Report No. 1404
October 25, 2018

The Honorable David J. Kautter
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
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The Honorable Charles P. Rettig
Commissioner
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The Honorable William M. Paul
Principal Deputy Chief Counsel and
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Re: *Report No. 1404 on Section 245A*

Dear Messrs. Kautter, Rettig, and Paul:

I am pleased to submit Report No. 1404, which makes recommendations for guidance addressing the application of Section 245A and related provisions added to the Code 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. In general, Section 245A provides for a 100% dividends received deduction with respect to the "foreign-source portion" of any dividend received from a "specified 10-percent owned foreign corporation" by a domestic corporation that is a United States shareholder with respect to such foreign corporation. Section 245A is an integral part of the changes made to the international tax rules in the Code which, broadly speaking, adopt a modified territorial tax system for income earned by foreign subsidiaries of domestic corporations and other domestic shareholders. This Report discusses the issues under Section 245A that we have identified so far and that we consider most significant.

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

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Chair

Enclosure

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Report No. 1404

New York State Bar Association Tax Section

Report on Section 245A

October 25, 2018

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I. Introduction

This report (the "**Report**")[1] makes recommendations for guidance addressing the application of Section 245A and related provisions added to the Code[2] 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**"). In general, Section 245A provides for a 100% dividends received deduction, referred to herein as the "**participation exemption**" or the "**Section 245A participation exemption**," with respect to the "foreign-source portion" of any dividend received from a "specified 10-percent owned foreign corporation" (an "**STFC**") by a domestic corporation that is a United States shareholder with respect to such STFC. Section 245A is an integral part of the changes made to the international tax rules in the Code which, broadly speaking, adopt a modified territorial tax system for income earned by foreign subsidiaries of domestic corporations and other domestic shareholders.

Part II of this Report contains a summary of our recommendations. Part III provides a summary of Section 245A and related provisions added to the Code by the Act. Part IV contains a more detailed discussion of our recommendations. This Report discusses the issues under Section 245A that we have identified so far and that we consider most significant. As a consequence, there are issues under Section 245A that are not covered in this Report.

II. Summary of Principal Recommendations

1. Guidance should be issued to clarify that deemed dividends not specifically referenced in the legislative history qualify for the participation exemption.

2. Guidance should be issued to clarify that a domestic corporation that is a partner in a partnership is allowed to claim the Section 245A participation exemption (assuming the requirements of Section 245A are otherwise met) with respect to the portion of any dividends received by the partnership from a foreign corporation that are allocated to the corporate partner, as long as such allocation has substantial economic effect.

[1] The principal drafters of this Report were William Curran and Michael Mollerus, with substantial assistance from Elina Khodorkovsky, Tracy Matlock, Brad Sherman and Dov Sussman. Helpful comments were received from Neil Barr, Kim Blanchard, Andy Braiterman, Robert Cassanos, Marc Countryman, Tim Devetski, Michael Farber, Shane Kiggen, Stephen Land, Deborah Paul, Amit Sachdeva, Michael Schler, Eric Sloan, Karen Gilbreath Sowell, Joseph Toce, Shun Tosaka, Dana Trier, and Gordon Warnke. This Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of the New York State Bar Association Executive Committee or House of Delegates.

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

3. Guidance should be issued regarding the application of the Section 958 attribution rules to partnerships for purposes of determining whether a partner in a partnership is a United States shareholder.

4. If Treasury determines that Congress intended that any amount treated as a "dividend received" by a domestic corporation from a foreign corporation under Section 78 prior to the effective date of the amendments made to Section 78 by the Act should not be treated as "any dividend received" for purposes of Section 245A, Treasury should issue guidance to that effect or, if Treasury believes that it does not have the authority to issue such guidance, it should propose a technical correction to the Act for consideration by Congress.

5. Guidance should provide that Section 1059 should not apply to deemed dividends that arise under Section 1248(a) and Section 964(e).

6. Guidance should provide that Section 245A applies to a foreign corporation that receives a dividend from another foreign corporation, subject to certain exceptions, including for distributions of amounts that are excluded from gross income for purposes of Section 951(a) by reason of Section 959(b).

7. Guidance should clarify that the holding period aggregation rule in Treasury Regulations section 1.1502-13(c)(1)(ii) applies for purposes of applying Section 246(c)(1) to a dividend received by a member of a consolidated group that acquires a share of stock of an STFC from another member of the same consolidated group.

8. Guidance should be issued on identifying when a dividend is paid with respect to a particular share of stock of an STFC (and the amount thereof) as taxpayers may hold multiple blocks of shares of an STFC with different holding periods.

9. Guidance should provide that, in the case of a dividend-equivalent redemption (or deemed redemption) or dividend-equivalent reorganization, for purposes of Section 246(c) a domestic corporation's holding period for the stock redeemed or exchanged includes the holding period that accrues, after the redemption or exchange, with respect to the stock of the redeeming corporation or the acquiring corporation which such domestic corporation owns, either directly or by attribution, at and after the time of the redemption or exchange.

10. Guidance should provide that a domestic corporation's holding period for the stock of an STFC is not tolled under Section 246(c)(4)(A) by reason of entering into a contract to sell the stock of the STFC.

11. Guidance should be issued to provide that if the taxpayer has not satisfied the holding period requirement in Section 246(c) with respect to a dividend from an STFC at the time that the taxpayer files its tax return, the taxpayer is permitted to provisionally claim the deduction with respect to such dividend on its tax return for the year in which the dividend is received, subject to appropriate certification and correction procedures.

12. Guidance should be issued to clarify that the portion of a dividend that is eligible for a Section 245A participation exemption is treated as tax-exempt income for purposes of Treasury Regulations section 1.1502-32(b)(3)(ii)(B).

13. Guidance under the investment adjustment rules should be issued to prevent the avoidance of Section 961(d) by a consolidated group through the sale of a member that holds STFC stock, rather than a direct sale of the STFC stock.

14. Guidance should be issued on the computation of the "foreign-source portion" of a dividend received for purposes of Section 245A.

15. Guidance should be issued to clarify the application of the hybrid dividend rules to foreign tax systems that provide (a) a tax benefit to the shareholder receiving the dividend, (b) a tax benefit to the foreign corporation with an offsetting tax detriment to the shareholder and (c) for an accrued deduction that is not dependent on the payment of a dividend.

16. Guidance should be issued to clarify the determination of deductions properly allocable or apportioned to income with respect to stock of an STFC or stock of an STFC under Section 904(b)(4).

III. Summary of Section 245A and Related Provisions

In this Part III, we provide an overview of Section 245A and several related provisions that govern adjustments needed to account for the effect of Section 245A. In addition, we provide a brief summary of the role that Section 245A plays in the modified territorial tax system introduced by the Act.

a. Overview of Section 245A

The Act replaced the former rules for taxing income earned by foreign subsidiaries of U.S. taxpayers with a modified territorial tax system. A key feature of the current tax system is the deduction available under Section 245A to certain domestic corporations[3] on the "foreign-source portion" of dividends received from certain corporate foreign subsidiaries, which is generally referred to as the "participation exemption."[4] The participation exemption applies to dividends received from an STFC, which is defined as a foreign corporation in which a domestic corporation owns, directly, indirectly or by attribution, 10% or more of the voting power or value[5] (other than a

[3] *See* H.R. Rep. No. 115-466 at 599 (2017) (Conf. Rep.) [hereinafter Conference Committee Report] (noting that the participation exemption "is available only to C corporations that are not RICs or REITs"); Section 1363(b) (noting that S corporations calculate taxable income in the same manner as individuals, such that deductions allowed only to corporations are not available to S corporations).

[4] Section 245A(a).

[5] Section 245A(b). This 10% ownership test is contained in the definition of "United States shareholder" under Section 951(b), which includes direct and indirect ownership and ownership through attribution.

foreign corporation which is a passive foreign investment company with respect to the domestic corporation and which is not a controlled foreign corporation ("**CFC**" [6])).[7]

The "foreign-source portion" of a dividend is the amount that bears the same ratio to the dividend as the "undistributed foreign earnings" do to the "undistributed earnings" of the STFC.[8] For this purpose, "undistributed earnings" are the earnings and profits of the STFC as of the close of the STFC's taxable year in which the dividend is distributed without diminution by reason of any dividends distributed during the taxable year.[9] An STFC's "undistributed foreign earnings" are undistributed earnings that are neither (i) income described in Section 245(a)(5)(A) (generally, effectively connected income that is subject to U.S. income tax) nor (ii) dividends described in Section 245(a)(5)(B), determined without regard to Section 245(a)(12) (generally, dividends received from a domestic corporation which is at least 80% owned, directly or indirectly, by the STFC).[10]

The participation exemption is disallowed in the case of "hybrid dividends," which generally are amounts received from a CFC[11] that would otherwise qualify for the participation exemption and for which the CFC received a deduction (or other tax benefit) with respect to any taxes imposed by any foreign country.[12] In addition, hybrid dividends received by one CFC from another CFC (where a domestic corporation is a

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[6] A "controlled foreign corporation" or "CFC" is a foreign corporation, more than 50 percent of the voting power or value in which is owned, directly, indirectly or constructively, by United States shareholders. *See* Section 957(a).

[7] Section 245A(b)(2). Section 246(a) also provides that the deduction allowed by Section 245A does not apply to dividends received from a tax-exempt corporation.

[8] Section 245A(c)(1).

[9] Section 245A(c)(2). The method for calculating the foreign corporation's earnings and profits is "substantially similar" to that used for the calculation of earnings and profits of domestic corporations. *See* Section 964(a), Section 986(b).

[10] A dividends received deduction may be available with respect to the dividends attributable to these amounts under Section 245.

[11] Note that a Section 245A participation exemption is applicable to dividends received from an STFC, for which the ownership threshold is 10%, while the hybrid dividend rules are applicable to amounts received only from a CFC, for which the ownership threshold is greater than 50%.

[12] Section 245A(e)(4). This approach to hybrid dividends is consistent with the recommendations made under the OECD Base Erosion and Profits Shifting Project. *See OECD, Neutralising the Effects of Hybrid Mismatch Arrangements*, OECD/G20 Base Erosion and Profit Shifting Project Action 2, OECD Publishing (2015) [hereinafter *OECD Hybrid Mismatch Report*]. The OECD proposes that, in the case of a hybrid dividend (*i.e.*, a payment that is deductible in the payor jurisdiction but treated as an exempt dividend in the payee jurisdiction) the primary rule be that the payee jurisdiction should not grant an exemption for the dividend. *See id.* at 45 (Recommendation 2), 175-177 (Example 1.1). In the absence of the payee jurisdiction not granting an exemption,, the payor jurisdiction may invoke the "defensive rule" and deny the deduction. *See id.* at 23 (Recommendation 1), 175-77 (Example 1.1). The aim of these two rules is to achieve inclusion of the amount at least once and to prevent the shifting of profits from one jurisdiction to another. *See id.* at 25.

United States shareholder with respect to both CFCs)—so called "tiered corporations"—are treated as subpart F income of the receiving CFC, resulting in a pro rata income inclusion for the United States shareholder.[13] Foreign tax credits and deductions are disallowed for foreign taxes paid or accrued with respect to (i) any dividend qualifying for the participation exemption[14] or (ii) hybrid dividends and amounts included in gross income as tiered hybrid dividends.[15]

No participation exemption is available with respect to a dividend unless the taxpayer held the stock in the STFC for more than 365 days during the 731-day period beginning 365 days before the ex-dividend date.[16] This required holding period includes only periods during which (i) the taxpayer held the stock, (ii) the foreign corporation that paid the dividend qualified as an STFC and (iii) the taxpayer qualified as a United States shareholder with respect to the STFC.[17] Any period during which the taxpayer had certain contractual arrangements, including those that reduce the taxpayer's economic risk of loss with respect to the stock in the STFC, does not count towards the holding period.[18] In addition, a participation exemption is not available with respect to a purging distribution made by a passive foreign investment company to its United States shareholder.[19]

Finally, Section 245A(g) gives the Secretary broad authority to prescribe regulations or other guidance that are necessary or appropriate to carry out the provisions of Section 245A, including regulations for the treatment of United States shareholders that own stock in an STFC through a partnership. This grant of authority is in addition to the Secretary's general authority[20] and gives the Department of the Treasury and the Internal Revenue Service (the "**IRS**", and together with the Department of the Treasury, "**Treasury**") broad latitude to provide guidance and clarification with respect to Section 245A.[21]

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[13] Section 245A(e)(2).

[14] Section 245A(d).

[15] Section 245A(e)(3).

[16] Section 246(c)(1), (c)(5)(A).

[17] Section 246(c)(5)(B).

[18] Section 246(c)(4).

[19] Section 245A(f).

[20] *See* Section 7805(a) ("the Secretary shall prescribe all needful rules and regulations for the enforcement of this title").

[21] The explicit grant of authority has been deemed to grant Treasury broad discretion to act within the delegation of rulemaking authority. *See, e.g.*, *Hardy Wilson Memorial Hosp. v. Sebelius*, 616 F.3d 449, 457-58 (5th Cir. 2010); *Lantz v. Comm'r*, 607 F.3d 479, 486 (7th Cir. 2010); *Rowan Cos., Inc. v. United States*, 452 U.S. 247, 253 (1981).

b. Overview of related provisions

In addition to Section 245A, the Act modified some existing Sections to coordinate with Section 245A.

Foreign tax credits are generally only available to offset the tax that would otherwise be imposed on foreign-source taxable income.[22] The Act amended the foreign tax credit limitation to exclude the foreign-source portion of dividends received that qualified for the participation exemption and any deductions properly allocable to income with respect to an STFC or stock of the STFC from the computation of foreign-source taxable income (other than any income includable under Section 951(a)(1) or Section 951A(a)).[23]

In addition, in the event that a domestic corporation receives a dividend from an STFC that qualifies for the Section 245A participation exemption, solely for purposes of determining any loss upon any disposition of the stock in the STFC, such corporation must reduce its basis in the stock (but not below zero) by the amount of the participation exemption. No reduction to the basis is required to the extent that the basis was previously reduced under Section 1059 as a result of the receipt of the dividend.[24] Section 1059(b)(2) was amended by the Act to specifically refer to dividends eligible for the Section 245A participation exemption in addition to Sections 243 and 245.

Lastly, in the event that a CFC is deemed to receive a dividend because such CFC disposed of stock in another foreign corporation,[25] the foreign-source portion of that dividend is treated as subpart F income and a United States shareholder is required to include in gross income its pro rata share of such subpart F income.[26] The United States shareholder is entitled to the Section 245A participation exemption in respect of such subpart F income as if such subpart F income were a dividend received by the shareholder from the selling CFC.[27] Moreover, when the CFC sells stock in another foreign corporation, rules similar to the basis adjustment described above will apply to determine the amount of any loss.[28]

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[22] Section 904(a).

[23] Section 904(b)(5), renumbered as Section 904(b)(4). *See* Pub. L. No. 115-141, § 401(d)(1)(D)(xiii).

[24] Section 961(d).

[25] Section 964(e)(1).

[26] Section 964(e)(4)(A), (B).

[27] *Id.*

[28] *Id.* A similar deemed dividend that may qualify for a Section 245A participation exemption results when certain U.S. persons sell stock in certain foreign corporations. *See* Section 1248(a), (j).

c. Role of Section 245A in the modified territorial tax system

The participation exemption under Section 245A is an integral part of the current system that, broadly speaking, is a modified territorial tax system. Under the former tax system, all earnings of a domestic corporation or other taxable U.S. person were subject to U.S. income tax. However, tax on the earnings of a CFC, other than subpart F income and effectively connected income ("**ECI**"), generally was deferred until such earnings were repatriated to the United States through the payment of a dividend or a taxable disposition of the CFC stock. No participation exemption existed under the former tax system because it would have effectively exempted foreign earnings from U.S. tax. However, under the current tax system, in addition to the subpart F rules, the global low-taxed intangible income (or "**GILTI**") regime generally imposes, at a reduced tax rate and on a current basis, a tax on a United States shareholder's pro rata share of the net income of a CFC, other than subpart F income (and certain income that would be subpart F income but for the high-tax kickout), dividends received from related persons, certain foreign oil and gas extraction income, and income deemed to be a return on a qualified business asset investment ("**QBAI Return**").[29] QBAI Return generally equals 10 percent of the tax basis of qualified business asset investment less net interest expense that would otherwise be taken into account in determining net income. In many cases, a CFC's net income that is subject to current tax in the hands of its United States shareholder(s) will constitute a very large percentage of the CFC's total net income. Section 245A thus implements the territorial tax portion of the modified territorial tax system by effectively exempting from U.S. tax that portion of a CFC's earnings that are not subject to tax under the subpart F and GILTI rules, and thus are subject only to foreign tax.

IV. Discussion and Recommendations

This Part IV contains a more detailed discussion of the recommendations and requests for guidance outlined above.

a. Clarification on the definition and scope of a "dividend received"

As noted above, the Section 245A participation exemption applies to "any dividend received"[30] from an STFC.[31] However, no definition of what constitutes a "dividend received" for such purposes is provided. The Conference Committee Report notes that the term is intended to be interpreted broadly, "consistently with the phrases 'amounts received as a dividend' and 'dividends received' under Sections 243 and 245,

[29] Section 951A.

[30] Section 316(a) defines the term "dividend" as a distribution of property by a corporation to its shareholders from its accumulated earnings and profits. Section 301 dictates the treatment of a distribution of property by a corporation to its shareholder, including whether an amount is treated as a dividend or a return of basis.

[31] Section 245A(a).

respectively."[32] In its explanation of the intended reach of the phrase, the Conference Committee Report further notes that (1) gain included in gross income as a dividend under Section 1248(a) or Section 964(e) would constitute a dividend received for which the participation exemption may be available[33] and (2) a domestic corporation owning stock of a foreign corporation indirectly through a partnership should qualify for the participation exemption with respect to its distributive share of the partnership's dividend income from the foreign corporation, if the domestic corporation would qualify for the participation exemption with respect to dividends from the foreign corporation if the domestic corporation owned such stock directly.[34]

Under Section 243, a corporation is entitled to a deduction for the "dividends received" from certain domestic corporations. Similarly, under Section 245, a domestic corporation is entitled to a dividends received deduction for the U.S.-source portion of the dividends received from certain foreign corporations. As discussed in more detail below, although the language in the Conference Committee Report is helpful in establishing that, in addition to actual distributions from an STFC, deemed distributions also qualify for the participation exemption, we recommend that Treasury use its authority under Section 245A(g) to issue guidance providing that any amount deemed to be, or treated as, a dividend from an STFC to a domestic corporation under any provision of the Code qualifies for the participation exemption, assuming the domestic corporation otherwise meets the requirements of Section 245A. This guidance should specifically provide that the deemed distributions in the below fact patterns would qualify for the participation exemption.

i. Deemed distributions to which the Section 245A participation exemption applies

The Act amended Section 1248 and Section 964 to specifically provide that deemed dividends under those sections qualify for the participation exemption. We would recommend that Treasury clarify that no negative inference was intended by amending Section 1248 and Section 964 but no other sections of the Code that provide for deemed dividends, such as Section 304 and Section 367.

Section 304 results in deemed dividend treatment for certain related-party stock sale transactions that are in substance a distribution of the earnings and profits of a corporation. In the event that one or more persons are in control of two corporations and one corporation acquires the stock of the other corporation from the person so in control in exchange for property, Section 304 recharacterizes the sale as a redemption and, possibly, a dividend distribution to the extent made out of earnings and profits of the acquiring corporation and the issuing corporation (in that order).[35] A deemed dividend as

[32] *See* Conference Committee Report at 599.

[33] *See id.* at 595 n.1479.

[34] *See id.* at 599.

[35] Section 304(a), (b); Section 302(b).

a result of Section 304 would qualify for the dividends received deduction under Section 243, and we see no reason why such deemed dividend would not qualify for the Section 245A participation exemption.[36]

Similarly, Section 367 denies nonrecognition treatment to certain transactions involving foreign corporations, which can result in a deemed distribution to certain shareholders of such foreign corporation.[37] For example, under Treasury Regulations section 1.367(b)-4, under certain circumstances if a foreign corporation acquires the stock or assets of a foreign target corporation in a nonrecognition transaction, a "Section 1248 amount"[38] is required to be included in income as a deemed dividend if the reorganization either eliminates the potential for Section 1248 to apply to a subsequent stock sale or diminishes this potential by shifting beneficial interests in earnings and profits. Any such deemed dividend is treated as a dividend for all purposes of the Code.[39] As noted above, the Conference Committee Report specifically identifies gain included as a result of Section 1248(a) as a dividend to which the participation exemption should apply. We recommend that Treasury confirms that any amount expressly included as a "deemed dividend" under the regulations issued under Section 367(b) and to which Treasury Regulations section 1.367(b)-2(e)(2) applies also qualifies for the participation exemption.

Finally, we note that it has been suggested that, to address the interaction between the application of Section 245A to a Section 1248 deemed dividend and the subpart F and GILTI rules in certain situations, Treasury may consider providing by regulation that Section 245A does not apply to a Section 1248 deemed dividend in such situations. For example, in our prior report on the GILTI rules, we described the interaction of Section 245A, Section 1248 and the GILTI rules in a situation in which a United States shareholder sells the stock of a CFC to another United States shareholder in the middle of the CFC's year (with the CFC remaining a CFC), and a portion of the selling United States shareholder's gain is treated as a deemed dividend under Section 1248 on account of tested income earned during the year of the sale. In this situation, the Section 1248 deemed dividend received by the selling United States shareholder would generally be eligible for the Section 245A participation exemption (assuming the requirements of Section 245A are otherwise met), while the amount of tested income included by the purchasing United States shareholder for purposes of determining its GILTI inclusion

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[36] We expect that the rules under Section 304 for determining the amount and source of the deemed dividend (*e.g.*, Section 304(b)(2)) would apply for purposes of Section 245A (*e.g.*, for purposes of determining the foreign-source portion of the dividend under Section 245A(c)).

[37] *See* Section 367(b); Treas. Reg. § 1.367(b)-4(b).

[38] The Section 1248 amount is defined as "the net positive earnings and profits (if any) that would have been attributable to such stock and *includible* in income as a dividend under section 1248 and the regulations thereunder if the stock were sold by the shareholder." Treas. Reg. § 1.367(b)-2(c)(1) (emphasis added).

[39] *See* Treas. Reg. § 1.367(b)-2(e)(2).

would be reduced by the amount of the Section 1248 deemed dividend to the selling United States shareholder, with the result that this portion of the CFC's tested income would permanently go untaxed.[40] As in our prior report on the GILTI rules, we take no position on the appropriateness of this result or whether this result should be changed by legislation or, if there is authority to do so, by regulations.[41] However, if Treasury believes that this result should be changed by regulations, we would reiterate the point made in our prior GILTI report that this would be a basic structural change to the subpart F and GILTI rules, as well as Section 245A, and would create other complexities.[42] Moreover, denying the Section 245A participation exemption to the selling United States shareholder in order to protect the perceived integrity of the GILTI rules would result in the dividend income being taxed to the selling United States shareholder at an effective tax rate of 21% (without the benefit of any foreign tax credits),[43] which would leave the United States shareholder in a worse position than if Section 1248 did not apply and it was subject to tax on such income under the GILTI rules, which would typically be at an effective tax rate of 10.5%, subject to reduction for deemed-paid foreign tax credits under Section 960(d), or even under subpart F, which would be subject to tax at the rate of 21% but as to which the taxpayer would still be entitled to claim deemed-paid foreign tax credits under Section 960(a).

ii. Application to STFCs held through a partnership

The Conference Committee Report states that "if a domestic corporation indirectly owns stock of a corporation through a partnership and the domestic corporation would qualify for the participation [exemption] with respect to dividends from the foreign corporation if the domestic corporation owned such stock directly, the domestic corporation would be allowed a participation [exemption] with respect to its distributive share of the partnership's dividend from the foreign corporation."[44] Although the legislative history is clear that a corporate partner in a partnership that owns stock of an STFC is entitled to the Section 245A participation exemption with respect to dividends

[40] *See* NYSBA Tax Section, Report No. 1394, *Report on the GILTI Provisions of the Code* (May 4, 2018), at 50-52 [hereinafter NYSBA GILTI Report]. Note that the same result applies if the CFC's income is subpart F income rather than GILTI tested income, and if the selling United States shareholder receives a pre-closing dividend from the CFC that is eligible for the Section 245A participation exemption rather than a Section 1248 deemed dividend. *See id.*

[41] *See id.* at 58.

[42] *See id.* at 52-56. This point also applies to other situations in which Section 245A and the subpart F and GILTI rules intersect, which are described in the NYSBA GILTI Report. *See id*.

[43] With the repeal of Section 902 by the Act, a taxpayer is no longer entitled to deemed-paid foreign tax credits with respect to a dividend received from a foreign corporation.

[44] *See* Conference Committee Report at 599.

allocated to it,[45] the application of the participation exemption in the partnership context is unclear.

A corporate partner is generally allowed to claim a dividends received deduction under Section 243 with respect to the portion of the dividends received by the partnership from a domestic corporation that are allocated to the corporate partner, as long as the allocation has substantial economic effect.[46] The IRS addressed a similar question in the context of foreign tax credits under Section 901 and Section 902 prior to the repeal of Section 902 by the Act. Under Section 902(a), only a domestic corporation that owned at least 10% of the voting stock of a foreign corporation was deemed to have paid a proportionate share of creditable foreign taxes paid by a foreign corporation. In Revenue Ruling 71-141, corporations M and Q formed a partnership that acquired 40% of the stock of foreign corporation T.[47] Because M and Q owned equal shares of the partnership, each was treated as owning 20% of T stock, and therefore each of M and Q met the 10% ownership test of Section 902(a).[48]

We recommend that Treasury prescribe guidance clarifying that these principles apply for purposes of Section 245A, such that a domestic corporation that is a partner in a partnership is allowed to claim the Section 245A participation exemption (assuming the requirements of Section 245A are otherwise met) with respect to the portion of any dividends received by the partnership from a foreign corporation that are allocated to the corporate partner, as long as such allocation is respected under Section 704(b).

Whether a partner that receives an allocation of a dividend that is potentially participation exemption-eligible qualifies to claim the exemption is then determined based on the partner's attributes (in other words, while the determination of the existence and amount of the dividend income in respect of a distribution received by a partnership from an STFC is made at the partnership level, the qualification of the dividend for the Section 245A participation exemption is made at the level of the partner). The deduction under Section 245A is only available to a "domestic corporation which is a United States shareholder with respect to such" STFC,[49] and only if the corporate partner satisfies the

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[45] *See id.*

[46] *See* Treas. Reg. § 1.701-2(d) Ex. 5 (providing that a special allocation of dividends, in a proportion different than the partners' capital interests and the proportions in which other items of income were allocated, was respected where the business arrangement was in part intended to enable the partners to claim their proportionate dividends received deductions under Section 243). *See also* CCA 200943036 (Oct. 23, 2009) (advising that the partnership audit should make all determinations necessary to determine the taxability of the dividend, including the amount allocated to each corporate partner that would qualify for the Section 243 dividends received deduction).

[47] 1971-1 C.B. 211.

[48] *Id.*

[49] Section 245A(b)(1).

Section 245A holding period requirement.[50] Thus, the deduction would not be available to any non-corporate partners. In addition, the restriction of the deduction to United States shareholders requires the partner to own, directly, indirectly or constructively, 10% or more of the stock of the STFC by vote or value. Ownership is determined using the attribution rules described in Section 958, which include a proportionate attribution of stock owned by a partnership to its partners.[51] Thus, some of the stock of a foreign corporation owned by the partnership could be attributed to a partner to satisfy the ownership requirement, in addition to any stock of the foreign corporation owned directly by the partner or attributed to the partner other than through the partnership.

There is no guidance on how to apply the proportionate attribution rule to a partnership, making the attribution unclear where the partnership has special allocations, or where partners have different profits and capital interests.[52] The allocation of profits and losses under a partnership agreement may be extraordinarily complex, in which case the partners may struggle to determine how to apply Section 245A. Given the importance of the Section 245A participation exemption and the frequency with which it is likely to apply, we recommend that Treasury issue guidance regarding the application of the Section 958 attribution rules to partnerships.

Finally, we note that similar issues to those discussed below in Part IV.f, relating to the coordination of Section 961(d) with the consolidated return regulations, are presented when a domestic corporation indirectly owns an STFC through a partnership and the partnership receives a dividend from the STFC with respect to which the domestic corporate partner is entitled to the Section 245A participation exemption. Treasury should consider the appropriateness of issuing guidance that addresses these issues in the partnership context.[53]

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[50] We believe that the partner's holding period for the stock of an STFC owned by the partnership should include only those days which are included in both the partner's holding period for its interest in the partnership and the partnership's holding period in the stock of the STFC. Modifications to this rule would be appropriate where the partner contributes the STFC stock to the partnership in a nonrecognition transaction, in which case it would be appropriate to allow the partner to include in its holding period for purposes of Section 245A its pre-contribution holding period in the STFC stock. Similarly, where a partner receives a distribution of STFC stock from a partnership in a transaction in which no gain or loss is recognized, it may be appropriate to allow the partner to include in its holding period for purposes of Section 245A the partnership's holding period in the STFC stock.

[51] Section 958(a)(2); Section 958(b); Section 318(a)(2).

[52] *See* Fred M. Ringel, et al., *Attribution of Stock Ownership in the Internal Revenue Code*, 72 HARV. L. REV. 209, 213-214 (1958); *Baker Commodities, Inc. v. Comm'r*, 415 F.2d 519, 524 (9th Cir. 1969).

[53] Such guidance should address, among other things, how Section 961(d) applies at the partnership level where some, but less than all, of the partners were eligible for the benefits of Section 245A with respect to dividends received by the partnership from an STFC, and the outside basis consequences for such partners where the partnership is required to reduce its basis in the stock of an STFC under Section 961(d).

b. Application of the Section 245A participation exemption to Section 78

Section 902(a), prior to its repeal by the Act, Section 960(a), and Section 960(d), as amended by the Act, all permit a United States shareholder that includes an amount in income under Section 951 or Section 951A, to elect to be treated as having paid a portion of the foreign taxes attributable to the amount so included in income.[54] Section 78 requires shareholders claiming such an indirect foreign tax credit to "gross up" the amount included in their gross income by the amount of the indirect foreign tax credit, and specifically provides that the amount "shall be treated for purposes of this title (other than Sections 245 and 245A) as a dividend received by such domestic corporation from the foreign corporation." The Act added the reference to Section 245A, effective for the taxable year 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.[55] However, Section 245A applies to distributions made after December 31, 2017.[56] As a result of these effective dates, an STFC with a taxable year that begins before January 1, 2018 may be able to avail itself of the pre-Act Section 78 (which appears to treat a Section 78 gross-up as a dividend for purposes of Section 245A), including with respect to a Section 78 gross-up that results from an inclusion under Section 965, and therefore take the position that a Section 78 gross-up that arises after December 31, 2017 is eligible for the Section 245A participation exemption. There is a question as to whether this result was intended by Congress. If Treasury determines that this result was not so intended, it may wish to issue guidance changing this result or, if Treasury does not have the authority to provide such guidance, to propose a technical correction to the Act for consideration by Congress.

c. Application of Section 1059 to deemed distributions under Sections 1248(a) and 964(e)

Under Section 1248(a), gain recognized on the disposition of stock of certain foreign corporations by certain U.S. persons is included in the gross income of such U.S. persons as a dividend to the extent of earnings and profits of the foreign corporation.[57] Earnings and profits taxed under Section 1248(a) are treated as "previously taxed income" ("**PTI**") and are not subject to additional U.S. income tax (either directly or through subpart F) when distributed to a shareholder.[58] Under Section 964(e), gain recognized by a CFC on the disposition of stock in another foreign corporation may be included in the gross income of the CFC as a dividend to the same extent that it would

[54] Section 960(a) and Section 960(d). *See* also repealed Section 902(a).

[55] Pub. L. No. 115-97, § 14301(d). *See also* Conference Committee Report at 606.

[56] Pub. L. No. 115-97, § 14101(f). *See also* Conference Committee Report at 600.

[57] Section 1248(a) applies only if at some point during the five-year period prior to the disposition, the U.S. person owned, actually or constructively, 10% of the stock of the foreign corporation while such foreign corporation was a CFC.

[58] Section 1248(k); Section 959(e).

have been included under Section 1248(a) if the CFC was a U.S. person. As noted above, the Conference Committee Report specifically identified these two provisions as situations in which the participation exemption should apply, and the Act amended Section 1248 and Section 964 accordingly.[59]

The Act also amended Section 1059(b)(2) to specifically refer to dividends eligible for the Section 245A participation exemption (in addition to Sections 243 and 245). Thus, a dividend deemed to be received under Section 1248(a) or Section 964(e) that is not subject to tax as a result of the participation exemption could be subject to the provisions of Section 1059, which require a corporate taxpayer to reduce its basis in the stock of a subsidiary from which it receives an "extraordinary dividend" in certain circumstances to the extent of the nontaxed portion of such extraordinary dividend, *i.e.*, the amount of the deduction allowed under the Section 245A participation exemption.[60]

We do not believe that it is appropriate to apply Section 1059 to dividends deemed to be received as a result of Section 1248(a) and Section 964(e). Section 1059 was added to the Code in order to address dividend stripping, a transaction in which a corporation acquired the stock of another corporation shortly before a dividend was paid on the acquired stock, claimed the dividends received deduction under Section 243 with respect to such dividend, and then sold the acquired stock at a loss (because the value of the stock decreased as a result of the dividend paid). As illustrated in the following examples, the abusive situations that Section 1059 seeks to address do not exist in the context of Section 1248(a) and Section 964(e), which only recharacterize gain (to the extent of the selling shareholder's share of the target CFC's earnings and profits) as a deemed dividend but do not shift the earnings and profits of a CFC (indeed, they are intended to preserve the locus for taxation of such earnings and profits by attributing them to the shareholder who owned the stock of the CFC during the period such earnings and profits were generated).

Example 1—Section 245A Actual Dividend of Pre-acquisition Earnings

P, a domestic corporation, acquires all of the stock of FC on January 1, 2018 for \$200, from an unrelated foreign corporation. Prior to P's acquisition, FC was not a CFC, and P does not make an election under Section 338(g) with respect to the acquisition of FC. FC has \$100 of accumulated earnings and profits on January 1, 2018. FC does not generate any additional earnings and profits during 2018 or 2019. On January 10, 2019, FC distributes \$125 to P. On January 11, 2019, P sells all of its FC stock to A, an unrelated domestic corporation, for \$75.

[59] *See* Section 1248(j); Section 964(e).

[60] An "extraordinary dividend" is generally a dividend that exceeds 10% of a shareholder's adjusted basis in stock owned by the shareholder for less than two years prior to the dividend distribution, *see* Section 1059(a), (c), and dividends arising in certain redemption and reorganization transactions, *see* Section 1059(e).

The dividend from FC to P qualifies for the Section 245A participation exemption and, because it is an "extraordinary dividend" within the meaning of Section 1059(c) paid within two years of P's purchase of the FC stock, P's basis in the FC stock is reduced by the nontaxed portion of the dividend, or $100, under Section 1059(a)(1), in addition to the reduction in basis of $25 by reason of the portion of the distribution treated as return of capital under Section 301(c)(2). P's FC stock basis is thus reduced to $75, and P has no gain or loss on the sale of FC to A. If Section 1059 had not applied to the dividend, P would have recognized a loss of $100 on the sale of FC as a result of a dividend that was not subject to U.S. tax under Section 245A. We believe that this fact pattern is indistinguishable from the dividend stripping transaction under Section 243 that Section 1059 was enacted to prevent, and thus that it is appropriate for Section 1059 to apply in this case.

Example 2— Section 245A Section 1248 Dividend

> The facts are the same as in Example 1 except that FC does not pay a dividend, FC generates $100 of earnings and profits during 2018 (none of which is attributable to GILTI or subpart F income) and P sells its FC stock to A for $300. Because $100 of FC's earnings and profits is attributable to P's FC stock under Treasury Regulations section 1.1248-2, all of P's $100 gain on the sale of the FC stock is treated as a dividend under Section 1248.

This deemed dividend would be eligible for the participation exemption under Section 245A and, assuming Section 1059 did not apply, P would have no income, gain or loss on this transaction. A would have a $300 basis in the FC stock and FC would have $100 of PTI as a result of the $100 dividend P is deemed to receive, along with $100 of non-PTI earnings.[61] Because P does not hold the FC stock with respect to which the participation exemption applied immediately after its application, there is no opportunity for P to generate a loss (or reduced gain) in respect of this stock. Moreover, because no actual dividend is paid, there is no reduction in value of FC that could result in the type of loss or reduced gain that is present in dividend stripping transactions.

Nor would the operation of the participation exemption in this case create an opportunity for abuse in A's hands. The $100 deemed dividend received by P results in $100 of PTI for FC. When FC distributes this PTI, A's basis in the FC stock will be reduced accordingly under Section 961(b), *i.e.*, the reduction in the FC stock basis will match the reduction in the value of CFC that results from the distribution.

Moreover, the limitations inherent in Section 1248 protect against the abuses that Section 1059 was intended to prevent. Specifically, Section 1248 applies to recharacterize gain as a dividend only to the extent of earnings and profits accumulated by the CFC during the period the seller held the stock, among other limitations.[62] The

[61] Section 959(e).

[62] Section 1248(a)(2).

earnings and profits FC earned before the seller acquired the stock thus would not be eligible for Section 1248 recharacterization and the participation exemption. As demonstrated by Example 1, it is these pre-acquisition earnings and profits that provide the potential for abuse at which Section 1059 was targeted.[63]

A similar issue with respect to post-acquisition earnings arises with respect to actual dividends.

> **<u>Example 3</u>**—Section 245A Actual Dividend of Post-Acquisition Earnings
>
> The facts are the same as in Example 2 except that FC distributes $100 to P on January 10, 2019, and on January 11, 2019, P sells all of its FC stock to A for $200.

Section 1059 would appear to apply to this distribution, reducing P's basis in its FC stock from $200 to $100 (notwithstanding that the stock basis was not increased to reflect the increased value resulting from the $100 of post-acquisition earnings). On P's sale of its FC stock, P would apparently have $100 of gain and this gain would not be subject to Section 1248 because FC's earnings and profits attributable to P's FC stock under Treasury Regulations section 1.1248-2 had already been distributed.

As an economic matter, Examples 2 and 3 are indistinguishable. P receives $300 of value in connection with its disposition of FC, and $100 of this value is attributable to earnings accumulated after P acquired the FC stock. Because both examples involve the application of the Section 245A participation exemption only to earnings accumulated in the hands of P, the taxpayer that would be benefiting from the exemption, the policy concerns of Section 1059 are not present in either case, and we thus believe that Section 1059 should not apply in either case.

For the reasons set forth above, we would recommend that Treasury clarify that Section 1059 does not apply to (i) deemed dividends received by a United States shareholder under Section 1248(a) and Section 964(e)[64] or (ii) actual dividends paid to a

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[63] *See* Section 1059(d)(6) (providing an exception to the application of Section 1059 with respect to stock of a corporation held by a taxpayer during the entirety of the corporation's existence).

[64] The analysis set forth in this section is applicable regardless of whether a taxpayer sells all or only a portion of its shares because Section 1248 applies with respect to the earnings and profits attributable to particular shares. For example, assume the same facts as Example 2 (P purchased all of the shares of FC for $200 on January 1, 2018, FC had $100 of accumulated earnings and profits and FC earns $100 of earnings and profits during 2018) except that P sold half of its FC shares to A for $150 instead of selling all of its FC shares. P has gain of $50 on this sale and $50 of earnings and profits is attributable to the sold shares, with the result that all $50 of the gain is treated as a dividend pursuant to Section 1248 that is eligible for the participation exemption. P's remaining FC shares are not affected by the sale. A has a basis of $150 in the FC shares—their fair market value—and $50 of PTI that, when distributed, would reduce A's basis under Section 961(b). As is the case with the sale of all of P's shares, there is no potential for abuse.

United States shareholder out of earnings attributable to the shareholder's stock.[65] We acknowledge that it is not clear whether Treasury has the regulatory authority to implement the latter of these recommendations. If, and to the extent, Treasury concludes it does not have this authority, we recommend this proposal be adopted by way of a technical correction to the Act.

d. Application of Section 245A(a) to dividends received by a CFC from an STFC

By its terms, Section 245A(a) applies only to a dividend paid by an STFC to a "domestic corporation"—in other words, looking only at the statutory language, it does not appear that the statute applies to a dividend paid by one foreign corporation to another foreign corporation. However, both the legislative history of Section 245A and the operation of Section 245A(e) and Section 964(e)(4) may suggest that Congress intended a broader reading of Section 245A. In this Part IV.d, we consider whether Treasury should exercise its authority under Section 245A(g) to provide that certain dividends received by certain foreign corporations ("**Foreign to Foreign Distributions**") should be eligible for the participation exemption. We conclude that it should.[66] We also address potential issues with respect to the scope of the application of Section 245A, particularly as it relates to provisions intended to prevent the duplication of losses or deductions.

i. Application of Section 245A to Foreign to Foreign Distributions

Although the language of Section 245A(a), viewed in isolation, seems clear, a review of the entirety of Section 245A reveals that it is ambiguous whether the participation exemption applies to Foreign to Foreign Distributions. Section 245A(a) states:

> In the case of any dividend received from a specified 10-percent owned foreign corporation ***by a domestic corporation*** which is a United States shareholder with respect to such foreign corporation, there shall be allowed as a deduction an amount equal to the foreign-source portion of such dividend. (Emphasis added.)

A plain reading of Section 245A(a) thus indicates that the Section 245A participation exemption is available only to dividends received directly by a domestic corporation from an STFC. However, an anti-abuse rule in Section 245A that addresses distributions that are potentially eligible for the Section 245A participation exemption and deductible in a non-U.S. jurisdiction suggests a broader reading may be appropriate.

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[65] The rules for determining whether earnings are attributable to stock under Treasury Regulations section 1.1248-2 could be used for determining the earnings that are attributed to a United States shareholder's stock for purposes of the application of Section 1059 to distributions to such shareholder that are eligible for the 245A participation exemption.

[66] *But see* note 68.

This interpretation results from reading the definition of "hybrid dividend" together with the rule that addresses hybrid dividends of "tiered corporations." Section 245A(e)(4) defines a "hybrid dividend" as follows:

> The term "hybrid dividend" means an amount received from a controlled foreign corporation—
>
> (A) for which a deduction would be allowed under subsection (a) but for this subsection, and
>
> (B) for which the controlled foreign corporation received a deduction (or other tax benefit) with respect to any income, war profits, or excess profits taxes imposed by any foreign country or possession of the United States.

Section 245A(e)(2) states:

> If a ***controlled foreign corporation with respect to which a domestic corporation is a United States shareholder receives a hybrid dividend from any other controlled foreign corporation*** with respect to which such domestic corporation is also a United States shareholder, then, notwithstanding any other provision of this title—
>
> (A) the hybrid dividend shall be treated for purposes of section 951(a)(1)(A) as subpart F income of the receiving controlled foreign corporation for the taxable year of the controlled foreign corporation in which the dividend was received, and
>
> (B) the United States shareholder shall include in gross income an amount equal to the shareholder's pro rata share (determined in the same manner as under section 951(a)(2)) of the subpart F income described in subparagraph (A). (Emphasis added.)

Because (i) a "hybrid dividend" is an amount for which a deduction would be permitted under Section 245A(a) "but for" Section 245A(e) and (ii) Section 245A(e)(2) expressly addresses a CFC receiving a hybrid dividend from another CFC, this provision may suggest that the statute contemplates that at least some Foreign to Foreign Distributions would be eligible for the participation exemption.

We note, however, that there is an alternative reading of Section 245A(e). The definition of a hybrid dividend may be read to mean an amount that would be eligible for a deduction if paid to a United States shareholder, and thus a payment from one foreign corporation to another could qualify as a hybrid dividend even if Section 245A(a) would not apply to such payment itself. Under this reading, Section 245A(e)(2) could be given effect even if Foreign to Foreign Distributions were not eligible for the participation exemption. Weighing against this interpretation is the fact that it requires the definition of hybrid dividend to be read to include a hypothetical element—adding language along the lines of "if paid to a United States shareholder" that does not appear in the text. We acknowledge, however, that the application of the Section 245A(a) to Foreign to Foreign Distributions itself requires a broad reading of that subsection.

The legislative history provides some support for the application of the participation exemption to Foreign to Foreign Distributions. A footnote to the discussion in the Conference Committee Report describing Section 245A provides that the "domestic corporations" intended to be eligible for the participation exemption include:

> a controlled foreign corporation treated as a domestic corporation for purposes of computing the taxable income thereof. See Treas. Reg. sec. 1.952-2(b)(1). Therefore, a CFC receiving a dividend from a 10-percent owned foreign corporation that constitutes subpart F income may be eligible for the [participation exemption] with respect to such income.[67]

Under Treasury Regulations section 1.952-2(b)(1), the taxable income of foreign corporations is generally computed by treating foreign corporations as domestic corporations. Accordingly, this footnote seems to suggest a broad application of the participation exemption to a Foreign to Foreign Distribution, where such Foreign to Foreign Distribution constitutes subpart F income to the CFC receiving the distribution.

Another provision of the Act may support the application of the participation exemption to Foreign to Foreign Distributions. As discussed above, Section 964(e)(1) provides that where a CFC sells or exchanges stock in any other foreign corporation, gain recognized on such sale or exchange shall be included in the gross income of such CFC as a dividend to the same extent that it would have been so included under Section 1248(a) if such CFC were a United States person. Section 964(e)(4)(A), which was added by the Act, provides that the amount so treated as a dividend shall constitute subpart F income of the selling CFC and be includable in the gross income of the United States shareholders of such CFC, and that such United States shareholders shall be eligible for the Section 245A participation exemption with respect to such inclusion as if such inclusion were the result of a dividend from the selling CFC. Because Congress thought it appropriate for subpart F income arising from a deemed Foreign to Foreign Distribution to qualify for the participation exemption (albeit in the hands of the United States shareholder), Congress may also have intended for an actual Foreign to Foreign Distribution to so qualify.

Finally, in the absence of another exception to the current taxation of Foreign to Foreign Distributions,[68] we believe that the application of the participation exemption is

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[67] Conference Committee Report at 599 n.1486.

[68] As discussed below in note 75, Section 954(c)(6) currently applies to broadly exempt from treatment as subpart F income dividends paid from one CFC to a related CFC but is scheduled to sunset in 2020. The strength of the policy arguments for applying the participation exemption to Foreign to Foreign Distributions would be significantly diminished if Section 954(c)(6) were enacted on a permanent basis. Indeed, such an approach would in many ways be preferable to applying the participation exception to Foreign to Foreign Distributions because it would not present the issues discussed below in Part IV.d.ii.

consistent with the policies of the U.S. international tax regime put in place by the Act. Under the Act, all income earned by a CFC is subject to current U.S. taxation under subpart F or GILTI provisions, other than ECI, QBAI Return and certain other exceptions of a more limited relevance. Accordingly, as a general matter, all distributions by one CFC to another CFC will be attributable to PTI and not result in an income inclusion to the applicable United States shareholder, other than distributions that are attributable to income that qualifies for these specifically enumerated exceptions. It would strike us as odd policy if these exceptions to current taxation were rendered ineffective as a result of a distribution by the CFC that earned non-PTI income to its parent CFC, particularly because this result would not occur if the distributing CFC were owned directly by the United States shareholder.[69] Put differently, we can identify no policy reason why the operation of the participation exemption should turn on whether a United States shareholder owns all of its CFCs directly (in a brother-sister arrangement) or through one or more CFC holding companies (in a tiered arrangement).

We believe that Treasury has ample authority under Section 245A(g) to issue regulations providing that Section 245A applies to Foreign to Foreign Distributions. Section 245A(g) directs Treasury to provide such regulations or other guidance as may be "necessary or appropriate to carry out the provisions" of Section 245A. In light of the ambiguity of the statute regarding Foreign to Foreign Distributions and the legislative history and policies of the Act, we believe regulations providing that Foreign to Foreign Distributions are eligible for the participation exemption are well within Treasury's authority.

ii. Scope of Application of Section 245A to Foreign to Foreign Distributions

Assuming that Treasury writes regulations to provide that the Section 245A participation exemption is applicable to Foreign to Foreign Distributions, Treasury must address the scope of its application to such distributions. In particular, there are a number of instances where the hybrid dividend rule of Section 245A(e) and the basis reduction rules of Section 1059 (together with the hybrid dividend rule, the "**245A Anti-abuse Rules**") could have consequences that are inconsistent with other Code sections and

[69] These exceptions would be ineffective only after Section 954(c)(6) expires (*i.e.*, for taxable years of foreign corporations beginning on or after January 1, 2020 and for taxable years of United States shareholders with or within which such taxable years of foreign corporations end). However, Section 245A applies to dividends received from an STFC, not just a CFC, and the same issue described in the text is raised under current law in the context of a Foreign to Foreign Distribution that is not between related CFCs. For example, if a domestic corporation owns the stock of an STFC (that is not a CFC) directly, dividends received by the domestic corporation on such stock from the STFC are eligible for the participation exemption and thus would be exempt from U.S. federal income tax. By contrast, if the domestic corporation holds the stock of such STFC indirectly through a CFC, unless the Section 245A participation exemption applies to Foreign to Foreign Distributions, a dividend paid by the STFC to the wholly owned CFC would not be eligible for the Section 245A participation exemption, would generally constitute subpart F income under current law, and therefore would be potentially subject to U.S. federal income tax in the hands of the domestic corporation.

presumably unintended when applied to Foreign to Foreign Distributions. The 245A Anti-abuse Rules were designed to prevent the duplication of losses or deductions in situations where Section 245A(a) reduces taxable income, and can thus have odd consequences when applied to situations where Section 245A(a) does not reduce taxable income because another provision already does so. We consider several such situations below.

iii. Previously taxed income

Guidance is needed regarding whether a distribution out of PTI from one CFC to another CFC is a dividend for purposes of Section 245A in general, or the 245A Anti-abuse Rules in particular.[70] Because the earnings associated with PTI have already been subject to tax in the United States, PTI is not subject to further U.S. tax when distributed by a CFC to a United States shareholder under Section 959(a) and by a CFC to another CFC under Section 959(b). The application of Section 245A(a) could create results in this situation that would be unfair to both taxpayers and the fisc.

For example, if the participation exemption applied to a PTI distribution by a CFC to its United States shareholder, the United States shareholder would receive a deduction in respect of a distribution that did not result in an inclusion, an unjustifiable result. Fortunately, this potential issue is addressed through Section 959(a), which provides that such a distribution to a United States shareholder is not includable in the gross income of such United States shareholder, and Section 959(d), which provides that a distribution excluded from gross income under Section 959(a) is not treated as a dividend for purposes of this chapter (except for purposes of reducing the earnings and profits of the payor), and thus Section 245A, which by its terms applies only to "dividends," would not be applicable. However, there is no corresponding rule for a PTI distribution by one CFC to another as Section 959(d) does not apply to Section 959(b), which provides that the distribution is not included in the gross income of the recipient CFC, but only "[f]or purposes of section 951(a)." Thus, absent guidance, such a distribution would, for example, potentially be subject to the 245A Anti-abuse Rules notwithstanding that Section 245A is not operating in this case to prevent an income inclusion; rather, the income associated with the distribution has been previously fully included under the subpart F regime, which was left intact by the Act, or the GILTI rules.

Example 4—PTI

Parent, a domestic corporation, owns all of the shares of CFC1, a foreign corporation, which in turn owns all of the shares of CFC2, a foreign corporation. Parent has $200 of basis in its CFC1 shares and CFC1 has $75 of basis in its CFC2 shares. In year 1, CFC2 had $50 of subpart F income and neither CFC2 nor CFC1 had any other income. Parent included this subpart F income in its income for year 1 under Section 951(a)(1). As a result, CFC2 has $50 of PTI described in

[70] For a broader consideration of the PTI regime in light of the Act, see NYSBA Tax Section, Report No. 1402, *Report on Previously Taxed Earnings under Section 959* (Oct. 11, 2018).

Section 959(c)(2), Parent's basis in its CFC1 shares is increased by $50 under Section 961(a) and, for purposes of determining any subsequent subpart F inclusion of Parent, CFC1's basis in its CFC2 shares is increased by $50 under Section 961(c).[71]

In year 2, CFC 2 makes a $50 distribution to CFC 1, and CFC 1 makes a $50 distribution to Parent. If Section 245A did not apply to the CFC2 to CFC1 distribution, CFC1 would not include the distribution in gross income for purposes of determining its subpart F income and, if CFC1 increased its basis in its CFC2 stock as a result of the subpart F inclusion in year 1, it would reduce its basis in its CFC2 stock by the amount of distribution. This result would not be affected by whether the CFC2 to CFC1 distribution (a) was made during the two-year period after CFC1 acquired CFC2's shares (thus potentially implicating Section 1059) or (b) resulted in a deduction for CFC2 for non-U.S. tax purposes (thus potentially implicating Section 245A(e)).

The application of Section 245A would not change this result unless the Section 245A Anti-abuse Rules were also applicable.

Example 5—PTI, Section 245A and Section 1059

The facts are the same as in Example 4 except Section 245A and the basis reduction rules of Section 1059 apply. In this case, notwithstanding that the earnings distributed by CFC2 to CFC1 have already been fully taxed in the United States, CFC1's basis in its CFC2 stock would be reduced by the amount of the distribution under Section 1059(a). Assuming neither the increase nor decrease to basis under Section 961(c) occurred in this case, CFC1's basis would be $25 ($75 less the $50 distribution) while the fair market value of CFC2 would continue to be $75 ($75 plus $50 of earnings less a $50 distribution). Thus, on a sale of the CFC2 shares, CFC1 would have gain notwithstanding that the distributed earnings that caused the reduction in basis were already fully taxed in the United States. The results would presumably be the same if the offsetting basis adjustments under Section 961(c) were made.[72]

Example 6—PTI, Section 245A Tiered Hybrid Dividend

The facts are the same as in Example 5 except the holding period requirement of Section 1059 is met so Section 1059 does not apply and CFC2 receives a deduction or other tax benefit for non-U.S. tax purposes with respect to the

[71] Because Section 961(c) applies "[u]nder regulations prescribed by the Secretary" and no such regulations have been promulgated, there is a question as to whether Section 961(c) is operative. We assume for purposes of this discussion that it is.

[72] A deemed dividend under Section 304 to CFC1 that resulted from the sale of the CFC2 shares raises the same issue under Section 1059 as that presented by this actual distribution. See Example 9 for a related discussion of the application of Section 304 and Section 1059 in connection with Section 245A.

distribution to CFC1. Notwithstanding that the CFC2 to CFC1 distribution was of PTI, the distribution also would constitute a hybrid dividend from CFC2 to CFC1 and thus result in subpart F income under Section 245A(e)(2). In such a case, the same earnings would be taxed as subpart F income twice—once when earned by CFC2 and again when distributed to CFC1.

We do not think it is appropriate from a policy perspective for Section 1059 or Section 245A(e) to apply to PTI distributed from one CFC to another CFC. While, in the case of Section 245A(e), the legislative history[73] suggests a broad reading and the statute provides the hybrid dividend rules shall apply to cause a subpart F inclusion "notwithstanding any other provision of this title," the question in this case is whether a distribution of PTI is properly treated as a dividend eligible for the Section 245A(a) deduction and thus whether it is a hybrid dividend in the first instance. Because (a) the legislative history described above suggests that Congress intended a Foreign to Foreign Distribution to be eligible for the Section 245A participation exemption only where the distribution "constitutes subpart F income," which a distribution of PTI is not, (b) there would be troublesome policy issues with taxing PTI twice, and (c) we do not see a distinction between a PTI distribution from a CFC to a United States shareholder that would not be treated as a dividend under Section 959(d) and a PTI distribution from a CFC to a CFC, we recommend that Treasury write regulations providing that a distribution of PTI does not constitute a dividend for purposes of Section 245A, regardless of whether the distribution is received by a United States shareholder or a CFC. We believe that Treasury has the authority to write such regulations in light of the ambiguity of the application of Section 245A to Foreign to Foreign Distributions generally.[74]

iv. Interaction with Section 954(c)(6)

Section 954(c)(6) broadly excepts from subpart F income dividends paid from one CFC to a related CFC.[75] Enacted in 2005 and scheduled to sunset in 2020, Section 954(c)(6) greatly increased the mobility of capital among CFCs. In light of the GILTI provisions of the Act, the import of Section 954(c)(6) will be significantly limited because most Foreign to Foreign Distributions will constitute PTI. Section 954(c)(6) will

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[73] According to the legislative history of the Act, the hybrid dividend rules are intended to result in a subpart F inclusion even if the distribution would otherwise not result in subpart F income under Section 954(c)(6). *See* Conference Committee Report at 600.

[74] For example, we do not draw a negative inference from the fact that Section 959(d) excepts only a distribution of PTI from a CFC to a United States shareholder from dividend treatment and thus renders Section 245A(a) inapplicable because Section 245A(a) itself only addresses a dividend to a domestic corporation.

[75] Section 954(c)(6) excludes from foreign personal holding company income (which is included in subpart F income) dividends, interest, rent and royalties received or accrued from a related CFC to the extent allocable to income of the related person that is not subpart F income or ECI. *See also* Notice 2007-9, 2007-1 C.B. 401 (providing guidance for what dividends and other income are eligible under Section 954(c)(6)).

generally apply only to earnings that are not taxed under the GILTI regime because they fall within one of the exceptions to that regime, including the exemption for QBAI Return. However, Congress retained Section 954(c)(6), and thus its policies must be taken into account in the implementation of Section 245A. As discussed in the examples set forth below, we think this can be achieved in a manner consistent with the policies of Section 245A.

Example 7—Section 1059 and Section 954(c)(6)

S, a domestic corporation, owns 100% of the stock of CFC1, which acquired 100% of the stock of CFC2 for $50 on day 1 of year 1. CFC2 had no earnings and profits at the time of the acquisition. During year 1, CFC2 generates $60 of earnings and profits that do not constitute PTI. On day 1 of year 2, CFC2 distributes $60 to CFC1. Absent the application of Section 245A, as a result of the application of Section 954(c)(6), this dividend would not result in subpart F income and CFC1's basis in its CFC2 stock would not be adjusted because neither Section 1059 nor Section 961 would apply.

However, if Section 1059 applied to this Foreign to Foreign Distribution because CFC1 received a deduction under Section 245A with respect to such dividend, the dividend would be treated as an extraordinary dividend that results in the elimination of CFC1's $50 basis in its CFC2 stock and the recognition by CFC1 of $10 of gain from the deemed sale of CFC2 stock under Section 1059(a)(2). This gain would be subpart F income and thus would be currently includable in the income of S, a result that is flatly inconsistent with the exclusion of this distribution from subpart F income pursuant to Section 954(c)(6). It is difficult to understand why the enactment of a participation exemption should result in subpart F income in transactions that would not have resulted in subpart F income before such enactment and under other provisions of current law. Accordingly, we do not believe that Section 1059 should apply to such a distribution.

We note that this example addresses a distribution to a shareholder of earnings accumulated while the shareholder owned the shares with respect to which the distribution was made, a case that does not implicate the policies of Section 1059, as discussed above. A more difficult case is presented where pre-acquisition earnings are distributed.

Example 8—Pre-acquisition Earnings, Section 1059 and Section 954(c)(6)

The facts are the same as in Example 7 except that CFC2 had $10 of accumulated earnings and profits at the time it was acquired by CFC1 and, on day 1 of year 2, CFC2 distributes $70 to CFC1. On day 2 of year 2, CFC1 sells its CFC2 stock for $40 (the $50 purchase price, plus $60 of year 1 earnings, less the $70 year 2 distribution). Absent the application of Section 245A, as a result of the application of Section 954(c)(6), the dividend would not result in subpart F income and CFC1's basis in its CFC2 stock would not be adjusted because neither Section 1059 nor Section 961 would apply. Accordingly, CFC1 would recognize a $10 loss on the sale of the CFC2 stock.

This example raises difficult questions because the loss at issue results from a tax-free distribution of pre-acquisition earnings and therefore arguably implicates the policies of Section 1059. However, because the tax-free nature of the distribution results from Section 954(c)(6) and therefore does not depend on a provision that Section 1059 was intended to police, it is not clear if and, if so, how Section 1059 should apply in such a case. If applicable at all, we think Section 1059 should only apply to the portion of the distribution that relates to pre-acquisition earnings. As discussed below, we think an approach to preventing uneconomic losses based on the principles of Section 961(d) is preferable to either a broad application of Section 1059 or a tracing rule.

A similar issue with respect to the application of Section 1059 would result from any redemption of CFC stock treated as a dividend, a disposition of CFC stock that constitutes a Section 304 transaction (and therefore results in deemed dividend treatment) and a reorganization with boot treated as a dividend. Such transactions are treated as resulting in per se extraordinary dividends if Section 1059 is applicable to them. These transactions are very commonplace, and the application of Section 1059 to them could result in significant amounts of subpart F income notwithstanding Section 954(c)(6). We think this result is inappropriate.

> **Example 9**—Section 304, Section 1059 and Section 954(c)(6)
>
> CFC Parent owns all of the stock of CFC1 and CFC2. CFC1 has a fair market value of $150, stock basis of $20 and non-PTI earnings and profits of $50. CFC 2 has a fair market value of $150, stock basis of $80 and non-PTI earnings and profits of $100. CFC2 acquires all of the CFC1 stock from CFC Parent in exchange for a $150 note.
>
> Assuming the non-application of Section 245A to this transaction, the following would result. The transaction would be analyzed as the contribution of the CFC1 stock by CFC Parent to CFC2 in exchange for CFC2 shares pursuant to Section 351(a) followed by the redemption of the CFC2 shares deemed issued in exchange for the note. CFC2's deemed redemption of its shares would be treated as a $150 dividend to CFC Parent under Section 304(a)(1) and Section 301 (the sum of CFC2's $100 of earnings and profits and CFC1's $50 of earnings and profits). This dividend would be excluded from foreign personal holding company income under Section 954(c)(6) and thus would not result in subpart F income.
>
> The consequences would be materially different if Section 245A, and thus Section 1059(e), applies to this transaction. In this case, the deemed $150 dividend would be extraordinary under Section 1059(e) and thus would reduce the basis in the notional CFC2 shares from $20 to $0 and then result in $130 of gain (includable under subpart F) under Section 301(c)(3). In sum, notwithstanding that the participation exception does not apply to reduce income in this transaction, the application of Section 1059 would result in $130 of incremental subpart F income.

Instead of broadly applying Section 1059 to Foreign to Foreign Distributions or adopting a tracing approach for pre- and post-acquisition earnings, we recommend that Treasury follow the approach adopted by Congress in the closely analogous situation of deemed foreign to foreign dividends resulting from the application of Section 964(e) to a sale of CFC stock. In Section 964(e)(4)(B), Congress provided that basis adjustments in these transactions should be made in a manner similar to those required under Section 961(d). Section 961(d), in turn, requires the reduction of basis of the stock of a CFC only where necessary to prevent a loss that would result from a disposition of shares with respect to which a Section 245A participation exemption applied on a distribution to a United States shareholder. A rule along these lines would prevent uneconomic losses from being generated by Foreign to Foreign Distributions without creating subpart F income that is inconsistent with Section 954(c)(6).

e. Section 246(c) holding period issues

The Act amended Section 246(c) to provide that, among other things, no deduction shall be allowed under Section 245A in respect of any dividend on any share of stock which is held by the taxpayer for 365 days or less during the 761-day period beginning on the date that is 365 days before the date on which the share becomes ex-dividend with respect to such dividend.[76] A taxpayer's holding period for purposes of Section 246(c) is determined under the rules of Section 1223, other than paragraph (3) thereof.[77] In addition, Section 246(c)(4) provides that a taxpayer's holding period for purposes of Section 246(c) shall be "appropriately reduced (in the manner provided in regulations prescribed by the Secretary)" for any period in which

> (A) the taxpayer has an option to sell, is under a contractual obligation to sell, or has made (and not closed) a short sale of, substantially identical stock or securities, (B) the taxpayer is the grantor of an option to buy substantially identical stock or securities, or (C) under regulations prescribed by the Secretary, a taxpayer has diminished his risk of loss by holding 1 or more other positions with respect to substantially similar or related property.

Finally, Section 246(c)(5)(B) prescribes special additional rules for purposes of applying the holding period requirement of Section 246(c)(1) with respect to Section 245A, providing that the taxpayer shall be treated as holding the stock referred to in Section 246(c)(1) for any period only if (i) the STFC referred to in Section 245A(a) is an STFC at all times during such period and (ii) the taxpayer is a United States shareholder with respect to such STFC at all times during such period.

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[76] *See* Section 246(c)(1), (c)(5). Section 246(c)(1) also provides that no deduction shall be allowed under Section 245A in respect of any dividend on any share of stock to the extent that the taxpayer is under an obligation (under a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

[77] *See* Section 246(c)(3)(B); Section 1223.

i. Tacking of holding period with respect to transfers within a consolidated group

As described above, a taxpayer's holding period for purposes of Section 246(c) is generally determined under the rules of Section 1223, as modified by Section 246(c)(3). Under these rules, a taxpayer's holding period for a share of stock generally begins on the day after the date of acquisition; as an exception to this rule, a taxpayer is permitted to include in its holding period another person's holding period for such stock only if the taxpayer acquires such stock from such person in a carryover basis transaction (such as a Section 351 transaction or a Section 368 reorganization).[78] A taxpayer is also permitted to include in its holding period for stock the holding period for any property exchanged for such stock in an exchanged basis transaction.[79]

In the case of a transfer of property between a selling member (S) and a purchasing member (B) of a consolidated group in an intercompany transaction, Treasury Regulations section 1.1502-13(c)(1)(ii) provides that, for purposes of determining B's corresponding items and S's intercompany items under the "matching" rule, the holding period for the property is the aggregate of the holding periods of S and B. Thus, for example, if S sells investment property that it has held for more than one year to B, and six months later B, which also holds the property for investment, sells the land to an unrelated third party at a gain, both S's intercompany item and B's corresponding item are long-term capital gain.[80] However, where the intercompany transaction at issue is the transfer of stock of an STFC, and B receives a dividend from the STFC, it is not entirely clear whether B's receipt of the dividend triggers the application of the matching rule.[81] It is thus unclear whether, for purposes of determining B's eligibility for the Section 245A participation exemption with respect to a dividend received from the STFC on the transferred stock, B's holding period for the transferred stock includes S's holding period.

We recommend that Treasury exercise its authority under Section 245A(g) and Section 1502 to clarify that the holding period aggregation rule in Treasury Regulations

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[78] *See* Section 1223(2).

[79] *See* Section 1223(1).

[80] *See* Treas. Reg. § 1.1502-13(c)(7) Ex. 1.

[81] Under Treasury Regulations section 1.1502-13(c)(1)(i), the separate company attributes of both S's intercompany items and B's intercompany items are redetermined to the extent necessary to produce the same effect on consolidated taxable income and consolidated tax liability as if S and B were divisions of a single corporation. Under Treasury Regulations section 1.1502-13(b)(3)(i), B's income from property acquired in an intercompany transaction is a corresponding item. Although it is not entirely clear, it would appear that B's receipt of a dividend with respect to the transferred STFC stock would be income from property acquired in an intercompany transaction, and thus be subject to redetermination under the matching rules, even if there is no recognition of any income, gain or loss by S with respect to its intercompany item. Note, however, that if any portion of a distribution received by B from the STFC is a non-dividend distribution described in Section 301(c)(2) or 301(c)(3), S may recognize some or all of its deferred gain under the matching rule.

section 1.1502-13(c)(1)(ii) applies for purposes of applying Section 246(c)(1) to a dividend received by B from an STFC. The consolidated return rules operate to treat the members of a consolidated group as if they were divisions of a single corporation for many purposes, and the holding period aggregation rule is an integral component of the system for achieving this result.[82] Although there are limits on and exceptions to such treatment, the context in which Section 245A operates, as part of the general overhaul of the international tax provisions of the Code produced by the Act, provides substantial grounds for application of the holding period aggregation rule to members of a consolidated group in the context of Section 245A. For example, even before the Act, the intercompany transaction regulations operated to redetermine S's and B's Section 1248 deemed dividend amounts on the intercompany sale of the stock of a CFC by S to B, followed by a sale of the stock by B, in order to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation, and the transaction was a transaction between divisions. If neither S nor B (or only one of them) satisfied the Section 246(c)(1) holding period requirement with respect to the transferred CFC stock on a separate company basis, but they did so in the aggregate, then absent the holding period aggregation rule, in many cases the single entity result would not be achieved with respect to the application of Section 245A to the redetermined Section 1248 deemed dividend amount.

> **Example 10**—Intercompany Transfer of STFC Stock, Dividend from STFC
>
> On January 1 of year 1, S forms FT, a wholly owned foreign subsidiary, with a \$10 contribution. During years 1 through 3, FT has earnings and profits of \$45. None of the earnings and profits is taxed as subpart F income under Section 951, none of the earnings and profits is attributable to tested income under Section 951A, and FT distributes no dividends to S during this period. On January 1 of year 4, S sells its FT stock to B for \$50. While B owns FT, FT earns additional earnings and profits of \$5, none of which is taxed as subpart F income under Section 951 or attributable to tested income under Section 951A, and FT distributes no dividends to B during this period. On December 31 of year 4, B sells its FT stock for \$70 to X, an unrelated foreign corporation.
>
> Under the matching rule, the attributes of S's intercompany gain (\$40) and B's corresponding gain (\$20) are redetermined to have the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation. On a single entity basis, there is \$60 of gain, and the portion characterized as a dividend under Section 1248 is determined on the basis of FT's \$50 of earnings and profits at the time of the sale to X.

[82] *See, e.g.*, Treas. Reg. §§ 1.1502-13, 1.1502-32(a)(1). For example, we note that the determination of the allowable dividends received deduction under Sections 243 and 245 for a consolidated group is determined on a consolidated basis. *See* Treas. Reg. § 1.1502-11(a) (consolidated taxable income determined by taking into account, among other things, the consolidated dividends received deduction under Treasury Regulations section 1.1502-26); Treas. Reg. § 1.1502-26 (Section 246(c) limitation on consolidated dividends received deduction based on consolidated taxable income).

> Therefore, \$50 of the gain is treated as a dividend under Section 1248, and the remaining \$10 is treated as capital gain. On a separate entity basis, all of S's \$40 of gain would be treated as a dividend under Section 1248, but only \$5 of B's \$20 gain would be treated as a dividend under Section 1248, and the remainder would be capital gain. Thus, as a result of the single entity redetermination, \$5 that would be treated as capital gain on a separate entity basis is redetermined to be a dividend under Section 1248. On a separate entity basis, only B would have any amount of capital gain available for redetermination, and accordingly, \$5 of B's income is redetermined to be a dividend under Section 1248, with the result that \$10 of B's corresponding gain is treated as a dividend under Section 1248 and the remaining \$10 is treated as capital gain.[83]

Absent the holding period aggregation rule, however, the \$10 of B's \$20 of gain that is treated as dividend under Section 1248—*including the portion attributable to the \$5 of earnings and profits earned by FT while S held FT's stock*—would not be eligible for the Section 245A participation exemption because on a separate company basis, B's holding period for the FT stock (January 2 to December 31) would not meet the Section 246(c)(1) holding period requirement. This result would violate the principles of the matching rule. In order to effectuate these principles, the holding period aggregation rule should apply in these circumstances to determine B's holding period for purposes of Section 246(c)(1). (It should be noted that the holding period aggregation rule clearly applies to determine the attributes of B's remaining \$10 of capital gain as long-term capital gain; it would be incongruous for the holding period aggregation rule <u>not</u> to apply for purposes of applying Section 246(c)(1) to the same transaction.)

We acknowledge that this example involves a situation in which the matching rule clearly applies, and thus presents the strongest case for the application of the holding period aggregation rule for purposes of Section 246(c)(1). It also appears that the matching rule would similarly apply where, following an intercompany transfer of STFC stock from S to B, B receives a dividend from the STFC,[84] and we do not see any reason why the result to B (and the consolidated group) should be different in the case where B receives an actual dividend from the STFC, as opposed to a deemed dividend under Section 1248 on a sale of the STFC stock. Moreover, not applying the holding period aggregation rule to B's receipt of a dividend from an STFC would effectively allow a consolidated group to elect not to have Section 245A apply to the dividend (by transferring the STFC stock within the group to B before the dividend is paid and having B transfer the STFC stock within the group after the dividend is paid, in order to ensure

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[83] This example is based on, but not identical to, Example 15 in Treasury Regulations section 1.1502-13(c)(7).

[84] Under Treasury Regulations section 1.1502-13(b)(3), B's corresponding items include its income, gain, deduction and loss from an intercompany transaction "or from property acquired in an intercompany transaction."

that, on a separate company basis, B did not satisfy the Section 246(c) holding period requirement).[85]

In making this recommendation, we do not express any view on whether or how the holding period aggregation rule currently applies (or should apply) for purposes of applying Section 243 or Section 245 to dividends received from a domestic or foreign corporation by B following an intercompany transaction of stock of the domestic or foreign corporation, and it is entirely possible that the holding period aggregation rule should apply for such purposes as well. That issue is beyond the scope of this report. In addition, we believe that guidance on the application of the holding period aggregation rule for purposes of Section 245A is of relatively greater importance than in the context of Sections 243 and 245, both because of the longer holding period requirement that applies for purposes of Section 245A (relative to the shorter holding period requirement that applies for purposes of Sections 243 and 245) and because we expect that, for many taxpayers, the Section 245A participation exemption will be of much greater importance, in terms of the amounts at issue, than the dividends received deductions under Sections 243 and 245.

ii. Application of Section 246(c) to shares with split holding periods and blocks of stock with separate holding periods

Taxpayers may own a share of STFC stock with a split holding period, as a result of receiving such share in a prior nonrecognition transaction (e.g., a Section 351 transaction).[86] Similarly, taxpayers may own blocks of stock of an STFC with separate holding periods as a result of acquiring stock of the STFC at different times.

Section 246(c)(1) clearly applies on a share-by-share basis, with the result that a taxpayer may satisfy the holding period requirement of section 246(c)(1) with respect to the dividend received on one share of stock of an STFC while failing to satisfy the holding period requirement with respect to the dividend received on a different share of stock of the same STFC. Similarly, while we are not aware of any authority on the application of Section 246(c) to a share of stock with a split holding period, we would expect that a dividend received on a share of stock of an STFC with a split holding period would be determined by allocating the dividend proportionately to each portion of the share with a separate holding period.

[85] Note that the same electivity is arguably present where S receives a dividend from an STFC prior to an intercompany transfer of the stock of the STFC and, on a separate entity basis, S does not satisfy the holding period requirement under Section 246(c). The dividend received by S is not an "intercompany item" under Treasury Regulations section 1.1502-13 because it is income "from" an intercompany transaction, and thus does not appear to come within the scope of the holding period aggregation rule. Note that there is an argument that a different result should apply if the dividend received by S is attributable to the recognition by S of deferred intercompany gain that is treated as a dividend under Section 1248. *See* Jerred G. Blanchard Jr., *Is There a Deduction for Dividends from Foreign Corporations?*, Tax Notes, July 30, 2018, at 627-28.

[86] *See* Rev. Rul. 85-164, 1985-2 C.B. 117.

Finally, we note that, because we expect that Section 245A will dramatically increase the number and amount of dividends to which the holding period requirement of Section 246(c) will be relevant, identifying when a dividend is paid with respect to a particular share of stock (and the amount thereof) will take on increased importance as a result of the Act. Although this determination will be easy in the case of a pro rata dividend that is declared and paid on a per-share basis, in more complex situations—such as redemptions that are treated as dividends under Section 302(d) and Section 301, Section 304 transactions that are treated as giving rise to distributions to which Section 301 applies, and reorganizations in which the payment of boot "has the effect of the distribution of a dividend" under Section 356(a)(2)—the determination of the shares on which the dividend is treated as having been paid will now take on even greater importance than it did before. As we have previously described in our report on the related issue of basis recovery in such transactions,[87] current law is unclear on these issues, and there are various alternative approaches to making these determinations. While we are not aware of any reason why the existence of Section 245A should affect the proper approach to making this determination (and accordingly do not believe that any special rules are appropriate or required in the context of the application of Section 246(c), either generally or with respect to the application of Section 246(c) for purposes of Section 245A), we recommend that guidance on this issue be a priority for Treasury after it has completed the initial round of guidance projects in response to the Act.

iii. Application of Section 246(c) in dividend-equivalent redemption or reorganization transactions

In the case of a distribution in redemption of stock of an STFC (including a deemed redemption of stock), the stock that is actually redeemed or deemed to have been redeemed will cease to be owned by the redeemed shareholder, and thus will cease to accrue any additional holding period for purposes of Section 246(c). Examples of such distributions in redemption of stock of an STFC would include, again, redemptions that are treated as dividends under Section 302(d) and Section 301, and Section 304 transactions that are treated as giving rise to distributions to which Section 301 applies.

In situations in which the taxpayer has a holding period for STFC stock of more than 365 days prior to the transaction in which it is redeemed (or deemed to have been redeemed), giving rise to the Section 301 distribution, the taxpayer will be in a position to satisfy the holding period requirement in Section 246(c) based on its pre-transaction ownership of the stock. However, in a situation in which the taxpayer's holding period for the stock of the STFC that is redeemed (or deemed to have been redeemed) is 365 days or less, the taxpayer will be unable to satisfy the holding period requirement in Section 246(c) with respect to the dividend (or portion thereof) which is treated as having been paid on the shares that are actually redeemed (or deemed to have been redeemed).

[87] *See* 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* (Feb. 6, 2015) at 9-16; NYSBA Tax Section, Report No. 1112, *Report on Basis Recovery in a Dividend Equivalent Redemption* (June 13, 2006).

This will be true even in a case where the taxpayer continues to own, either directly or by attribution, sufficient stock of the redeeming STFC such that (a) the taxpayer is and continues to be a United States shareholder with respect to the STFC and (b) the redemption distribution is treated as a distribution to which Section 301 applies.

The same result can occur in the case of a reorganization in which the receipt of boot by a target shareholder "has the effect of the distribution of a dividend" under Section 356(a)(2) and thus is treated as a distribution subject to Section 301. The most extreme example of such a transaction is an "all-cash" D reorganization in which a domestic corporation that owns all of the stock of a target STFC receives only cash or other non-stock boot in the transaction, and some or all of such boot is treated as a distribution subject to Section 301 by reason of the attribution of stock of the acquiring corporation to the domestic corporation shareholder.

We believe that, in such situations, it is inappropriate to apply Section 246(c) to prevent a domestic corporation that is treated as having received a dividend from an STFC from qualifying for a participation exemption.[88] In such situations, treatment of the redemption proceeds or boot, as the case may be, as a dividend is based on the taxpayer's continued ownership, directly or by attribution, of other stock of the STFC, and it is the continued ownership of that stock which should be relevant for purposes of the holding period requirement in Section 246(c). Accordingly, we recommend that Treasury issue guidance to the effect that, where there is (a) a redemption (or deemed redemption) of shares of an STFC from a domestic corporation that is treated as a dividend paid by the STFC, or (b) the receipt of boot by a domestic corporation in exchange, in whole or in part, for the stock of a target STFC in a reorganization, which boot is treated as a dividend paid by an STFC under Section 356(a)(2), for purposes of Section 246(c) the domestic corporation's holding period for the stock so redeemed or exchanged will include the holding period that accrues, after the redemption or exchange, with respect to the stock of the redeeming corporation or the acquiring corporation, as the case may be, which such domestic corporation owns, either directly or by attribution, at and after the time of the redemption or exchange.[89] In the case of such stock owned only

[88] In making this recommendation, we again do not express any view on whether a similar rule should apply for purposes of applying Section 243 or Section 245 in similar situations, although it is entirely possible that the same rule should apply for such purposes. That issue is beyond the scope of this report.

[89] Appropriate rules would be required to determine which directly or constructively owned STFC shares are taken into account for purposes of measuring the domestic corporation's post-transaction holding period with respect to the STFC shares that the domestic corporation disposed of in the redemption or dividend-equivalent reorganization transaction. For example, one approach could be to treat the domestic corporation's holding period with respect to the disposed-of STFC shares as continuing on a pro rata basis with respect to all of the STFC shares that the domestic corporation owns directly or by attribution. An alternative would be to take into account only those shares as to which there is a basis adjustment in respect of the eliminated basis of the shares that are redeemed or the subject of the dividend-equivalent reorganization. This latter approach has the potential virtue of simplicity, but could lead to somewhat unintuitive results (for example, where a redeemed shareholder retains a single share in the STFC but dividend treatment with respect to the redemption is based almost entirely on shares of the STFC that are owned by attribution from related persons).

by attribution, appropriate rules may be required to implement the rules of Section 246(c)(4) with respect to such stock and the stock or interests of other entities through or from which the stock of the redeeming corporation or the acquiring corporation is attributed to the domestic corporation.

iv. Application of Section 246(c)(4)(A) for purposes of Section 245A

As noted above, Section 246(c)(4)(A) provides that a taxpayer's holding period for purposes of Section 246(c) shall be "appropriately reduced (in the manner provided in regulations prescribed by the Secretary)" for any period in which the taxpayer, among other things, "is under a contractual obligation to sell" substantially identical stock or securities.

The "contractual obligation to sell" prong of Section 246(c)(4)(A), if applied for purposes of Section 245A, has the potential to render the participation exemption inapplicable to many dividends (including deemed dividends under Section 1248) received by a domestic corporation in private sales of STFCs. In a private sale of a business or entity, it is common for there to be some period of time between the date on which the buyer and seller agree to enter into a contract for the sale of the business or entity and the date on which the sale closes. In the case of a transaction in which a domestic corporate seller is selling the stock of an STFC to a third party, the seller will be "under a contractual obligation to sell" the stock of the STFC during such period between signing and closing, and therefore is at risk of having its holding period for the STFC stock "appropriately reduced" for such period. Because (a) the relevant period during which the domestic corporate seller can satisfy the more than 365-day holding period requirement in Section 246(c)(1) begins on the date which is 365 days before the date on which the relevant share becomes ex-dividend and (b) the domestic corporate seller will dispose of the stock on the closing date and thus cannot accrue any holding period with respect to such stock after such date, any reduction in its holding period on account of the period during which the contract is pending will necessarily result in the holding period requirement of Section 246(c)(1) not being satisfied with respect to any dividend received by the domestic corporate seller from the STFC with an ex-dividend date after the date on which the seller enters into the contract to sell the STFC stock, regardless of how long the domestic corporate seller has actually held the STFC stock. This would include not only actual dividends declared and paid by the STFC after the contract is signed—for example, to extract cash or other unwanted assets out of the STFC prior to closing (which is common practice for private sales of STFC stock)—but would also include deemed dividends under Section 1248, since Section 1248(j) provides that in the case of a sale or exchange by a domestic corporation of stock in a foreign corporation held for one year or more, any amount received by the domestic corporation which is treated as a dividend by reason of Section 1248 is treated as a dividend for purposes of applying Section 245A.[90]

We do not believe that this result is appropriate or intended by Congress, especially with respect to Section 1248 deemed dividends. The legislative history to

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[90] *See also* Section 964(e)(4), described in Part IV.c above.

Section 246(c) makes it clear that the holding period requirement generally, and the holding period tolling rules under Section 246(c)(4) specifically, were directed at abusive arbitrage transactions, generally involving portfolio stock,[91] rather than at transactions involving dispositions of stock of privately held corporations. We previously made a similar recommendation in the context of the application of Section 246(c)(4)(A) to the qualification of pre-sale dividends for treatment as qualifying dividend income under Section 1(h)(11)(B)(iii).[92] We noted that "shareholders who own stock pending the closing of an acquisition agreement do not have the offsetting 'long' and 'short' positions that appear to be contemplated by the legislative history of Section 246(c), because the sale is subject to closing conditions and might therefore never occur. An acquisition agreement for the sale of all or most of the company is almost certainly not motivated by the tax arbitrage that the statute was intended to prevent."[93] Moreover, the legislative history to Section 245A suggests that Congress did not contemplate that Section 246(c)(4)(A) would generally apply to prevent the application of Section 245A. For example, the Conference Committee Report states that the term "dividend received" in the House version of Section 245A "is intended to be interpreted broadly," and goes on to state that "[c]onsequently, for example, gain included in gross income as a dividend under section 1248(a) or 964(e) would constitute a dividend received for which the deduction under section 245A may be available."[94] This statement makes it clear that Congress contemplated that Section 245A would be generally available with respect to deemed dividends under Section 1248(a) and Section 964(e). Because in many cases such dividends will arise only in transactions involving sales of STFC stock with respect to which the selling shareholder enters into a contract to sell the stock on a date before the date on which the sale closes, applying the tolling rules of Section 246(c)(4) to these dividends would appear to be inconsistent with Congress' intention. Finally, the fact that Congress included specific holding period rules in Section 1248(j) and Section 964(e)(4) themselves suggests that, at least with respect to deemed dividends under these provisions, the rules of Section 246(c)(4) should not apply.[95]

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[91] *See* S. Rep. No. 85-1983, at 29 (1958), *reprinted in* 1958 U.S.C.C.A.N. 4791, 4817.

[92] *See* NYSBA Tax Section, Report No. 1158, *Report on Distributions in Connection with Acquisitions* (June 18, 2008), at 48-53.

[93] *Id*., at 50-51 (footnote omitted).

[94] *See* Conference Committee Report at 595.

[95] Indeed, it is not even clear that, in the case of a deemed dividend under Section 964(e)(4), the tolling rules of Section 246(c)(4)(A) would in fact apply to a contractual obligation to sell the stock of the target foreign corporation. Under Section 964(e)(4)(iii), the deduction under Section 245A is allowable to the United States shareholder of the selling CFC with respect to the amount included in subpart F income "as if such subpart F income were a dividend received by the shareholder *from the selling controlled foreign corporation*," not the target foreign corporation. Any contract to sell in this case will be with respect to the stock of the target foreign corporation, not the stock of the selling CFC, in which case Section 246(c)(4) would likely be irrelevant.

For these reasons, we recommend that Treasury issue guidance to the effect that a domestic corporation shareholder's holding period for an STFC is not tolled under Section 246(c)(4)(A) by reason of entering into a contract to sell the stock of an STFC, at least in the context of a private sale of the stock of an STFC that is not publicly traded and in which there are substantial conditions to closing.[96] Again, in making this recommendation, we do not express any view on whether or how a similar rule should apply for purposes of applying Section 243 or Section 245 to similar situations, which is beyond the scope of this report. However, for many of the same reasons as described above in Part IV.e.i relating to the application of the holding period aggregation rule, and because only Section 245A can apply to Section 1248 deemed dividends, which are of significant importance in international tax planning and the operation of the international tax provisions of the Code, we believe that guidance under Section 245A is especially important.

v. Tax return filing considerations

Because the holding period requirement in Section 246(c) can be satisfied by the continued ownership of stock after the ex-dividend date, where a taxpayer has not satisfied the holding period requirement prior to the ex-dividend date, the taxpayer will not know at the time it receives a dividend from an STFC whether the dividend will be eligible for the deduction under Section 245A. Indeed, in a case where a taxpayer acquires the STFC stock only one day before the ex-dividend date, the taxpayer will not know whether it will have satisfied the Section 246(c) holding period requirement until 365 days after the ex-dividend date.

This raises the question of how a taxpayer that receives a dividend from an STFC in a taxable year and is required to file its tax return for such year (with or without permitted extensions) before it has met the Section 246(c) holding period requirement with respect to the dividend should treat the dividend for purposes of filing its tax return.[97] We think there are three alternative approaches to this situation. First, a taxpayer could be allowed to claim the deduction under Section 245A with respect to a dividend from an STFC (assuming that all of the other requirements for claiming the deduction are met) on its tax return for the year in which the dividend was received only if, at the time it files its tax return, the holding period requirement in Section 246(c) is

[96] A similar approach (i) with respect to customary commercial contracts can be found in Treasury Regulations section 1.1504-4(d)(iii), under which stock purchase agreements or similar arrangements whose terms are commercially reasonable and in which the parties' obligations to complete the transaction are subject to reasonable closing conditions are not treated as options for purposes of the regulation, and (ii) with respect to nonpublicly-traded stock can be found in Section 1259(c)(2), under which a taxpayer is not treated as having made a constructive sale solely by entering into a contract for the sale of any stock, debt instrument or partnership interest that is not a marketable security (as defined in Section 453(f)) if the contract settles within one year after the date the contract is entered into.

[97] Note that this issue does not typically arise with respect to a dividend on stock of a domestic corporation that is received by another domestic corporation, because the holding period requirement of Section 246(c) with respect to such dividends is only 45 days (or 90 days, in the case of certain dividends on preferred stock). *See* Section 246(c)(1)(A); Section 246(c)(2)(A).

met with respect to such dividend. If the holding period requirement with respect to such dividend is not met as of the time that the taxpayer files its tax return, but is met at a later date, the taxpayer would then file an amended tax return claiming the deduction. Second, a taxpayer could be allowed to claim the deduction under Section 245A with respect to a dividend from an STFC (assuming that all of the other requirements for claiming the deduction are met) on its tax return for the year in which the dividend was received if, at the time it files its tax return, it reasonably expects that the holding period requirement in Section 246(c) will be met with respect to such dividend, even though the holding period requirement is not satisfied at the time the return is filed. In the event the holding period requirement is not ultimately satisfied, the taxpayer could be required to file an amended tax return reflecting the unavailability of the deduction. Third, if the holding period requirement is not satisfied with respect to such dividend at the time the return is filed, a taxpayer could be allowed to elect to provisionally claim the deduction under Section 245A with respect to such dividend (assuming that all of the other requirements for claiming the deduction are met) on its tax return for the year in which the dividend was received, subject to appropriate certification and correction procedures.[98] Such certification and correction procedures could include (a) a certification by the taxpayer that (i) the holding period requirement in Section 246(c) will not have been met with respect to such dividend as of the date the return is filed and (ii) it reasonably expects at a certain date duly in advance of the filing deadline that the holding period requirement will be met with respect to such dividend,[99] and (b) on the tax return for the following year, the taxpayer either (i) certifies that the holding period requirement was in fact met with respect to the dividend or (ii) if the holding period requirement was not in fact met with respect to the dividend, either includes in gross income in that following year an amount equal to the Section 245A participation exemption deduction claimed in the prior year or computes and pays, with its return for such following year, an additional amount of tax in respect of the prior year in effectively the same manner as if it filed an amended return for such prior year reversing the claimed Section 245A deduction.[100] (We expect that the IRS would prescribe an appropriate form or schedule for these certifications and computations.)[101] While potentially administratively more complex for the IRS, this third alternative is most appealing in a situation where a taxpayer has accrued most but

[98] If the taxpayer did not so elect, it would remain entitled to file an amended return for the year in which the dividend was received claiming the Section 245A participation exemption once the Section 246(c) holding period requirement was met.

[99] Since this certification would relate to the taxpayer's expectations as to the future, we believe that the certification should be delivered on a "reasonable belief" basis.

[100] Unless the taxpayer's certification in the prior year was in fact not supported by a reasonable belief that the taxpayer would meet the holding period requirement with respect to the relevant dividend, we do not believe that the taxpayer should be subject to any penalties, *e.g.*, under Section 6662, by reason of having claimed a deduction under Section 245A with respect to such dividend if the holding period requirement turns out not to have been satisfied.

[101] If Treasury adopts this approach, it may be appropriate to forgo some of the requirements that would otherwise apply to an actual amended return (such as the requirement that a shareholder recertify the entire return, as amended).

not all of the holding period necessary to satisfy Section 246(c) at the time the tax return for the relevant tax year is filed, and therefore there is a high likelihood that the taxpayer will in fact satisfy the Section 246(c) holding period requirement.[102]

We are aware of at least one similar situation that arises under the Code, *i.e.*, where a taxpayer may be required to report on its tax return the tax consequences of a transaction before all of the facts needed to determine such tax consequences come into existence.[103] Under Section 217(a), a taxpayer is allowed to deduct specified moving expenses in connection with the commencement of work at a new principal place of work if certain conditions are met. Under Section 217(c)(2), these conditions must be satisfied by the taxpayer, either as a full-time employee, or as a self-employed individual providing services on a full-time basis, for a minimum period during the 12-month or 24-month period immediately following arrival in the general location of the new principal place of work. Section 217(d)(2) addresses the tax return filing issue that is analogous to that described above with respect to Section 245A and the holding period requirements of Section 246(c). Specifically, Section 217(d)(2) provides that, if a taxpayer has not satisfied the requirements of Section 217(c)(2) before the time prescribed by law (including extensions) for filing the return for the taxable year during which the moving expenses that would otherwise be deductible under Section 217(a) are paid or incurred, but the taxpayer may still satisfy such condition, then the taxpayer may elect to deduct the moving expenses for such taxable year notwithstanding Section 217(c)(2). If (a) the taxpayer so claims the deduction, and (b) in a subsequent taxable year, the condition of Section 217(c)(2) cannot be satisfied by the close of such subsequent taxable year, Section 217(d)(3) requires the recapture of the deduction through an inclusion in gross income of an amount equal to the expenses which were so deducted in the subsequent taxable year.

We recommend that Treasury issue guidance instructing taxpayers to follow the third alternative. The first alternative would result in a significant number of amended returns, which would be an administrative burden to both taxpayers and the IRS. The

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[102] This third alternative bears some similarity to the rules with respect to gain recognition agreements under Treasury Regulations section 1.367(a)-8. Under those rules, if a taxpayer enters into a gain recognition agreement and a gain recognition event subsequently occurs within a prescribed period, the taxpayer generally must report the gain required to be recognized on an amended federal income tax return for the taxable year of the initial transfer, unless the taxpayer has elected in the gain recognition agreement to include in income any gain recognized in the taxable year during which a gain recognition event occurs. *See* Treas. Reg. § 1.367(a)-8(c)(iii). Where, as suggested in the text, a taxpayer is being permitted to provisionally claim a deduction, we believe that the more appropriate corrective action if the taxpayer turns out not to be entitled to the deduction is for the taxpayer to be required to file an amended tax return for the year in which the deduction was (incorrectly) claimed or, as suggested in the text, the equivalent thereof in connection with the filing of the taxpayer's return for the next taxable year.

[103] *Cf. Comm'r v. Gordon*, 391 U.S. 83 (1968) ("Absent other specific directions from Congress, Code provisions must be interpreted so as to conform to the basic premise of annual tax accounting. It would be wholly inconsistent with this premise to hold that the essential character of a transaction, and its tax impact, should remain not only undeterminable but unfixed for an indefinite and unlimited period in the future, awaiting events that might or might not happen.") (footnote omitted).

requirement to file an amended return would apply even where at the time of filing a tax return, only a few days or weeks were left in order to satisfy the holding period requirement for stock in a privately held corporation and it was nearly certain that the stock would not be sold before the holding period was met. The second alternative, which would rely on a taxpayer to self-report on an amended tax return the failure to satisfy the Section 246(c) holding period requirement, would create too great a risk of reporting failures, inadvertent or otherwise, especially in light of the fact that there is no information reporting or other mechanism short of an audit for the IRS to determine whether the holding period requirement is met. The third alternative appears to balance efficiency and accuracy more appropriately because fewer amended returns would be required. We thus think that the interests of sound tax administration are best served by permitting a taxpayer to provisionally claim the deduction, subject to appropriate certification and correction procedures, as described above in the third alternative.

f. Coordination of Section 961(d) with consolidated return regulations

As discussed above, the Act added Section 961(d) to prevent the recognition of a loss upon the sale of stock in an STFC that is attributable to a dividend that qualified for the participation exemption. Guidance is needed to clarify that the potential application of Section 961(d) does not affect the treatment under the investment adjustment rules of the portion of a dividend received by a member of a consolidated group that is eligible for a Section 245A participation exemption. In addition, guidance is needed to ensure the treatment of a loss recognized by a member of a consolidated group upon the sale of stock in a domestic corporation that holds an STFC is consistent with the loss that would be recognized after application of Section 961(d) if the stock of the STFC were sold instead.[104]

i. Clarification of investment adjustment rules

Treasury Regulations section 1.1502-32 provides rules for adjusting the stock basis of members of a consolidated group (the "**investment adjustment rules**"). Under these rules, a member of the group (M) that owns stock in another member of the group (S) increases its adjusted basis in S's stock in respect of any taxable income and any tax-exempt income of S (a "**positive investment adjustment**").[105] In addition, M's basis in the stock of S is reduced by any taxable loss and noncapital, nondeductible expenses of S,

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[104] There are other issues relating to Section 961(d) that Treasury may consider addressing in guidance. These other issues would include (i) how Section 961(d) should apply where a United States shareholder receives a dividend from an STFC to which the Section 245A participation exemption applies, and then transfers the stock of the STFC for stock of another corporation in an exchanged basis transaction, *e.g.*, a transaction governed by Section 351 or 368, and (ii) how Section 961(d) should apply if, after the receipt of a dividend on STFC stock to which the Section 245A participation exemption applies, the United States shareholder transfers the STFC stock in a redemption governed by Section 302(d) or a transaction governed by Section 304 in which the United States shareholder's basis in the stock of the STFC is eliminated and such basis is added to the basis of other shares (including shares owned by a different shareholder).

[105] *See* Treas. Reg. § 1.1502-32(b)(2).

and any distributions received from S (a "**negative investment adjustment**").[106] The purpose of these adjustments "is to treat M and S as a single entity so that consolidated taxable income reflects the group's income."[107]

To the extent that taxable income or gain is "permanently offset by a deduction or loss that does not reduce, directly or indirectly, the basis of S's assets, the income or gain is treated as tax-exempt income," and results in a positive investment adjustment.[108] An example in the regulations provides that where a corporation is entitled to a 70% dividends received deduction under Section 243[109] with respect to a $100 dividend, it is treated as having $30 of taxable income (equal to the $100 dividend reduced by the $70 dividends received deduction) and $70 of tax-exempt income, for a total positive investment adjustment of $100.

Guidance is needed to clarify that the portion of a dividend eligible for a Section 245A participation exemption is treated as tax-exempt income under the investment adjustment rules, as illustrated by the following example:

> **Example 11**—Post-acquisition Earnings and Profits, STFC Dividend to Consolidated Group Subsidiary
>
> Domestic corporation M formed and directly owns 100% of the stock of S, a domestic corporation and a member of M's consolidated group. S formed and directly owns 100% of FC, a foreign corporation, and owns no other assets. M contributed $80 to S on the formation of S, and S contributed $80 to FC on the formation of FC. FC earns $20 of non-PTI earnings and profits, increasing its value to $100. FC distributes $20 to S as a dividend that qualifies for the Section 245A participation exemption. S in turn distributes $20 to M. After these distributions, S has a basis of $80 in the stock of FC, the stock of FC is worth $80, and S is also worth $80.

In this example, if the Section 245A participation exemption is treated as producing tax-exempt income under the investment adjustment rules, M's basis in the stock of S would increase by the amount of the dividend received by S from FC that is eligible for the participation exemption ($20), and then decrease by the same amount on the distribution by S to M, leaving M with a basis of $80 in the S stock. As a result, M would not recognize any gain or loss on the sale of the S stock for $80, which would have

[106] *Id.*

[107] Treas. Reg. § 1.1502-32(a)(1).

[108] Treas. Reg. § 1.1502-32(b)(3)(ii)(B).

[109] Section 243 provides certain corporations a deduction equal to 50% of the dividends received from a domestic corporation. The deduction is generally increased to 65% or 100%, respectively, if the shareholder corporation owns 20% or 80% or more of the stock of the distributing corporation. Section 243(a)(3), (c). Prior to the Act, the general deduction was 70%, and the regulation has not been updated to reflect the Act.

the effect of preserving for M the benefit of the Section 245A participation exemption, and be consistent with the purpose of the investment adjustment rules. However, under Section 961(d), S's basis in its FC stock may be reduced by $20 on a later disposition of the stock of FC for purposes of calculating any loss on that disposition.[110] If the stock of FC were to depreciate to $70, and then S sold its stock in FC, S would initially recognize a loss of $10, but Section 961(d) would apply to effectively decrease S's basis in the FC stock by the same amount (solely for purposes of determining S's loss on the sale), resulting in no gain or loss to S. It is unclear whether the mere possibility of a future reduction in the basis of S's FC stock is an "indirect" reduction in basis, such that the dividend would not be treated as tax-exempt income. The language of Treasury Regulations section 1.1502-32(b)(3)(ii)(B) uses the present tense—"does not reduce, directly or indirectly, the basis of S's assets" —and thus is more naturally interpreted to apply only to a current reduction in basis, not a possible future reduction in basis. However, if a possibility of a future reduction in the basis of S's stock in FC was treated as an "indirect" reduction in basis, such that the FC dividend to which the Section 245A participation exemption applied was not treated as tax-exempt income under the regulation, M's basis in the stock of S would *not* be increased by the amount of the dividend received by S from FC, leaving M with a basis in the S stock of $60. On a sale of the S stock for $80, M would then recognize $20 of gain—effectively denying M the benefit of the Section 245A participation exemption, and violating the purpose of the investment adjustment rules.[111] Because the amount, if any, of a basis reduction under Section 961(d) is not known at the time of the dividend, applies only for purposes of determining losses and not gains and may not occur until after S leaves the group, if ever, the participation exemption should not be treated as indirectly reducing basis.

Treating the full dividend that was eligible for a 245A participation exemption as tax-exempt income would provide certainty regarding the amount of the investment adjustment, which is crucial given the importance of Section 245A to the operation of the Act and likely substantial amount of dividends eligible for the participation exemption for many consolidated groups. For these reasons, we recommend that Treasury issue guidance to clarify that a dividend eligible for a participation exemption is tax-exempt income for purposes of the investment adjustment rules. As discussed immediately below, any potential loss (or reduced amount of gain) that M may realize on a subsequent disposition of the stock of S that is attributable to the positive investment adjustment for the participation exemption can be addressed at that time through a negative investment adjustment that mirrors the result that would apply under Section 961(d).

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[110] Although Section 961(d) is not by its terms limited to the determination of loss that is *recognized* on a disposition of STFC stock, its application would appear to be limited to dispositions in which loss would otherwise be recognized. (For example, Treasury may wish to clarify that Section 961(d) is inapplicable to a liquidation of an STFC in a transaction governed by Section 332 with respect to the shareholder, as the shareholder's basis in the stock of the STFC is eliminated without the recognition of any gain or loss.) As indicated above, Treasury should also consider issuing guidance as to how Section 961(d) applies to the transferor and transferee of STFC stock in other nonrecognition transactions.

[111] If S did not distribute $20 to M in Example 11, while the numbers in the example would change, the ultimate results would not.

ii. Guidance to preserve effect of Section 961(d) in a consolidated group

Permitting M to have a positive investment adjustment for the allowance of the Section 245A participation exemption to S can result in a built-in or potential future loss in both the stock of an STFC and the stock of the member of a consolidated group that owns the STFC stock. Section 961(d) would apply to prevent the recognition of the loss if the STFC stock were sold, but it does not appear that the unified loss rules would prevent the recognition of the loss on the sale of the stock in the parent corporation.

> **<u>Example 12</u>—**STFC Dividends to Consolidated Subsidiary; Sale of Consolidated Subsidiary
>
> Assume the same facts as Example 11. After S makes the distribution to M, the stock of FC depreciates in value to $70, and M sells its stock in S for $70.
>
> If S sold FC for $70, S would have an initial loss of $10. However, for purposes of determining the loss, Section 961(d) would apply to reduce S's basis in the FC stock by the amount previously claimed as a Section 245A participation exemption with respect to the dividend previously received from FC, resulting in S not recognizing any gain or loss on the sale. Effectively, Section 961(d) operates to disallow S's loss on a subsequent sale of FC up the amount of the aggregate Section 245A participation exemption deductions previously allowed to S in respect of dividends from FC.

On M's sale of S, M would have an initial loss of $10 (amount received of $70 less adjusted basis of $80). Section 961(d) does not by its terms apply to this loss (because M did not receive any dividends from FC and is not disposing of FC stock), and, for the following reasons, the loss would not appear to be disallowed by the unified loss rules.

Generally, the unified loss rules, contained in Treasury Regulations section 1.1502-36, apply to prevent the recognition of noneconomic losses in connection with the transfer of stock in a member of a consolidated group by adjusting either the basis in the transferred stock or other tax attributes of the transferred subsidiary. The unified loss rules achieve this result primarily through two rules.[112] First, Treasury Regulations section 1.1502-36(c) reduces the basis in a share of transferred stock by the lesser of (a) the net positive adjustment with respect to such share (generally, the sum of all investment adjustments reflected in the basis of the share, but excluding negative adjustments for distributions, to the extent in excess of zero) and (b) the disconformity amount with respect to the share (generally, the excess, if any, of the transferring member's basis in the share over the share's allocable portion of the transferred subsidiary's net inside attribute amount). In the case of Example 12, the adjustment

[112] The unified loss rules also redetermine the basis in transferred stock to reduce the disparity between basis in various blocks of the transferred subsidiary's stock. *See* Treas. Reg. § 1.1502-36(b).

under Treasury Regulations section 1.1502-36(c) is zero, because M's basis in its S stock ($80) does not exceed S's basis in the stock of FC ($80)—even though S's basis in its FC stock is potentially subject to reduction under Section 961(d) on a later transfer of the FC stock.[113] Second, Treasury Regulations section 1.1502-36(d) prevents the duplication of loss by requiring either a reduction in the transferred subsidiary's inside attributes or, at the election of the taxpayer, a reduction in the basis of the transferred share, but in each case only to the extent of the "attribute reduction amount" with respect to the transferred subsidiary, which is generally the lesser of (i) the selling member's net loss in the transferred stock and (ii) the transferred subsidiary's aggregate inside loss (which is generally the excess of the transferred subsidiary's net inside attribute amount over the value of all of the transferred subsidiary's stock).[114] In this case, as a holding company, S has no assets or tax attributes to reduce other than its basis in the stock of FC. Reducing the basis of the FC stock would eliminate the built-in loss in that stock, but that loss is already subject to potential disallowance in the future under Section 961(d). The only real impact of this reduction would occur if the stock of FC appreciated in value and S sold the stock of FC, causing S to recognize more gain upon this sale than if the basis had not been reduced. Even if this increased gain is ultimately recognized, the increase merely prevents the duplication of the noneconomic loss and does not offset the loss claimed by M.[115]

These two rules are modified by operating rules that apply where previous adjustments to the basis of stock in a subsidiary or attributes of the subsidiary altered the relationship between the basis in the subsidiary stock ("outside basis") and the subsidiary's inside attributes, including its basis in its assets ("inside basis").[116] Treasury Regulations section 1.1502-36(e)(2)(iii) contains a broad catch-all rule that requires "appropriate adjustments" to be made, but only where an adjustment to the transferring member's basis in the stock of the transferred subsidiary or the subsidiary's net inside attributes alters the relationship between such amounts, and the adjustment does not relate to the extent to which loss reflected in the transferring member's basis in the stock of the transferred subsidiary is noneconomic or duplicated. In Example 10, neither the distributions nor the Section 245A participation exemption, although each affected outside and inside basis, altered the relationship between such amounts (M's outside basis in its S stock and S's basis in its stock in FC remain the same ($80) before and after the distributions)—a reduction in S's inside basis in its FC stock has not yet occurred, and will not occur, under Section 961(d) unless and until S later transfers its FC stock. As a result, it does not appear that Treasury Regulations section 1.1502-36(e)(2)(iii) would apply to M's transfer of S stock on these facts.

[113] Under Treasury Regulations section 1.1502-36(c)(5), S's net inside attribute amount is determined as of the transfer by M.

[114] Treas. Reg. § 1.1502-36(d)(3)(i).

[115] As in Example 11, if S did not distribute $20 to M prior to M's disposition of the S stock, while the numbers in Example 12 would change, the ultimate results would not.

[116] Treas. Reg. § 1.1502-36(e).

To address this issue, we recommend that guidance be issued which would provide for a special negative investment adjustment rule that would require M, when it sells the stock of S, to reduce its basis in the stock of S if, at such time, S would be required to reduce its basis in the stock of FC under Section 961(d) on a hypothetical sale by S of the stock of FC for fair market value. The amount of the reduction in the basis of the stock of S would be equal to the amount of loss that S would be unable to recognize on the hypothetical sale of stock of FC due to the application of Section 961(d). This is intended to achieve the same result, in computing M's basis in its S stock, for the year in which the sale of the S stock occurs, that would apply if S's basis in the FC stock had been reduced under Section 961(d), which would result in a noncapital, nondeductible amount that would be taken into account by M in determining its basis in the stock of S under Treasury Regulations section 1.1502-32, and therefore would be an investment adjustment taken into account in applying Treasury Regulations section 1.1502-36(c) to M.[117] In Example 12, our recommended basis adjustment would reduce the basis in the S stock by the amount of the loss that S would be prevented from recognizing due to Section 961(d) if S had sold the FC stock ($10). Thus, M's basis in the S stock would be reduced to $70, and M would not recognize any loss on the sale, correcting the basis disparity that arose as a result of the prior positive investment adjustment that occurred as a result of the application of the Section 245A participation exemption to S's receipt of the dividend from FC.

It is important to note that this special negative investment adjustment rule would apply even where M sells its stock in S at a gain.

> **Example 13—**STFC Dividends to Consolidated Subsidiary; Sale of Consolidated Subsidiary at a Gain
>
> Assume the same facts as Example 12, except that S also owns Asset X, which has a basis of $0 and a value of $40. M sells its stock in S for $110.

In Example 13, the unrealized $10 loss that S has in its FC stock effectively shelters an equivalent amount of built-in gain in Asset X, resulting in the recognition by M of only $30 of gain. By contrast, if S had sold both the stock of FC for $70 and Asset X for $40, for the reasons described above, S's $10 loss on the sale of the stock of FC would be effectively disallowed by Section 961(d), and S would have $40 of gain on the sale of Asset X, resulting in total net gain of $40. Therefore, in order to prevent M from effectively using a built-in loss in the stock of FC, which loss would be effectively disallowed to S on a direct disposition of FC stock under Section 961(d), to shelter gain on other assets owned by S and the value of which is reflected in the stock of S, it is

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[117] In concept, we expect this this rule would apply with respect to any STFC stock held by S or any lower-tier members of the consolidated group, although we recognize that the computations could be complex, for example, where such lower-tier members are not wholly-owned subsidiaries of S.

necessary to adjust M's basis on its disposition of S stock even if M disposes of its stock of S at a gain.[118]

We considered whether this issue could be addressed through an expansion of the unified loss rules, pursuant to which the portion of the loss on the sale of a member of a consolidated group that is attributable to a built-in loss in STFC stock resulting from dividends for which a Section 245A participation exemption was available would be disallowed through a reduction in the basis of the member. However, because, as indicated by Example 13, the basis inconsistency described above can manifest itself even where M disposes of S stock at a gain, and because the unified loss rules by their terms apply only where a transferred share of S stock is a loss share, we do not believe that the issue can be addressed completely through an expansion of the unified loss rules.

Finally, we note that, if the proposal described above is adopted, Treasury will also need to consider other, potentially complex, issues in implementing the proposal, including (i) whether, if M's basis in its S stock has been reduced as proposed above, a corresponding reduction to S's basis in the stock of the relevant STFC should be made, (ii) whether and to what extent Section 961(d) should continue to apply to S (to the extent of dividends received from STFCs while S was a member of the group) after S leaves the group in a circumstance where M's basis in its S stock has been reduced as proposed above,[119] and (iii) how the proposal should apply if, after M has received a positive investment adjustment in its S stock on account of a dividend received by S from an STFC, the STFC liquidates in a transaction governed by Section 332, thereby eliminating the future application of Section 961(d) with respect to S.

g. Clarification of "foreign-source portion"

As discussed above, the participation exemption is available only for the "foreign-source portion" of a dividend paid by an STFC. The foreign-source portion is the amount of the dividend corresponding to the percentage of the undistributed earnings of the STFC that are undistributed foreign earnings. Undistributed foreign earnings are all of the undistributed earnings of the STFC other than those attributable to (i) ECI that is subject to U.S. income tax or (ii) a dividend received by the STFC (or its wholly owned

[118] Under Treasury Regulations section 1.1502-36(a)(3)(i), the unified loss rules are applied if "after taking into account the effect of all applicable rules of law," the transferred share of S stock is a loss share (which is defined as a share of stock with a basis that exceeds its value). We would expect that our proposed negative investment adjustment would be taken into account prior to the application of the unified loss rules.

[119] Indeed, one could reasonably ask whether Section 961(d) should continue to apply to S (to the extent of dividends received from STFCs while S was a member of the group) after S leaves the group even where S does not have a built-in loss in its STFC and accordingly there is no reduction in M's basis under the proposed rule. In these circumstances, where the policy of Section 961(d) has been implemented through the proposed rule on M's sale of the stock of S, if the stock of the STFC later depreciates and S then sells the stock of the STFC at a loss, applying Section 961(d) to reduce or eliminate S's (and thus effectively the acquiror's) loss—an economic loss—as a result of dividends S received while it was a member of the prior group does not appear to serve any purpose sought to be achieved by Section 961(d).

foreign subsidiary) from a domestic corporation in which the STFC (or foreign subsidiary) owns at least 80 percent of the stock by vote and value.[120]

It would seem based on these rules that the foreign-source portion of the dividend includes earnings attributable to income that is not foreign-source income under the Code. For example, such income would include all U.S.-source income other than ECI (and dividends described in (ii) above). Moreover, such income would also appear to include ECI (both U.S.-source and foreign-source) that is exempt from U.S. income tax under an applicable tax treaty because it is not attributable to a permanent establishment in the United States. Because these results are somewhat counterintuitive, we would recommend that Treasury issue guidance regarding the treatment of earnings that are attributable to these types of income for purposes of Section 245A.

h. Hybrid dividend rules of Section 245A(e)

The hybrid dividend rules are designed to prevent a dividend from qualifying for the Section 245A participation exemption for which the CFC paying the dividend receives "a deduction (or other tax benefit)" with respect to any income, war profits or excess profits tax imposed by any foreign country or U.S. possession.[121] The rule is intended to prevent the "double non-inclusion" of income[122] in both the payor and payee jurisdictions.[123] However, the application of Section 245A(e)(4)(B) is unclear as it relates to the treatment of distributions under certain foreign tax regimes.

i. Tax benefit to shareholders, not CFC

In certain cases, foreign law may provide a tax benefit to the shareholder receiving a dividend from a CFC that is economically equivalent to the CFC receiving a

[120] Section 245A(c)(3) (referencing Section 245(a)(5)).

[121] *See* Conference Committee Report at 599-600.

[122] *See* OECD Hybrid Mismatch Report, *supra* note 15, Ch. 3; Nicolaus McBee & Ken Brewer, *U.S. International Tax Reform: The Good, the Bad, and the GILTI*, 159 TAX NOTES 839, 840 (2017) (noting that the design "clearly applies to traditional stock instruments when the payor is a resident of a country that allows a deduction for dividends paid").

[123] *See* Conference Committee Report at 600. We note that there is the potential for "circularity" in the analysis of whether a dividend is a hybrid dividend under Section 245A(e)(4) if a foreign jurisdiction that otherwise would allow a deduction under local law for a payment made by the payor CFC does not allow such deduction if the payment is exempt from tax in the jurisdiction of the recipient (*e.g.*, because the recipient jurisdiction treats the payment as a dividend as to which a participation exemption generally applies), while at the same time the jurisdiction of the recipient does not exempt the payment from tax if the payor is allowed a deduction for the payment. As described above in note 12, under the OECD Hybrid Mismatch Report, it appears that the OECD has recommended that the primary rule be that the payee jurisdiction should not grant an exemption for the dividend. Therefore, if Treasury adopts the approach recommended by the OECD, it would determine whether a dividend was a hybrid dividend under Section 245A(e)(4) without regard to the application of any anti-hybrid rules in the country of the CFC payor. In any event, regardless of which approach Treasury adopts, Treasury should consider issuing clarifying guidance.

deduction. For example, Maltese law allows a shareholder to receive a refund for a portion of, or the entirety of, the tax paid by a Maltese corporation to Malta with respect to a dividend.[124] Where the shareholder is a non-resident of Malta, the net economic result of the refund is generally that any income paid by a Maltese corporation as a dividend is excluded from Maltese income tax.[125] Because the refund is owed to the shareholder rather than the foreign corporation, it appears to fall outside of the ambit of Section 245A(e)(4)(B), where the plain language requires the CFC *itself* to receive a deduction or other tax benefit. Treasury should promulgate guidance regarding whether a dividend is treated as a hybrid dividend where a deduction or other tax benefit accrues to a related party, rather than to the CFC directly, under foreign tax law. From an economic standpoint the CFC and its shareholders would appear to be in substantially the same position whether it is the CFC or its shareholder that receives the tax benefit under local law. In these circumstances, it would seem appropriate for Treasury to use its authority under Section 245A(g) to issue guidance to the effect that the requirement of Section 245A(e)(4)(B) is satisfied if a shareholder, rather than the payor CFC itself, receives the tax benefit.

ii. Deduction results in tax detriment to shareholders

Foreign law may permit the CFC to claim a deduction for all or part of a dividend paid to its shareholders but require an offsetting tax detriment to the shareholder. For example, in Brazil, a corporation may elect to treat a dividend distribution as interest on net equity up to the lesser of 50% of annual profits or the long-term interest rate times the total capital invested in the company. While the corporation receives a deduction for corporate income tax purposes for the portion of the dividend distribution treated as interest (at a 34% corporate income tax rate), a non-resident shareholder is subject to withholding tax of 15% (or 25% if the shareholder is resident in a tax haven) on such portion, which would otherwise not be subject to any Brazilian withholding tax. The net effect is to reduce the aggregate Brazilian tax on the portion of the distribution treated as interest by up to 19%. In these circumstances, guidance is needed on two questions. First, guidance should address, in the case where the amount of a deduction or other tax benefit received by the payor CFC in respect of a dividend is only partial (for example, where the deduction received is less than the full amount of the dividend, whether the entire dividend is a hybrid dividend for purposes of Section 245A, or only a portion of the dividend (*e.g.*, up to the amount of the deduction) is a hybrid dividend for such purposes. In these circumstances, it would seem appropriate for only the appropriate portion of the dividend to be treated as a hybrid dividend for purposes of Section 245A. Second, guidance is necessary to address whether and to what extent, in the case where a deduction or other tax benefit received by the payor CFC on a dividend is offset, in whole or in part, by a tax detriment (such as the imposition of a withholding tax on the recipient of the dividend), an adjustment should be made to the amount of the dividend otherwise

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[124] *See* Chapter 123 of the Laws of Malta, § 4(1); Chapter 372 of the Laws of Malta, § 4(b).

[125] No tax is imposed on the dividend with respect to a non-resident of Malta. *See* Chapter 123 of the Laws of Malta, § 60.

treated as a hybrid dividend for purposes of Section 245A to take into account the tax detriment incurred. For reasons similar to the reasoning set forth in Part IV.h.i above with respect to the situation in which a shareholder, rather than the payor CFC, receives a tax benefit in respect of a dividend paid by the CFC, it would seem appropriate to take into account, in determining the extent to which a dividend should be treated as a hybrid dividend, any tax detriment suffered by the shareholder that corresponds to the tax benefit enjoyed by the payor CFC and which, from the standpoint of the shareholder and the CFC in the aggregate, reduces or eliminates the overall tax benefit in respect of the dividend.

iii. Prior accrual of a deduction

An additional question would be presented by a foreign tax regime that permits a CFC to accrue and claim a "notional interest" deduction on its net equity, without regard to the amount or timing of any dividend payments paid. We recommend that Treasury issue guidance addressing whether these deductions, or similar deductions based on net equity that do not depend on the timing or amounts of any dividend payments, come within the ambit of the anti-hybrid dividend rule and, if so, how the rule applies in such situations.

For example, Treasury will need to address how to identify whether a particular deduction is associated with a particular dividend, and then address the fact that, in many cases, the relevant deduction will arise in a different tax year than the tax year in which the related dividend is paid. Where the deduction accrues in a prior year, it is known before the U.S. tax return reporting the dividend is due, and therefore the taxpayer has all the needed information to determine whether it is entitled to a participation exemption. Where the deduction accrues in a later year, and would therefore not be certain before the due date for the tax return reporting the participation exemption, the taxpayer does not know whether it is eligible for a participation exemption, and guidance is needed.

i. Guidance on determination of deductions "properly allocable or apportioned" to income with respect to stock of an STFC or to stock of an STFC under Section 904(b)(4)

As noted above, for purposes of the foreign tax credit limitation, Section 904(b)(4)[126] carves out from foreign-source income not only the foreign-source portion of dividends received from an STFC, but also any deductions that are "properly allocable or apportioned" (i) to income with respect to stock of the STFC or (ii) to stock of the STFC, to the extent that income with respect to such stock is other than amounts includable under Sections 951(a)(1) or 951A(a). While detailed guidance exists on how to properly allocate interest expense under Section 904,[127] and the Conference Committee

[126] Section 904(b)(4) was added by the Act as Section 904(b)(5) and later renumbered in a technical correction bill. Pub. L. No. 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.

[127] Treas. Reg. § 1.904-5(c).

Report applies the principles of Section 904 to determine foreign taxes that are "properly attributable" for GILTI purposes, no guidance is provided in the Conference Committee Report or the Code on the proper allocation or apportionment of deductions for the purpose of Section 904(b)(4).[128]

[128] *See* NYSBA GILTI Report, at 75-79. *See also id.* at 18 (recommending clarification that Section 864(e)(3), which prevents allocation of expense to stock that gives rise to exempt income, would not apply to stock of a CFC that gives rise to dividends eligible for Section 245A participation exemption).