is exempt by reason of the small business exception in Section 163(j)(3), then the interest expense of PS allocated to its partners should remain exempt from Section 163(j) in their hands – rather than being re-tested at the partner level. In addition, Section 163(j)(3) incorporates the \$25 million threshold from Section 448(c), which by its terms clearly applies that threshold at the partnership level to allow the partnership to use the cash method of accounting, notwithstanding that the partnership may have large, accrual-method partners.

Such a result is permitted under Section 448(c) because it contains aggregation rules, pursuant to which the \$25 million threshold is applied taking into account the gross receipts of all entities related under Sections 52(a) or (b) or 414(m) or (o) (broadly, all entities in a group

connected to one another through greater than 50% ownership, as well as entities that are functionally connected by conducting integrated activities). The effect of these rules is to limit opportunities for gamesmanship, by forcing a partner that has a significant relationship to a partnership to add the partner's (and its affiliates') gross receipts to those of the partnership. These aggregation rules are incorporated by reference in Section 163(j)(3), with a similar effect.

Arguably, there is not a compelling reason for a partner with a large amount of gross receipts to be able to claim deductions for its share of business interest expense incurred by small partnerships with which the partner is not closely related, without any Section 163(j) limitation on those deductions. However, on balance, that result seems to provide little opportunity for abuse, and it appears consistent with the statutory scheme. We recommend that Treasury and the IRS confirm that result is correct.

## 8. Special Allocations

Guidance should expressly confirm that special allocations by a partnership of items of ATI, ETI, business interest income and/or business interest expense do not affect the determination of the Section 163(j) limitation at the partnership level.

**Example 13.** I and J own all of the interests of PS. In 2018, PS has no business interest income, 300 of ATI, and 60 of business interest expense. PS allocates all items comprising its ATI solely to I and its business interest expense solely to J. Assume these allocations are respected under Section 704(b).

In Example 13, the Section 163(j) limitation is applied at the partnership level, and PS's limitation is 60 with the result that PS's business interest expense should not be subject to limitation. We note that because PS's business interest expense (but not its ATI) is allocated to J, applying the limitation at the partnership level can result in a better outcome for J (i.e., full deductibility of the business interest expense allocated from PS) than had the limitation been applied at the partner level. Nevertheless, we believe that it is consistent with the plain language of the statute to apply the limitation at the partnership level only (and not again at the partner level where special allocations have effect).

Once the limitation has been applied at the partnership level, however, it is important that regulations, consistent with the statutory provision, make clear that, in then applying Section 163(j) at the partner level, the partners should take into account neither (i) their shares of the partnership's business interest expense that is deductible after application of the limitation at the partnership level, nor (ii) their share of the partnership's ATI that was used to allow its business interest expense to be deductible (and thus not included in ETI) (collectively, "**Post-Calculation Items**"). Thus, in Example 13, 200 of the 300 of ATI allocated to I and all 60 of business interest expense allocated to J would be considered Post-Calculation Items. As a result, I would be unable to use 200 of the ATI it is specially allocated to calculate its own Section 163(j) limitation. Correspondingly, the 60 of business interest expense allocated to J would be subject to no further limitation regardless of the amount of ATI and business interest income otherwise recognized by J. The remaining 100 of ATI allocated to I for 2018 would constitute ETI (and not a Post-Calculation Item), and thus would be potentially usable by I in determining its own Section 163(j) limitation.

A more challenging fact pattern would be present where a partnership specially allocates deductions that are included in its ATI in a manner that differs from how it allocates items of income that are included in its ATI.

**Example 14.** I, J and K own all of the interests of PS. In 2018, PS has no business interest income, 300 of ATI, and 60 of business interest expense. PS's ATI consists of 500 of gross income and 200 of gross deductions. PS allocates that gross income solely to I, those gross deductions solely to J, and its business interest expense solely to K. Assume these allocations are respected under Section 704(b).

In Example 14, like in Example 13, because the Section 163(j) limitation is applied at the partnership level, PS's business interest expense should be fully deductible. Thus, the 60 of business interest expense allocated to K should be considered a Post-Calculation Item and, thus, not subject to further limitation on K's return.

In Example 14, PS will also have 100 of ETI. Because, however, PS's items of income and deduction comprising its ATI will be allocated to different partners, it is not clear how the gross items of income and deduction allocated to I and J, respectively, should be treated. We believe the simplest approach would be to (i) treat gross income included in ATI ("**ATI Income**") allocated to a partner as ETI on a proportionate basis based on the proportion of the partnership's ATI Income allocated to each partner (with any remaining ATI Income allocated to the partner treated as a Post-Calculation Item) and (ii) treat all deductions included in ATI ("**ATI Deductions**") allocated to a partner as Post-Calculation Items. Under this approach, because PS has 100 of ETI, and all 500 of PS's ATI Income was allocated to I, 100 of the 500 of ATI Income allocated to I will be ETI, with the remaining 400 of ATI income allocated to I, and all 200 of ATI Deductions allocated to J, being treated as Post-Calculation Items.

Our recommended approach to cases like Examples 13 and 14 comports with the final sentence of Section 163(j)(4)(A), which provides that a partner's distributive share of ETI must be determined in the same manner as the partner's share of the partnership's non-separately stated income or loss. Under our approach, a proportionate part of the ATI Income allocated to each partner (whether as part of an allocation of net ATI, as in Example 13, or through an allocation of gross income items, as in Example 14) is treated as ETI. The remaining proportionate part of the ATI Income allocated to each partner (i.e., the part that is a Post-Calculation Item) loses its character in the partner's hands as ATI, and so cannot be used by the partner to support deductions of partner-level business interest expense. This proportionate allocation is, in our view, contemplated by the statute.

It would be appropriate to apply a similar approach to allocations of a partnership's excess business interest.

**Example 15.** Same facts as Example 14, except that in 2018, PS has 100 of business interest expense.

In Example 15, PS's Section 163(j) limitation is 90 ( $90 = 0 \text{ business interest income} + \{30\% \times 300 \text{ of ATI}\}$ ). Thus, PS can deduct only 90 of its 100 of business interest expense, and has 10 of excess business interest. Under our approach, each dollar of business interest expense that is

allocated to a partner, must consist of a proportionate part of (i) business interest expense for which the partnership was allowed a deduction under Section 163(j) (a Post-Calculation Item), and (ii) excess business interest. Thus, since PS allocated all of its business interest expense to K in Example 15, the entire 10 of excess business interest must be allocated to K.

In this connection, we note that Section 163(j)(4)(B)(ii)(II) provides that excess business interest must be allocated to each partner in the same manner as the non-separately stated taxable income or loss of the partnership. We believe our approach, in which excess business interest is allocated among the partners in the same proportions as business interest expense for which the partnership is allowed a deduction, meets this requirement.

#### 9. **Section 704(c) Allocations**

Where a partnership owns Section 704(c) property, it is required to allocate items with respect to that property so as to take into account any variation between the property's adjusted tax basis and its fair market value at the time of contribution (or revaluation) using a reasonable method that is consistent with the purposes of Section 704(c). The three methods that are deemed to be generally reasonable for purposes of making those allocations (the traditional method, the traditional method with curative allocations, and the remedial method) affect how partnership items are allocated among its partners and, in the case of the remedial method, may cause offsetting items of income and loss to be created and allocated among the partners.

None of the Section 704(c) methods affects the net amount of income or loss recognized by a partnership. As a result, and consistent with our discussion of special allocations above, we believe that the Section 163(j) limitation should be applied at the partnership level without regard to the manner in which partnership items are allocated among its partners under Section 704(c). While disregarding the allocation of items under Section 704(c) can result in a different amount of interest disallowance under Section 163(j) than had the limitation been applied at the partner level, we believe that it is consistent with the plain language of the statute to apply the limitation at the partnership level only by ignoring the effect of Section 704(c) on the partnership's allocations.

#### 10. **Section 743 Allocations**

A partner's items of depreciation or amortization (or adjustment to gain or loss on sale of an asset) that results from a Section 743(b) basis adjustment appears similar, in some ways, to a special allocation. As a technical matter, basis adjustments under Section 743(b) increase or decrease the basis of partnership property. Such adjustments, however, do not enter into the partnership's taxable income or loss as computed under Section 703; instead, such adjustments affect only the adjusted partner (and have no effect on the partnership's other partners).<sup>111</sup> In other words, notwithstanding the fact that the basis adjustment occurs at the partnership level, the existing regulatory framework makes clear that such basis has no effect on the calculation of the partnership's taxable income. Accordingly, we recommend that regulations clarify that (i) Section 743(b) adjustments of a partnership's partners are not taken into account in applying the Section 163(j) limitation to the business interest expense of the partnership and (ii) each partner's Section 743(b) adjustments are taken into account as items derived directly by the partner in determining

---

<sup>111</sup> See Treasury Regulation Section 1.743-1(j).

its own Section 163(j) limitation. If a rule was adopted requiring that a partner's Section 743(b) adjustment be included in the computation of a partnership's ATI for purposes of applying Section 163(j) at the partnership level, then a particular partner's Section 743(b) items could impact the deductibility of partnership interest by other partners. Such a result seems inconsistent with the basic approach taken in the Section 743(b) regulations. Instead, a Section 743(b) adjustment is appropriately taken into account at the partner (rather than partnership level) in determining ATI.

Our recommended approach creates potentially significant differences between a transaction in which a partnership purchases assets (where depreciation and amortization deductions generated by the stepped-up basis of those assets will, until the end of 2021, enter into the partnership's ATI), and a transaction structured as a purchase of partnership interests (where depreciation and amortization deductions generated by the Section 743 basis adjustment will not enter into the partnership's ATI). However, we believe these differences are unavoidable consequences of the decision to exclude a partner's Section 743(b) items from the partnership's taxable income.

## I. International Issues

### 1. Outbound Investment

We recommend that guidance be issued discussing how (if at all) Section 163(j) applies to business interest expense of a controlled foreign corporation ("CFC") or passive foreign investment company ("PFIC").

We believe the analysis for a U.S. investor in a PFIC (specifically, a PFIC for which the investor elects qualified electing fund status) is relatively straightforward. Under Section 1293(a), such an investor's annual income inclusion is limited to the investor's pro rata share of the PFIC's E&P for the year. Thus, the key point for a U.S. investor is the impact on the calculation of the PFIC's E&P of a disallowance of business interest expense under Section 163(j). As explained in Part III.F above, such a disallowance should not cause a delay in time the interest expense is taken into account in computing E&P.<sup>112</sup>

The picture for a U.S. shareholder of a CFC is more complicated. It appears that the U.S. shareholder's computation of its Subpart F income will be impacted by application of Section 163(j) to the CFC's interest expense, unless guidance provides relief from that result. However, it is not entirely clear that it makes sense for Section 163(j) to apply to a CFC's interest expense, for purposes of computing Subpart F income. In addition, assuming Section 163(j) should have an impact on the computation of Subpart F income, guidance could be developed in order to clarify exactly how big that impact will be.

As an initial question, it can be asked whether, as a policy matter, Section 163(j) should apply at all to interest expense of a CFC. On one hand, if Section 163(j) did not apply to CFCs, then it would be possible for U.S. taxpayers to conduct leveraged activities through a CFC and get

---

<sup>112</sup> We note that Congress has on occasion specifically instructed that departures from the normal E&P rules be made, when computing a PFIC's E&P. See Section 1293(e)(3). It has not done so in the case of new Section 163(j).



the effect of a full interest deduction. However, the strength of this concern appears to be diluted, in cases where a CFC earns not only Subpart F income, but also material amounts of income that is not subject to Subpart F. This will particularly be the case if it is difficult to predict of the mix of Subpart F and non-Subpart F income from year to year. In addition, to the extent that a CFC's business interest expense is disallowed and then, in future years, a U.S. shareholder's percentage ownership goes below 10%, or the CFC does not have Subpart F income, the U.S. shareholder may have a limited, or no, ability to benefit from a carryforward of the interest by the CFC under Section 163(j)(2).

In the proposed regulations under old Section 163(j), Treasury and the IRS decided not to apply the statutory limitation to the interest expense of any foreign corporation (including a CFC) that did not conduct a U.S. trade or business. The Preamble stated that "The disallowance rules do not apply if the payor corporation is either an S corporation or a foreign corporation (except as provided under 1.163(j)-8, related to foreign corporations with effectively connected income)."<sup>113</sup> Consistent with that statement, the proposed rules for a foreign corporation with a U.S. trade or business applied only with respect to the corporation's income and expense attributable to that trade or business; and the proposed affiliated group rule referenced above applied only to U.S. corporations that were in an affiliated relationship (foreign corporations were not treated as members of the affiliated group).<sup>114</sup>

However, in the absence of similar guidance under new Section 163(j), it appears the provision would apply to CFCs. Pursuant to Section 954(b)(5), when a CFC has foreign base company income ("**FBCI**"), that income is reduced by "deductions...properly allocable to such income" (including interest expense) for purposes of computing the amount of a U.S. shareholder's income inclusion under Section 951.<sup>115</sup> For this purpose, a CFC computes the amounts of its items of income and deduction under largely the same U.S. federal income tax principles as apply to determine the taxable income of a U.S. corporation, including any applicable limits under the Code on the deductibility of particular expenses.<sup>116</sup> Thus, a CFC would compute its interest deduction for purposes of Section 954(b)(5) taking into account the Section 163(j) limit.

Under a straightforward reading of the rules, that limit would be computed by reference to a CFC's ATI from all its activities, other than exempt businesses, and all of its interest expense. Part of that deduction then would be apportioned to the CFC's FBCI, apparently by reference to the tax basis of the assets used to generate that income as compared to the assets of its business.<sup>117</sup>

---

<sup>113</sup> See Fed. Reg. Vol. 56, No. 117, p. 27907, at 27908 (June 18, 1991).

<sup>114</sup> Proposed Regulation Section 1.163(j)-5(a)(3).

<sup>115</sup> A CFC's interest expense is allocated to foreign base company income and other income using an asset-based allocation method. See Treasury Regulation Sections 1.861-9T(f)(3), 1.954-1(c)(1)(i). Historically, allocation on the basis of gross income was permitted as an alternative to allocation based on assets. Treasury Regulation Section 1.861-9T(j).

<sup>116</sup> See Treasury Regulation Sections 1.952-2(b), (c).

<sup>117</sup> Section 864(e)(2) (as amended by the Act) requires interest expense to be allocated using the tax basis of a taxpayer's assets, for purposes of the sourcing rules (and, presumably, rules that incorporate the sourcing rules by reference, such as the Section 954(b)(5) regulations).

It would appear reasonable for guidance to reverse the order of operations here, for purposes of computing a CFC's FBCI (and other Subpart F income): that is, a CFC's interest expense first would be allocated between its FBCI and other Subpart F income on one hand, and its non-Subpart F income on the other; and the CFC then would apply Section 163(j) to its FBCI or other Subpart F income and the interest expense allocated to such income. Such an approach would avoid seemingly distortive results, in which the amount of a CFC's non-Subpart F income or loss impacts its ATI and, thus, the amount of its Section 163(j) limitation. (We have recommended a conceptually similar approach in Part III.I.2 below regarding application of Section 163(j) to a foreign corporation with a U.S. branch.)

In a related point, if business interest expense allocated to a CFC's Subpart F income is disallowed under Section 163(j), then that interest expense should automatically be carried forward and allocated against Subpart F income in future years (rather than first being allocated in those years between Subpart F income, and other income included in ATI).

The Tax Section intends to submit separate comments on the provisions of the Act that deal with GILTI. This Report thus does not address questions about how Section 163(j) should be applied to a CFC for purposes of applying the GILTI rules.

## 2. Inbound Investment

We recommend that Treasury and the IRS issue guidance confirming that new Section 163(j) applies to a foreign corporation with a U.S. trade or business in a manner similar to the methodology adopted in the proposed regulations under old Section 163(j). That is, when applying Section 163(j) in order to determine the corporation's liability for corporate income and branch profits taxes, only business interest income and ATI that are included in the corporation's effectively connected taxable income and business interest expense that is allocated to effectively connected income pursuant to the regulations under Sections 882 and 884 would be taken into account.<sup>118</sup> This approach properly focuses on the economic activity a foreign corporation has in the United States, for purposes of computing the applicable Section 163(j) limitation.<sup>119</sup>

If a foreign corporation's interest expense allocable to its effectively connected income is disallowed under Section 163(j) and carried forward to a future year, it seems to us that the carryforward should automatically be treated in such future year as interest expense properly allocable to the corporation's effectively connected income for such year. That is, the corporation

---

We note that it sometimes may be difficult for a U.S. shareholder that owns a non-controlling stake in a CFC to obtain the detailed information about tax basis that will be needed in order to make an allocation of the CFC's interest expense in accordance with new Section 864(e)(2).

<sup>118</sup> See Proposed Regulation Section 1.163(j)-8(c); Treasury Regulation Section 1.882-5(a)(5).

<sup>119</sup> An approach could be imagined under which the limitation is computed by reference to the foreign corporation's worldwide ATI, business interest income and business interest expense; the resulting limitation is then applied to the corporation's worldwide interest expense; and the post-limitation interest expense is then allocated between the corporation's effectively connected income, and its other income. However, such an approach would appear to have the potential to lead to more arbitrary results than the one recommended.

should not be required, in the year to which the interest expense is carried forward, to allocate that interest expense between the corporation's effectively connected income and its other income.

#### **IV. Additional Issues Under Section 163(j)**

The issues addressed above do not represent all the significant issues raised by Section 163(j). A non-exclusive list of additional issues that Treasury and the IRS should consider addressing in subsequent guidance includes:

- Confirmation of whether a corporation that undergoes an ownership change under Section 382 is treated as using its carryforwards of disallowed business interest expense before it uses other tax attributes limited by Sections 382 and 383.
- An explanation of how a corporation that inherits carryforwards of disallowed business interest expense pursuant to new Section 381(c)(20) should treat those carryforwards following a Section 381(a) transaction, including confirmation whether rules analogous to those in Treasury Regulation Section 1.381(c)(1)-1 apply.
- Treatment of disallowed business interest carryforwards upon a taxable liquidation of a corporation under Section 331.
- Treatment of a non-corporate taxpayer's disallowed business interest carryforwards, upon death or other final disposition or termination of all trade or business activities.
- Application of Section 163(j) to S corporations, including (i) the treatment of shareholder carryforwards of an S corporation's disallowed business interest expense, in the event the S corporation subsequently converts to a C corporation, and (ii) the treatment of corporate carryforwards of disallowed business interest expense, in the event a C corporation converts to an S corporation.
- Application of Section 163(j) to trusts, estates and their beneficiaries.
- Whether Section 163(j) should apply, or not, to real estate investment trusts, regulated investment companies, and real estate mortgage investment conduits.
- The scope of activities that may be treated as an electing real property trade or business, including whether making mortgage loans constitutes such a trade or business.
- The time and manner for making an election for an electing real property trade or business or an electing farming business.

- Application of Section 163(j) to tiered partnership structures.
- Whether a taxpayer that cancels a debt with accrued, unpaid interest that has been disallowed under Section 163(j) should have a reduction in its cancellation of debt income, by the amount of such disallowed interest.
- Whether, in cases where a taxpayer excludes COD income under Section 108(a), the taxpayer's carryforwards of disallowed business expense should be reduced and, if so, the appropriate ordering for reduction of those carryforwards relative to the other attributes listed in Section 108(b).
- Whether the issuer of a contingent payment debt instrument should be entitled to offset disallowed business interest expense that has accrued under Treasury Regulation Section 1.1275-4, against the income inclusion that otherwise would be required under Treasury Regulation Section 1.1275-4(b)(6)(iii)(B) when there is a negative adjustment to the projected amount of a contingent payment.

The Tax Section would be happy to submit an additional report addressing some or all of the issues listed above or any other issues on which the government would like our input.

**163(j) Proposed Regulations**  
**Not yet published in the Federal Register**  
**(Link: [REG-106089-18](#))**

