Report No. 1406

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON PROPOSED GILTI REGULATIONS

November 26, 2018

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I. Introduction

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

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

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

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

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

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

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

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

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

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

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

II. Summary of Principal Recommendations and Comments[8]

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

10. We believe the methods of allocating QBAI and tested losses in the Proposed Regulations are reasonable. If no class of stock has liquidation value, we recommend first allocating tested loss to any shareholders that have guaranteed debt of the CFC, and then to the most senior class of common stock, unless another class of stock will in fact bear the economic loss. Also, QBAI should be allocated to participating preferred stock by bifurcating the stock into nonparticipating preferred stock and common stock. Part III.B.2(c).

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

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

12. As we stated in our Prior Report, we strongly believe that net operating losses should be allowed as a carryforward either at the CFC or shareholder levels. In addition, assuming future regulations state that Section 163(j) applies to CFCs,

regulations should confirm that interest deductions deferred under Section 163(j) are not subject to any restrictions on loss carryovers, since the deductions are deemed to arise in future years. Part III.C.2(a).

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

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

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

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

D. Proposed Regulation Section 1.951A-3: QBAI

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

18. Regulations should confirm that the use of ADS for GILTI purposes, for either new or preexisting assets, is not a change in method of accounting, or if it is a change in method, global approval should be given for such a change. Part III.D.2(a).

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

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

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

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

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

F. Proposed Regulation Section 1.951A-5: Partnerships

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

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

25. If the Proposed Regulations Hybrid Approach is adopted, and a partnership does not provide for pro rata ownership of partnership capital and profits, regulations should clarify the manner in which a partner is determined to be a U.S. shareholder of a CFC owned by the partnership. At a minimum, partnership level determinations should be binding on the partner. Part III.F.2(b)(iv).

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

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

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

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

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

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

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

Part IV: Basis Issues

A. Introduction

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

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

33. The CFC basis reduction rule reduces the tax basis of a CFC immediately before its sale by the net used tested loss amount of the CFC. If this rule or a similar rule will be retained in the final regulations, we suggest that the Treasury request a statutory amendment to confirm its authority to issue regulations to modify the basis rules of

Section 961. In addition, to support the validity of the regulations under the Administrative Procedure Act, the preamble to the final regulations should (i) further explain the nature of the double tax benefit from a tested loss that the rule is designed to prevent, and (ii) if applicable in the final regulations, explain why the rule applies to all used tested losses without regard to whether a double tax benefit from the tested loss is obtained by the U.S. shareholder. Part IV.B.2(b).

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

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

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

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

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

39. The definition of "disposition", which triggers the CFC basis reduction rule, should include a Section 165(g) worthless stock deduction. We discuss, but do not take a position on, whether Sections 301(c)(2), 301(c)(3), and 1059 should apply to distributions from a CFC by reference to the reduced basis of the CFC stock that would arise upon sale of the CFC. Part IV.B.3(e).

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

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

42. Regulations should confirm certain aspects of a rule that specially

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

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

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

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

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

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

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

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

48. We support the approach of the Proposed Regulations to immediately reduce the basis of the stock of a member holding stock in a CFC by the net used tested loss amount in the CFC. Part IV.D.2(a). However, any exceptions that are added to the CFC basis reduction rule should also be incorporated into this rule. Part IV.D.2(b).

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

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

51. The Proposed Regulations provide for a basis increase in member stock just before the member’s sale of a CFC, to the extent the CFC has offset tested income

and could have paid a dividend eligible for Section 245A. Regulations should clarify that this rule does not apply to the member if it joins a new group and then sells the CFC. Part IV.D.2(e).

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

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

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

55. Regulations should clarify whether the reduction in a member's basis in the stock of another member on account of the latter's net used tested loss amount of a CFC reduces the e&p of the former member. Correspondingly, if no such reduction in e&p arises, regulations should confirm that there is no increase in the former member's e&p on the disposition of the CFC as a result of the CFC basis reduction rule. Part IV.D.2(l).

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

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

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

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

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

E. Basis Issues in Intra-Group Reorganizations

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

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

F. General Basis Issues Under the Proposed Regulations

63. Regulations should determine the extent to which all shares of a CFC owned by a single U.S. shareholder are aggregated and treated as a single share, or else treated as separate shares with their own net used tested loss amounts and net offset tested income amounts. We believe that all shares of a single class held by a single U.S. shareholder should be aggregated, with an anti-abuse rule for transactions in shares undertaken with a principal purpose of tax avoidance. We do not believe common stock and preferred stock held by a U.S. shareholder should be aggregated. Part IV.F.1.

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

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

G. Our Preferred Approaches to Avoid Loss Duplication

66. We believe that either of our two alternative approaches to basis reduction

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

III. General Discussion and Recommendations

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

1. *Background*

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

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

For purposes of the Hypothetical Distribution, distributions within each class of stock are assumed to be made pro rata with respect to each share of stock in that class.[12] Distributions between classes of stock are generally based on the "distribution rights of

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[9] Prop Reg. § 1.951A-1(d)(1).

[10] Prop Reg. § 1.951-1(e)(1)(i).

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

[12] Prop Reg. § 1.951-1(e)(2)-(3).

each class of stock on the hypothetical distribution date . . . taking into account all facts and circumstances related to the economic rights and interest" in current e&p of that class.[13] Certain legal rights, however, are limited or disregarded in calculating the Hypothetical Distribution, including (i) rights to redemption, (ii) dividends that accrue at less than the applicable federal rate ("**AFR**") and (iii) other restrictions and limitations on distributions.[14]

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

2. *Comments*

(a) *The Anti-Avoidance Rule*

The Anti-Avoidance Rule states the following:

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

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

The location of the Anti-Avoidance Rule in the Proposed Regulations, as well as the heading of the section,[16] suggests that it is intended to be limited to transactions or arrangements that distort allocations of a fixed amount of Subpart F income (or a CFC tested item) among CFC shareholders. Under this construction, the IRS's sole remedy

[13] Prop Reg. § 1.951-1(e)(3).

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

[15] Prop Reg. § 1.951-1(e)(6).

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

for a breach of the rule would be to reallocate reported income among shareholders to eliminate the distortion created by the relevant transaction or arrangement. In other words, the IRS would not be able to challenge the aggregate amount of Subpart F income (or CFC tested item), but only the manner in which such amount is allocated. Similarly, under this interpretation, the rule would be limited to reallocations of income of the CFC among the *actual* Section 958(a) U.S. shareholders of the CFC. In particular, the rule would not allow the IRS to allege that a transfer of CFC stock by a U.S. shareholder to a related or unrelated third party had a principal purpose of the avoidance of tax, with the result that the income of the CFC should be allocated to the former shareholder (possibly forever). This interpretation of the rule is consistent with the heading of the rule quoted above, and the passing mention of the rule in the Preamble. We believe this is the appropriate scope of the rule.

However, the plain language of the Anti-Avoidance Rule arguably extends the rule much farther. The rule would disregard “any transaction or arrangement that is part of a plan a principal purpose of which is avoidance of Federal income taxation” in calculating a U.S. shareholder’s share of a CFC’s Subpart F income (or CFC tested item). This language can be interpreted to extend beyond transactions that affect the sharing of items among shareholders, to transactions that reduce the total amount of income that would be allocable by the CFC or that shift income allocations to new shareholders. For instance, the rule could apply to the purchase (rather than lease) of QBAI property by a single CFC, or alternatively a CFC raising funds by a borrowing rather than by an equity contribution from its shareholders. In both cases, the result could be a reduction in the GILTI inclusion of the shareholders and thus “the avoidance of Federal income taxation” by the shareholders.

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

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

We acknowledge that the Treasury might have concerns about transfers of ownership, particularly among related parties, for the purpose of avoiding Subpart F or

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

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

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

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

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

Thus, even if the narrow interpretation of the regulation is adopted, we believe the final regulation should not apply to transactions occurring before the general effective date of the final regulation. In fact, this issue should not arise to a material degree under GILTI, because there could not have been an intent to avoid the GILTI regime much before the date of enactment of the Act. As to the application of the narrow rule to

[18] Likewise, we do not believe the Proposed Regulations should apply to mid-year sales of CFC stock with an alleged principal purpose of avoiding tax on the seller's share of Subpart F or tested income for the year of sale. *See* Prior Report at 50-58. This is a mechanical problem that should be fixed, if desired by the Treasury, by a specific regulation or statutory change applicable to all taxpayers, rather than by an anti-abuse rule that depends on the motive for a sale. *See, e.g.*, Section 1377(a)(1) (taxing a shareholder of an S corporation on its pro rata share of income of the S corporation for its entire taxable year, without regard to ownership of the stock on any particular day during the year).

[19] Prop. Reg. § 1.951-1(i).

Subpart F, the regulation could apply to transactions before the date of publication of the Proposed Regulations only if the regulation qualified under Section 7805(b)(3) as a regulation to prevent abuse. However, few if any Treasury Regulations have been issued in reliance on this provision, and we question whether this regulation is critical enough to justify its application to transactions before the date the Proposed Regulations were published.

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

(b) *Hypothetical Redeeming Distributions*

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

> **Example 1.** *Hypothetical redeeming distributions.* FC1 has outstanding 40 shares of common stock and 10 shares of 4% nonparticipating, voting preferred stock with a par value of $50x per share. Pursuant to the terms of the preferred stock, FC1 has the right to redeem at any time, in whole or in part, the preferred stock. FC2 owns all of the preferred shares. USP1, wholly owned by FC2, owns all of the common shares. For Year 1, FC1 has $100x of e&p and $100x of Subpart F income within the meaning of Section 952. In Year 1, FC1 distributes as a dividend $20x to FC2 with respect to FC2's preferred shares.
>
> **Analysis.** If FC1 were treated as having redeemed any preferred shares, the redemption would be treated as a distribution to which Section 301 applies under Section 302(d) due to FC2's constructive ownership of the common shares. However, under paragraph (e)(4)(i) of this section, no

> amount of e&p is distributed in the Hypothetical Distribution to the preferred shareholders on the date of the Hypothetical Distribution as a result of FC1's right to redeem, in whole or in part, the preferred shares. FC1's redemption rights with respect to the preferred shares cannot affect the distribution of current e&p in the Hypothetical Distribution to FC1's shareholders. As a result, the amount of FC1's current e&p distributed in the Hypothetical Distribution with respect to FC2's preferred shares is $20x and with respect to USP1's common shares is $80x. Accordingly, under paragraph (e)(1) of this section, USP1's pro rata share of FC1's Subpart F income is $80x for Year 1.

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

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

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

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

(c) *Preferred Stock with Low Dividend Rate*

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

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

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

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

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

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

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

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

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

1. *Background*

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

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

[20] Prop Reg. § 1.951A-1(c)(1).

[21] Prop Reg. § 1.951A-1(c)(2).

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

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

2. *Comments*

(a) *Interest Expense and Interest Income*

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

Second, Section 951A(b)(2)(B) reduces DTIR of a U.S. shareholder by interest expense that reduces tested income (or increases tested loss) of the shareholder, except to the extent interest income "attributable" to that expense is included in tested income of the U.S. shareholder. At a minimum, this means that if a CFC pays interest to anyone, the interest expense would generally be specified interest that reduces NDTIR, but if the interest is paid to a CFC that has the same shareholder, so that it increases the tested

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

[23] *See* Prior Report at 62.

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

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

income from that CFC allocated to the same shareholder, then the interest expense is not specified interest and does not reduce the shareholder's NDTIR. This rule makes sense because there is no net tax benefit to the shareholder from the interest expense so there is no logical reason to reduce the shareholder's NDTIR by the expense.

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

This result arguably makes sense as a policy matter. It appears that the purpose of the rule for specified interest expense is that debt-financed assets should not count as QBAI, with "first dollars" of debt being allocated to QBAI. Since money is fungible, it can be argued that the appropriate measure of debt-financing for QBAI would be the net debt of all the shareholder's CFCs, or net interest expense of those CFCs, rather than gross interest expense paid to unrelated parties. (On the other hand, it can also be argued that a CFC by CFC approach, except for debt between CFCs, as provided in the statute also makes sense.) The Preamble further justifies the result in the Proposed Regulations on the ground that a requirement to trace interest income to interest expense would be administratively burdensome, especially if different CFCs are held by different U.S. shareholders.[26]

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

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

> **Example 3.** *Interest on debt to U.S. shareholder.* USP owns all the stock of CFC1. At the beginning of Year 1, USP loans $100 to CFC1 at an interest rate of 10%. In Year 1, assume CFC1 has $100 of gross tested

[26] Federal Register GILTI at 51078.

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

> income, $90 of DTIR, and $10 of interest expense on the loan from USP. USP will have net CFC tested income of $90 and NDTIR of $80, resulting in a GILTI inclusion amount of $10. USP will also have $10 of interest income attributable to the loan.

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

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

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

(b) *Taxable Year of GILTI Inclusion*

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

> **Example 4.** *Timing of GILTI inclusion.* USP, a calendar-year taxpayer, owns all of the stock of CFC1, a June 30 taxpayer. On December 31,

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

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

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

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

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

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

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

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

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

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

> **Example 6.** *Inability to determine U.S. shareholder status as of CFC inclusion date.* Assume the same facts as Example 4, but that FC sells the stock of CFC1 to USP2, an unrelated U.S. corporation, on June 29, 2019. Under the Proposed Regulations, the CFC inclusion date is now June 30, 2019. Thus, USP2 must include its share of the CFC tested items of CFC1 on its 2019 tax return, rather than USP including its share of those items on its 2018 tax return.

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

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

We note that the pro rata share of the tested income of a CFC for a CFC inclusion year to be allocated to a U.S. shareholder is based on the U.S. shareholder's stock ownership on the CFC inclusion date.[31] However, while this rule is necessary to

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

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

determine the *pro rata amount* to be allocated to the U.S. shareholder that has sold its stock on that date, this is not relevant for determining the *timing* of the inclusion to the U.S. shareholder.

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

(c) *Allocations of QBAI and Tested Loss*

The Preamble requests comments on "proposed approaches for determining a U.S. shareholder's pro rata share of a CFC's QBAI and tested loss, including how (or whether) to allocate tested loss of a CFC when no class of CFC stock has positive liquidation value."[32] We offer several comments on this topic.

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

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

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

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

[32] Federal Register GILTI at 51074.

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

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

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

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

Fourth, the Proposed Regulations should be revised to provide a rule for the allocation of QBAI with respect to convertible preferred stock or participating preferred stock. This is stock that has a fixed dividend and minimum liquidation value, but participates in increases in value above a stated floor in a manner comparable to common stock. Logically, this stock should be bifurcated into preferred stock (to the extent of the

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

fixed dividend and liquidation right) and common stock (to the extent that the participation right is "in the money"), and QBAI should be allocated to each piece separately. For example, the 10x limit should apply to the fixed portion of the preferred stock, and the excess QBAI should be allocated to both the regular common stock and the participating portion of the preferred stock.

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

1. *Background*

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

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

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

2. *Comments*

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

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

As noted in the Preamble, Treasury Regulation Section 1.952-2 generally requires that tested income or tested loss of a CFC be determined by treating the CFC as a

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[34] Prop. Reg. § 1.951A-2(c)(2).

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

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

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

First, Treasury Regulation Section 1.952-2(c)(5)(ii) states that net operating loss ("**NOL**") carryforwards are not taken into account for purposes of calculating Subpart F income. By application of this regulation to GILTI, NOL carryforwards cannot be taken into account in calculating tested income, so no NOL carryforwards are allowed at all under GILTI. As discussed in the Prior Report, this rule might make sense under Subpart F, which is limited to e&p and reduces Subpart F income by qualified deficits,[38] but we do not believe it is the proper rule under GILTI, which has neither such concept.

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

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

We continue to prefer a carryforward of NOLs at the U.S. shareholder level, as recommended in the Prior Report. We acknowledge, however, as we did in the Prior

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[36] Treas. Reg. § 1.952-2(a).

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

[38] *See* Prior Report at 35.

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

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

In any event, assuming future regulations state that Section 163(j) applies to CFCs, regulations should also confirm that interest disallowed under Section 163(j) is not subject to any restrictions on loss carryovers. The statute treats such interest as incurred in the following year, and in the following year it is not an NOL deduction under Section 172. Additional issues arise under Section 163(j) that are beyond the scope of the Proposed Regulations but should be covered in subsequent regulations.[40]

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

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

(b) *Disqualified Basis from Transition Period Transfers*

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

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

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

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

To deal with this possibility, Proposed Regulation Section 1.951A-2(c)(5) disallows a deduction or loss attributable to "**disqualified basis**", which is basis resulting from the transfer between two related CFCs of certain depreciable or amortizable property ("**specified property**") during the transition period. This exclusion does not apply to the extent the selling CFC had effectively connected income on the transfer, or the U.S. shareholder recognized Subpart F income as a result of the transfer.

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

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

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

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

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

[45] Conference Report at 645.

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

> **Example 8.** *Amortization of disqualified basis.* CFC1 has an intangible asset with a basis of $150 and sells it to CFC2 for $300 during the transition period. Assume that CFC2 is required to amortize the $300 basis over a new 15-year holding period, or $20 per year. The disqualified basis is the $150 basis step up, which is half of the asset's total basis.

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

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

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

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

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

[46] Prop. Reg. § 1.951A-2(c)(5)(i).

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

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

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

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

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

The Proposed Regulations illustrate the rule with an example. In year 1, the CFC has $100 of what would be Subpart F income (referred to herein as "**notional Subpart F income**"), and a non-Subpart F loss that reduces e&p to $0. In year 2, the CFC has $100

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

of tested income and $100 of e&p. The example states that there is no Subpart F income in year 1 because of the e&p limitation in Section 952(c)(1)(A). In year 2, there is $100 of Subpart F income under Section 952(c)(2) because of the e&p in year 2, and there is also $100 of tested income.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

D. Proposed Regulation Section 1.951A-3: QBAI

1. *Background*

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

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

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

2. *Comments*

(a) *Application of Alternative Depreciation System*

We are concerned about the complexity created by applying ADS to all specified tangible property placed in service before enactment of the Act. While CFCs may

[48] Prop. Reg. § 1.951A-3(c)(1).

[49] Prop. Reg. § 1.951A-3(e).

already use the ADS system to determine depreciation on much of their specified tangible property, the Preamble acknowledges that this will not always be the case. Therefore, taxpayers will be required to recalculate the basis of all non-ADS specified tangible property at the effective date of the GILTI rules as if they were already being depreciated under ADS, solely for purposes of calculating QBAI.

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

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

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

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

[50] Federal Register GILTI at 51076.

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

(b) *Anti-Abuse Rules*

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

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

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

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

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item in the immediately preceding year) to compute the taxpayer's taxable income for the immediately preceding taxable year."

[52] Conference Report at 645.

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

Given that there is similar uncertainty with the "a principal purpose" standard that is a prerequisite for the Temporary Ownership Rule, we urge the Treasury to adopt a presumption that, if specified tangible property is held by a CFC for more than a specified period of time, the Temporary Ownership Rule will not apply. The specified period would logically be a fixed period of time (e.g., 2 or 3 years). We considered the possibility of a period of time based on a percentage (such as 25% or 33%) of the depreciable life of the asset, but we do not think that the depreciable life of an asset is related to the question of whether use of the asset is "temporary."

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

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

> **Example 10.** *One-Year Rule.* CFC1 has specified tangible property that it purchased on January 1, 2019. On November 30, 2019, CFC1 sells the specified tangible property after deciding that the asset (or the entire related business) is not working out. The specified tangible property does not count towards CFC1's QBAI calculation. The same result would arise even if CFC1 replaced the sold property with other specified tangible property with the same or a higher tax basis, and the aggregate holding period of both properties was more than a year.
>
> **Example 11.** *One-Year Rule applies to seller of CFC because of post-sale disposition of CFC assets.* CFC1 has specified tangible property that it purchased on January 1, 2019. On November 30, 2019, USP1, CFC1's sole shareholder, sells its stock in CFC1 to a non-U.S. person, and CFC1 ceases to be a CFC. The purchaser causes CFC1 to sell the specified tangible property on December 15, 2019. USP1 has the GILTI inclusion

for 2019, but the specified tangible property does not count towards CFC1's QBAI calculation for USP1.

Example 12. *One-Year Rule applies to buyer of CFC because of post-sale disposition of CFC assets.* Same as Example 11, except USP1 sells the stock of CFC1 to a U.S. purchaser USP2 and CFC1 remains a CFC for all of 2019. USP2 has the GILTI inclusion for 2019. The GILTI inclusion disregards the QBAI attributable to the specified tangible property, since that property was held for less than one year, even though it was acquired prior to USP2's acquisition of CFC1.

Example 13. *One-Year Rule applies to seller of entity because of Section 338(g) election.* CFC1 has specified tangible property that it purchased on January 1, 2019. On November 30, 2019, CFC1's sole shareholder USP1 sells the stock of CFC1 to USP2, and USP2 makes a Section 338(g) election with respect to the sale. The specified tangible property does not count towards CFC1's QBAI calculation for USP1.

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

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

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

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

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

> **Example 15**. *No decrease in GILTI inclusion amount from related-party transfer of specified tangible property*. USP owns CFC1, which purchases specified tangible property on January 1, 2019. On September 30, 2019, CFC1 either (1) transfers the property to its wholly owned subsidiary CFC2 in a Section 351 transaction, or (2) sells the property to a related CFC2 wholly owned by USP for an amount less than or equal to its QBAI tax basis on that date. CFC2 holds the property for a period beyond January 1, 2020.

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

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

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

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

Proposed Regulation Section 1.951A-4 provides rules for determining tested interest expense and tested interest income of a CFC. "Interest expense" is defined broadly to include any expense or loss treated as interest under the Code, in addition to any other expense or loss incurred in one or more related transactions in which "the use of funds is secured for a period of time," if such expense or loss is "predominantly incurred in consideration for the time value of money."[53] "Interest income" has a comparably broad definition that picks up interest and interest equivalents.[54]

However, Section 951A(b)(2)(B) refers only to interest income and interest expense, not to interest equivalents. If the Treasury intends to adopt the position of the Proposed Regulations, we believe it should request an amendment to the statute to include interest equivalents, or to authorize regulations to include interest equivalents, for this purpose.[55] Since the regulations cover both interest income and interest expense, there is a particular risk of whipsaw to the government unless the validity of the regulations is clear.

F. Proposed Regulation Section 1.951A-5: Partnerships

1. *Alternative Approaches to CFCs Held by Partnerships*

Proposed Regulation Section 1.951A-5 provides rules for determining the GILTI inclusion amount for partners of a domestic partnership, where the partnership itself is a U.S. shareholder of a CFC (a "**U.S. shareholder partnership**" and such a CFC, a "**partnership CFC**"). Any particular partner of a U.S. shareholder partnership may itself be a U.S. shareholder with respect to any particular partnership CFC (a "**U.S. shareholder partner**") or may not itself be a U.S. shareholder with respect to any particular partnership CFC (a **non-U.S. shareholder partner**").

Before discussing the Proposed Regulations in detail, we describe four possible ways that the GILTI rules could be applied to a partnership CFC. We start with the approach that treats the partnership most as an entity, and gradually move to the approach that treats the partnership most as an aggregate of its partners.

(a) *The Pure Entity Approach*

Under a pure entity approach (the "**Pure Entity Approach**"), a U.S. shareholder partnership would calculate a single GILTI inclusion amount with respect to its entire ownership interest in all partnership CFCs, and then allocate to each partner its distributive share of that GILTI inclusion amount. The CFC tested items that make up the partner's share of the partnership GILTI inclusion amount cannot be aggregated with any items of the partner attributable to CFCs it holds outside of the partnership ("**non-**

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[53] Prop. Reg. § 1.951A-4(b)(1)(ii).

[54] Prop. Reg. § 1.951A-4(b)(2)(ii).

[55] *See* NYSBA Tax Section Report No. 1393, *Report on Section 163(j)* (March 28, 2018), at 13 (discussing the authority for proposed regulations that take the same position for purposes of Section 163(j)).

partnership CFCs"), regardless of whether the partner is itself a U.S. shareholder of the partnership CFCs or non-partnership CFCs.

(b) *The Proposed Regulations Hybrid Approach*

The Proposed Regulations do not adopt a pure aggregate or pure entity approach for all partners of a U.S. shareholder partnership. Rather, they adopt a hybrid approach (the "**Proposed Regulations Hybrid Approach**") under which aggregate principles apply to U.S. shareholder partners of a partnership CFC, and entity principles apply to non-U.S. shareholder partners of a partnership CFC.[56]

More specifically, if any partners of the U.S. shareholder partnership are non-U.S. shareholder partners for all the partnership CFCs, the U.S. shareholder partnership calculates a single GILTI inclusion amount with respect to all the partnership CFCs. The partnership then allocates to each such partner that partner's distributive share of the partnership's GILTI inclusion amount. As in the Pure Entity Approach, these partners cannot aggregate the CFC tested items—e.g., tested income or NDTIR—from the partnership with other CFC tested items (notably including tested loss) that they have based on their ownership of non-partnership CFCs.

By contrast, if a partner of a U.S. shareholder partnership is a U.S. shareholder partner with respect to a particular partnership CFC, the U.S. shareholder partner treats the U.S. shareholder partnership as a foreign partnership with respect to that CFC. The U.S. shareholder partner is then deemed to directly hold its indirect interest in the particular partnership CFC under Section 958(a). The U.S. shareholder partner includes its distributive share of CFC tested items of the particular CFC on its partner-level calculation of its GILTI inclusion amount. That calculation includes the U.S. shareholder's non-partnership CFCs, so that the shareholder can aggregate, say, tested losses from the partnership CFC with tested income from a non-partnership CFC.

If a partner of a U.S. shareholder partnership is a U.S. shareholder partner with respect to some, but not all, of the partnership CFCs, the U.S. shareholder partnership must recalculate its own GILTI inclusion amount for that partner. That calculation takes into account the CFC tested items only for those CFCs with respect to which the partner is a non-U.S. shareholder partner. The partner takes into account the CFC tested items from the CFCs for which it is a U.S. shareholder partner, and its share of the partnership level GILTI inclusion that only takes into account the CFCs for which it is a non-U.S. shareholder partner.

(c) *The Prior Report Hybrid Approach*

In the Prior Report, we suggested an alternative hybrid approach (the "**Prior Report Hybrid Approach**"). First, the domestic partnership is treated as an entity for

[56] Prop. Reg. § 1.951A-5(c).

purposes of determining whether its foreign corporate subsidiaries qualify as CFCs and, therefore, whether CFC tested items should be taken into account by its partners.[57] Then, aggregate principles apply to treat these CFC tested items as included in the partner-level calculation of the GILTI inclusion amount for each partner, regardless of whether a partner is itself a U.S. shareholder. This approach allows all partners to aggregate CFC tested items of partnership CFCs with CFC tested items of non-partnership CFCs.[58]

(d) *The Pure Aggregate Approach*

Under a pure aggregate approach (the "**Pure Aggregate Approach**"), all partners look through the domestic partnership in determining whether they are U.S. shareholders of a partnership CFC, in the same manner that they would look through a foreign partnership. The status of a domestic partnership as a U.S. shareholder is irrelevant. If they are themselves U.S. shareholders, partners are treated as in the Proposed Regulations Hybrid Approach and the Prior Report Hybrid Approach. If they are not themselves U.S. shareholders, they do not include in their calculation of the GILTI inclusion amount any CFC tested items from the partnership CFCs.

(e) *Summary of Approaches*

The four approaches described above can be illustrated in the following example:

[57] Prior Report at 91.

[58] As discussed in the Prior Report at 86-87, we would also allow a corporation that is not a U.S. shareholder of a CFC to claim FTCs and Section 250 deductions with respect to tested income of the CFC passed through from the partnership. Both are available to a domestic corporation without a requirement that the corporation be a U.S. shareholder, and, in any event, the only reason the corporation has a GILTI inclusion from the partnership is because the partnership is a U.S. shareholder.

Example 16. *Outcomes under different partnership approaches.* PRS is a U.S. shareholder partnership that wholly owns one partnership CFC, CFC1. CFC1 has tested income of $100 and no other CFC tested items. PRS has two domestic partners, X Corp (a 95% partner) and Y Corp (a 5% partner). The outcome of each of the four approaches is summarized in the following chart:

	X Corp.	Y Corp.
Pure Entity Approach	$95 GILTI inclusion amount	$5 GILTI inclusion amount
Proposed Regulations Hybrid Approach	$95 tested income	$5 GILTI inclusion amount
Prior Report Hybrid Approach	$95 tested income	$5 tested income
Pure Aggregate Approach	$95 tested income	no income inclusion

The Preamble asks for comments on whether approaches other than the Proposed Regulations Hybrid Approach, including the Pure Entity Approach and the Pure Aggregate Approach, would more appropriately harmonize the provisions of the GILTI regime, particularly in light of the compliance and administrative burdens of the various approaches.[59]

2. *Discussion of Alternative Approaches*

(a) *Pure Aggregate Approach*

As a policy matter, we reiterate our preference for the Pure Aggregate Approach as stated in a 2007 report.[60] We believe that approach better carries out the purposes of the GILTI and Subpart F rules, since the purposes of those rules are unrelated to the question of whether stock in a foreign corporation is owned by a U.S. or a foreign partnership. We therefore believe that no GILTI calculation should be made at the partnership level, and a domestic partnership owning stock in a foreign corporation should be looked through (just as is a foreign partnership) in determining whether a foreign corporation is a CFC and in testing for a partner's status as a U.S. shareholder of a CFC.

The current tax regime, under which the status of a foreign corporation as a CFC can be elective depending on whether the corporation is held through a domestic or foreign partnership, is difficult to justify on policy grounds. The current rules also

[59] Federal Register GILTI at 51080.

[60] NYSBA Tax Section Report No. 1124, *Report on Differences between Domestic and Foreign Partnerships* (January 3, 2007), at 11 (the **"2007 Report"**).

encourage nonproductive tax planning to avoid CFC status, or to avoid CFC inclusions by U.S. persons that are not themselves U.S. shareholders of a CFC, by causing a foreign corporation to be held by a foreign rather than domestic partnership.

We acknowledge that the Pure Aggregate Approach is inconsistent with Treasury Regulation Section 1.701-2(f), Example 3, adopted almost 25 years ago, which treats a U.S. partnership as a U.S. shareholder of a CFC regardless of the nature of its partners. It may also be inconsistent with Section 7701(a)(30), which states that a U.S. person includes a domestic partnership. In fact, taxpayers often rely on the example in the Section 701 regulations to treat a CFC owned by a U.S. shareholder partnership as a CFC rather than a PFIC, and the IRS has issued private letter rulings confirming this position.[61]

Moreover, the drafters of Section 951A presumably were aware of this background when they determined that inclusions under Section 951A are to be treated in the same manner as Subpart F inclusions. There is no indication that Congress intended either to adopt a rule for partnership shareholders of CFCs under GILTI that was different than the rule under Subpart F, or to change the rules applicable to both GILTI and Subpart F. Indeed, it would be even more inconsistent with the structure of Sections 951 and 951A, or with the statutory definition of CFC and U.S. shareholder and their use throughout the Code, if a particular foreign corporation could be a CFC for Subpart F purposes and not for GILTI purposes. Perhaps for these reasons, the Preamble rejects the Pure Aggregate Approach on the basis that such a result is "not clearly contemplated in [S]ection 951A or its legislative history and is inconsistent with [S]ection 951."[62]

However, Section 951A places significantly more weight than before on the characterization of domestic partnerships as U.S. shareholders of CFCs. In particular, (1) gross tested income is significantly more expansive than Subpart F income, (2) calculating the GILTI inclusion amount is significantly more complicated than calculating a Subpart F inclusion, and (3) in the context of GILTI, a significant portion of the calculations are done at the U.S. shareholder level.

Likewise, from the point of view of a non-U.S. shareholder partner of a U.S. shareholder partnership, the amount at stake in applying entity rather than aggregate principles is far higher than before, since all tested income rather than only Subpart F income is now taxable to a U.S. shareholder. The stakes are particularly high for an individual and possibly corporate non-U.S. shareholder partner that would not be entitled to a Section 250 deduction under an entity or hybrid approach to partnerships. We therefore believe that this is an appropriate time for the issue to be reconsidered.

[61] *See, e.g*, PLR 201106003 (Feb. 11, 2011); PLR 200943004 (Oct. 23, 2009).

[62] Federal Register GILTI at 51079. In the 2007 Report, we also stated that we believed that adoption of the Pure Aggregate Approach would require a legislative change. 2007 Report at 10.

The authority for a reconsideration of this issue by regulations would include the fact that general entity/aggregate principles have applied to partnerships at least since the enactment of the Internal Revenue Code of 1954 and are reflected in the legislative history thereof.[63] These principles are now codified in Treasury Regulation Section 1.701-2, which states that entity or aggregate principles should apply based on the purpose of the applicable rule.

For example, in 2007, the Treasury adopted Treasury Regulation Section 1.871-14(g)(3) under the portfolio interest rules. This regulation applies aggregate principles to look through a domestic or foreign partnership to determine if a non-U.S. partner is a 10% shareholder of a U.S. corporation owned by the partnership. A 10% shareholder of the U.S. corporation is ineligible for the portfolio interest exception to withholding tax on interest paid by the corporation.

Although that regulation did not change a long-established rule to the contrary, the greatly increased significance of the entity/aggregate issue in light of the enactment of GILTI seems to provide a "new" occasion to reconsider the issue. Finally, when Congress indicated that it was treating GILTI inclusions in the same way as Subpart F income, there is no indication that it was focusing on the existing noneconomic rule for domestic partnerships.

Moreover, even aside from general entity/aggregate principles, Section 7701(a)(4) states that the term "domestic", when applied to a partnership, means a partnership created or organized under the laws of the United States or a state thereof, "*unless . . . the Secretary provides otherwise by regulations*" (emphasis added). This exception has not been interpreted by the Treasury to be limited to recharacterization of domestic partnerships for all purposes of the Code. Rather, it was recently relied upon by the Treasury in adopting temporary regulations to require an otherwise domestic partnership to be treated as a foreign partnership for purposes of a particular Code provision.[64]

Likewise, Notice 2010-41, Section 4.01, relies on Section 7701(a)(4) to state that regulations will be issued to treat certain domestic partnerships owned by foreign corporations as foreign partnerships solely for purposes of certain Subpart F inclusion provisions of the Code. In fact, the Proposed Regulations themselves implement this rule

[63] "Both the House provisions and the Senate amendment provide for the use of the 'entity' approach in the treatment of the transactions between a partner and a partnership which are described above. No inference is intended, however, that a partnership is to be considered as a separate entity for the purpose of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions." H.R. Conf. Rep. No. 2543, 83rd Cong., 2d Sess. 59 (1954).

[64] Treas. Reg. § 1.721(c)-6T(b)(4) treats a domestic partnership as foreign solely for purposes of certain partnership reporting provisions. T.D. 9814, Jan. 23, 2017; Section X(a) of its preamble explains that this provision is based on Section 7701(a)(4).

for purposes of Subpart F, and expand it to GILTI.[65] The Preamble states that this rule is based on Notice 2010-41,[66] which as noted above is itself based on Section 7701(a)(4).[67]

Therefore, the Treasury already believes that at least in some circumstances, including circumstances involving Subpart F and GILTI, it is appropriate to issue regulations under Section 7701(a)(4) treating a domestic partnership as foreign. While the application of Section 7701(a)(4) has been limited so far to much narrower fact patterns, arguably the same authority could be used to treat a domestic partnership as foreign for purposes of determining the existence of a CFC and of a U.S. shareholder of a CFC for purposes of the Subpart F and GILTI provisions of the Code.

Nevertheless, if the Treasury desires to implement the Pure Aggregate Approach but believe that it does not have the authority to do so by regulations, we urge it to request a statutory amendment to adopt this approach or to authorize regulations that would do so.

However, as noted above, taxpayers now often rely on the existing rule for domestic partnerships in order to treat a foreign corporation owned by a domestic partnership as a CFC rather than a PFIC. It would be unfair to such taxpayers to change suddenly the rule for existing foreign corporations treated as CFCs, so that the CFCs would become PFICs. As a result, if future legislation or regulations adopt the Pure Aggregate Approach, we believe that generous grandfather provisions should apply to allow existing foreign corporations that are held by domestic partnerships and treated as CFCs under the existing rules to continue to be so treated, either permanently or at least for an extended period of time such as 10 years. Domestic partnerships holding grandfathered CFCs (not discussed further herein) would need to be subject to one of the approaches other than the Pure Aggregate Approach during the grandfather period. In any event, a regulation issued in reliance on Section 7701(a)(4) could only apply to partnerships organized after the regulation was proposed.[68]

(b) *Proposed Regulations Hybrid Approach*

If the Pure Aggregate Approach is not adopted, then non-U.S. shareholder partners of a Partnership CFC will be taxed, in one way or another, on their share of GILTI income from the CFC. In any particular U.S. shareholder partnership, there might

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[65] Prop. Reg. § 1.951-1(h).

[66] Federal Register GILTI at 51082.

[67] Separate proposed regulations would adopt the same rule for purposes of Section 965. *See* Prop. Reg. § 1.965-1(e).

[68] Section 7701(a)(4) was amended by P.L. 105-34 to allow regulations to change the status of domestic partnerships, but Section 1151(b) of that Public Law states that regulations under that provision can only apply to partnerships organized after the date determined under Section 7805(b) without regard to (b)(2).

be a large number of these partners, each owning a small percentage of the U.S. shareholder partnership. The Prior Report Hybrid Approach (discussed below) will require these partners to make their own GILTI calculations, even if they own no interests in any CFC except through the partnership. The major advantage of the Proposed Regulations Hybrid Approach, as compared to the Prior Report Hybrid Approach, is that these calculations are all done by the U.S. shareholder partnership, and a simple GILTI inclusion number is passed through to the non-U.S. shareholder partners.

We do not minimize the administrative benefit provided by this aspect of the Proposed Regulations. However, we see a number of problems with the Proposed Regulations Hybrid Approach.

(i) *Lack of Ability to Offset at the Partner Level*

A partner that is a non-U.S. shareholder partner of one or more partnership CFCs must include in income its share of the partnership GILTI inclusion amount for those CFCs, even if the partner has unused tested losses or excess NDTIR from non-partnership CFCs. The non-U.S. shareholder partner of one or more partnership CFCs will also lose the opportunity to use tested losses or NDTIR from those CFCs against tested income from non-partnership CFCs. This inability to offset will also exist for partnership CFCs held through different domestic partnerships. These results are unfair and uneconomic to the non-U.S. shareholder partners. They will also be greatly exacerbated if tested losses cannot be carried over, at either the shareholder or CFC level.

(ii) *Procedural Complexity*

The Proposed Regulations Hybrid Approach requires a U.S. shareholder partnership to determine whether each of its partners is a U.S. shareholder partner or a non-U.S. shareholder partner for each partnership CFC. In many cases, this will require the U.S. shareholder partnership to determine whether and to what extent each of its partners has separately held interests in each partnership CFC—directly and through attribution—and how these amounts change over time. The partnership needs to know the information in order to calculate the partnership level GILTI inclusion amount for each of its partners. Many partners will not be willing to give this information to their partnerships and should not be required to do so.

One way of addressing this problem would be to permit a partner that is U.S. shareholder partner of a partnership CFC, but whose interest in such CFC held through the partnership would not itself make it a U.S. shareholder partner of the CFC, to disregard its separately held ownership in the partnership CFC. This would allow such U.S. shareholder partner to accept its share of the partnership's GILTI inclusion amount (instead of its share of the partnership's CFC tested items). However, this could lead to tax planning opportunities, since segregation of partnership-level CFC tested items can be more favorable to the partner than an aggregate approach.

This problem could also be avoided if the U.S. shareholder partnership did not make its own calculation of a GILTI inclusion amount, but rather was required to pass through, to all its partners, the component parts of its partnership-level GILTI inclusion amount calculation. Each partner would be required to make its own *partnership-level* calculation of the GILTI inclusion amount, excluding those partnership CFCs for which it is itself a U.S. shareholder, and incorporate the remaining partnership CFCs into its *partner-level* calculation of the GILTI inclusion amount. This would reach the same dollar result as the Proposed Regulations, but the calculations would always be done at the partner level. However, if this were the end result, we see no reason to adopt this general approach instead of the Prior Report Hybrid Approach, discussed in Part III.F.2(c).

(iii) *Computational Complexity*

The Proposed Regulations Hybrid Approach can also create enormous computational complexity. Any U.S. shareholder partnership could have numerous partnership CFCs, and its partners could themselves be U.S. shareholders for any combination of those CFCs. As a result, a separate, personalized partnership-level calculation of GILTI inclusion for each partner would be required, taking into account only the partnership CFCs for which the partner is a non-U.S. shareholder. The number of required calculations could be very high, and these calculations could produce results for particular partners that are higher or lower than the baseline partnership-level GILTI inclusion amount.

Consider a simple example:

> **Example 17.** *Possible calculations of partnership GILTI inclusion amount.* PRS is a U.S. shareholder partnership that owns 50% of each of two partnership CFCs, CFC1 and CFC2. The partnership's share of CFC1's tested income is $50, and the partnership's share of CFC2's tested income is $100; there are no other CFC tested items. The partnership has a partnership level GILTI inclusion of $150. However, any particular partner might be required to report its pro rata share of a partnership GILTI inclusion of $0 (if it is a U.S. shareholder partner of both CFCs), $50 (if it is a U.S. shareholder partner of CFC2 only), $100 (if it is a U.S. shareholder partner of CFC1 only), or $150 (if it is not a U.S. shareholder partner of either CFC). Note also that if CFC1 instead had a tested loss of $100, the partnership level GILTI inclusion from CFC1 alone would be $0, but the partnership level tested income and tested loss calculation for individual partners for CFC1 alone could range from $100 of tested loss to $100 of tested income.

Indeed, if there are *n* partnership CFCs, there are ($2^n – 1$) possible partnership-level calculations of GILTI inclusion amounts for individual partners. This number reflects every potential combination of partnership CFCs for which one or more partners is a U.S. shareholder and the other partners are not.[69] The possible number of computations increases quickly with the number of partnerships CFCs—there are 31 potential calculations with five partnership CFCs, and 1,023 calculations with 10 CFCs. While the need for such a large number of calculations would likely rarely arise in practice, and the total number of calculations would never exceed the number of partners, the mere possibility of this need raises serious questions about the administrability of the general approach.

The Proposed Regulations also do not discuss the consequences for a partner of a U.S. shareholder partnership whose status shifts from being a U.S. shareholder partner of a CFC to being a non-U.S. shareholder partner of a CFC, or vice versa. This could arise either from a purchase or sale by the partner itself of equity in the partnership or of stock in a partnership CFC, or by the purchase or sale by the partnership of stock in a partnership CFC. This change in status would mean shifting from entity to aggregate treatment, or vice versa. It seems that a fairly complex set of rules would be needed, since CFC attributes that had been "locked up" within the partnership (e.g., net used tested loss amounts in a CFC) would now become partner attributes, or vice versa. The methodology for calculating basis in the partnership, and in the CFC, would also change.

(iv) *Allocation Issues*

In order to apply the Proposed Regulations Hybrid Approach, the U.S. shareholder partnership must first determine which of its partners are U.S. shareholder partners of each partnership CFC. As discussed in the 2007 Report,[70] it is unclear how this determination should be made in the absence of pro rata ownership of capital and profits over the life of the partnership. At a minimum, the U.S. shareholder partnership's determination of a partner's indirect ownership of a CFC should be binding on its partners to ensure that the government is not whipsawed. In addition, it would be helpful if regulations addressed whether this determination should be made based on each year's rights to capital or earnings, or based on projected future rights as determined either initially or as adjusted over time.[71]

In addition, if a partner is a non-U.S. shareholder partner of one or more partnership CFCs, it must report its share of the partnership level GILTI inclusion

[69] These numbers do not include the computation for the case where no partner of the partnership is a U.S. shareholder of any partnership CFC.

[70] 2007 Report at 8.

[71] There are also significant questions about how to measure a partner's rights to partnership capital and profits for purposes of these rules. For instance, in determining a partner's right to partnership capital, should the partnership use Section 704(b) capital, or capital upon a hypothetical liquidation at fair market value? Similarly, would a partner's right to partnership profits be based on allocations of Section 704(b) income or taxable income, and how would chargebacks of losses be taken into account? We note that, because similar issues present themselves any time stock is held through a partnership, any resolution for purposes of the GILTI rules could have broader implications throughout the Code.

calculated on its behalf. In the absence of pro rata ownership of partnership capital and profits, potentially this inclusion item could be allocated in the same manner that an increase in the Section 704(b) book value of the stock of the CFC (equal to the amount of the partnership-level GILTI inclusion) would be allocated upon a revaluation of partnership assets.

However, this could be quite complex, because the partnership-level GILTI inclusion for different partners can be different because the inclusion for each partner only takes account of the partnership CFCs for which the particular partner is not a U.S. shareholder. It is also unclear how overall partnership priority allocations can be taken into account in allocating the partnership level GILTI inclusion when there may be a different total partnership level GILTI inclusion to be allocated to different partners, and when U.S. shareholder partners of particular CFCs are reporting partnership income from those CFCs on a basis that is completely different than non-U.S. shareholder partners.

(v) *Interaction with Partnership Audit Rules*

Layered on top of these enormously complicated rules are the partnership audit rules enacted as part of the Bipartisan Budget Act of 2015.[72] Many of these computations—including the individualized calculations of the partnership's GILTI inclusion amount and basis adjustments—would be partnership items subject to audit at the partnership level. It would be enormously difficult for the IRS audit division to deal with these items, especially with respect to those determinations that are partly made at the partnership level and partly at the partner level.

For example, if a partner is a U.S. shareholder of a partnership CFC, and the items of the CFC passing through from the partnership to the partner are considered subject to partnership level audit, then some of the numbers going into the U.S. shareholder's calculation of a single GILTI inclusion amount will be subject to audit of the partnership under the partnership audit rules. Yet the items passing to the shareholder from CFCs held directly by the shareholder (or through other partnerships) will be subject to an entirely separate audit. Regulations should maximize the scope of items that will be subject to partnership-level audit, to prevent the need for multiple audits of individual partners to the extent possible.

(vi) *Incentive for Foreign Partnerships*

The Proposed Regulations Hybrid Approach can be avoided if a partnership that will hold CFCs is formed as a foreign partnership, or if an existing domestic partnership is redomiciled as a foreign partnership. The complexity of the Proposed Regulations Hybrid Approach may increase the incentives to use foreign rather than domestic partnerships. This will have the additional consequence of eliminating current GILTI

[72] *See* Sections 6221-6241.

inclusions for non-U.S. shareholders of partnership CFCs, since the foreign partnership will not itself be a U.S. shareholder of a CFC.

(vii) *Tax Basis*

The treatment of tax basis under the Proposed Regulations Hybrid Approach will be enormously complex. We believe the complexity will be greater than under the Prior Report Hybrid Approach because of the mixture of calculations required by the Proposed Regulations Hybrid Approach at both the partnership and partner levels. These calculations affect both the basis of each partner in its partnership interest and the partnership's basis in each CFC with respect to each partner.

If a partner is a non-U.S. shareholder partner of one or more partnership CFCs, the partner should clearly increase its outside tax basis in the U.S. shareholder partnership by the amount of any partnership level GILTI inclusion amount allocated to it. Similarly, since entity principles apply, under Section 961(a), the partnership's inside basis in the partnership CFCs should be increased to the extent of any GILTI inclusion amount determined at the partnership level and allocated to such partners under Proposed Regulation Section 1.951A-6(b)(2). Moreover, as discussed in Part IV.B.3(i), the partnership should disregard the CFC basis adjustment rule under Proposed Regulation Section 1.951A-6(e) in determining its gain or loss allocable to such partners on a sale of a CFC, because these partners will not be entitled to a Section 245A deduction on distributions from the CFC.

The treatment of U.S. shareholder partners is even more complex. Suppose the U.S. shareholder partnership allocates tested income to a U.S. shareholder partner and the partner does not have tested loss or NDTIR to offset that amount. The resulting GILTI inclusion amount should be treated comparably to a Subpart F inclusion of the partnership that is allocated to the U.S. shareholder partner, and therefore increase the partner's outside basis in its partnership interest. This should be the case even though the allocation is not an allocation of partnership income.

Suppose, instead, that the U.S. shareholder partner has tested income from the partnership that is fully offset by tested losses or NDTIR allocated to it from a non-partnership CFC. Arguably, the U.S. shareholder partner should get outside-basis credit for the tested income, provided that such partner could claim a deduction under Section 245A if the CFC paid a dividend to the partnership and Section 1059 would not apply to the dividend. Such a rule is similar to "Rule 3" discussed in Part IV.D.1 in the consolidated return context, and would preserve the benefit to the partner of the exempt income from the CFC if the partner sells the partnership interest. This rule would also avoid the need for "self-help" (through payment of a dividend from a CFC to the partnership) to achieve the same basis increase in the partnership interest by having the CFC make a tax-free distribution to the partnership.

On the other hand, such outside-basis credit in the partnership interest seems peculiar when no taxable income is passed through from the partnership. In that connection, it is not clear why a loss should be allowed to the extent it arises from the increase in tax basis. Such a result would be inconsistent with Section 1248, which recharacterizes gain to the extent of untaxed e&p but, if the gain is less than the amount of untaxed e&p, does not allow the creation of untaxed gain and a deductible loss.

Instead of such a basis increase, another approach would be to have the partner's sale of the partnership interest give rise to Section 1248 gain, and for the Section 751 amount relating to Section 1248 to be eligible for dividend treatment under Section 245A. This approach seems more appropriate than a basis increase for untaxed income. It puts the partner in a position similar to the position of holding the stock in the CFC directly, and either selling the stock or contributing it to the partnership after taking into account the CFC tested items of the CFC.

The authorities do not support the treatment of the Section 751 amount in this situation as a dividend.[73] However, those authorities arose before the enactment of Section 1248(j), which clearly contemplates that gain on sale of the stock of a CFC that is attributable to untaxed earnings of the CFC should be eligible for Section 245A. We urge that regulations treat the Section 751 amount arising under Section 1248 as a dividend eligible for Section 245A.[74]

Suppose next that the U.S. shareholder partner has a net used tested loss amount (defined below) in a partnership CFC at the time the partner sells its partnership interest. As discussed in Part IV.B.3(i), under Proposed Regulation Section 1.951A-6(e), a U.S. shareholder directly owning stock of a CFC in this circumstance would reduce its basis in the CFC immediately before the sale of the stock by such amount. Logically the partner should reduce its basis in the partnership interest by this amount immediately before selling the interest, or else a U.S. shareholder of a CFC could routinely avoid the tax cost of that regulation by holding a CFC through a partnership.

Such a basis reduction in the partnership interest is analogous to Rule 1 (discussed in Part IV.D.1) in the consolidated return context, which requires an immediate basis

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[73] Gain on the sale of stock of a foreign corporation that is subject to Section 1248 is treated as an unrealized receivable under Section 751(c), so that gain realized on the sale of a domestic partnership interest, to extent attributable to such stock (a "Section 751(c) amount"), has been treated by the Treasury as ordinary income but not as a dividend. *See* T.D. 9345, Federal Register Vol. 72, No. 145, July 30, 2007, 41442-41450 at 41443; T.D. 9644, Federal Register Vol. 78, No. 231, Dec. 2, 2013, 72394-72449 at 72419-20. The correctness of this view under current law is beyond the scope of this Report.

[74] Other issues will also arise if the partner that is a U.S. shareholder of the CFC receives untaxed tested income through the partnership. For example, rules would be needed for the treatment of capital accounts and Section 704(b) book value of the stock in the CFC. This would be particularly complicated if some partners were U.S. shareholders of a particular CFC and other partners were not, and because the same income of a partnership CFC might be taxable tested income to some U.S. shareholder partners and offset tested income to other U.S. shareholder partners. These rules would be far more complicated than today's rules for CFCs owned through a domestic or foreign partnership, because the Subpart F rules do not involve the aggregation of CFCs at either the partnership or partner levels.

reduction in the stock of a member of a consolidated group to reflect the net used tested loss amount of a CFC held by the member. The basis reduction is also analogous to Proposed Regulation Section 1.951A-6(e)(1)(iii), which requires a reduction in the basis of the equity in a foreign entity (other than a CFC), when the foreign entity holds stock in a CFC with a net used tested loss amount and the U.S. shareholder of the CFC sells the equity in the foreign entity.

A technical way to reach this result would be to require the partnership to reduce its basis in the CFC, with respect to a selling partner, by the partner's net used tested loss amount in the CFC, and then to treat the basis reduction as a noncapital, nondeductible expense of the partnership under Section 705(a)(2)(B) allocable to the selling partner. This would reduce the selling partner's basis in the partnership interest accordingly.

Turn now to the calculation of the U.S. shareholder partnership's basis in partnership CFCs. Pure entity principles cannot apply, since they would create enormous disparities depending on whether a U.S. shareholder partner held its interest directly or through a partnership.

> **Example 18.** *Partnership's inside basis in tested income CFC.* PRS is a U.S. shareholder partnership that wholly owns one partnership CFC, CFC1. PRS has one 50% corporate partner, USP1, and ten 5% partners. USP1 separately owns 100% of CFC2. In Year 1, CFC1 has tested income of $100x and CFC2 has tested loss of $50; neither has any other CFC tested items.

Under the Proposed Regulations, PRS's own GILTI inclusion amount is $100, of which $50 is allocated to the non-U.S. shareholder partners. Separately, USP1 is allocated $50 of tested income, which is fully offset by the tested loss of separately-owned CFC2. If pure entity principles applied, PRS's basis in CFC1 would increase by $100. However, if USP1 directly held its indirect interest in CFC1, there would be no basis increase, so the aggregate basis increase in CFC1 would be $50.

The disparity in basis results is even greater if the partnership CFC has a tested loss.

> **Example 19.** *Partnership's inside basis in tested loss CFC stock.* Assume the same facts as Example 18, but that, in Year 1, CFC1 has tested loss of $100 and CFC2 has tested income of $50. After Year 1, PRS sells CFC1 to a third party.

Under pure entity principles, the sale of CFC1 would not trigger any downward basis adjustment under Proposed Regulation Section 1.951A-6(e), since CFC1's tested loss did not offset the tested income of any partnership CFCs. However, from the perspective of USP1, USP1's $50 share of the tested loss of CFC1 was used to offset $50 of tested income from CFC2, and so its allocable share of basis in CFC1 should be reduced by $50. It is therefore necessary to separately compute the basis of USP1 in

CFC1 to give effect to the aggregate treatment accorded to USP1 under Proposed Regulation Section 1.951A-5(c).

As a result, it seems necessary for a U.S. shareholder partnership to be treated as having a separate basis in each partnership CFC with respect to each partner, as follows:

1. For CFCs for which a particular partner is a non-U.S. shareholder partner, the partnership's basis in each such CFC with respect to such partner is determined based on the personalized partnership-level GILTI inclusion amount calculated for that partner.

2. For each CFC for which a particular partner is a U.S. shareholder partner, the partnership's basis for such partner in each such CFC is determined as if such partner owned the CFC directly.

3. To the extent a particular U.S. shareholder partner is treated as having a net used tested loss amount in a partnership CFC, the partnership must be treated as having reduced its basis in the CFC with respect to such partner by such amount immediately before a disposition of the CFC. The U.S. shareholder partner would have to tell the partnership whether it had used a tested loss of the partnership CFC against its own tested income.

Under these rules, even if none of the partners is a U.S. shareholder with respect to a particular CFC, the partnership could have different bases in the CFC stock with respect to different partners, because of the potential status of those partners as U.S. shareholders of other partnership CFCs. The reason is that the individualized partnership-level GILTI calculations to different partners might make different use of the tested income and tested loss of the particular CFC. Moreover, a U.S. shareholder partnership will frequently not know its basis in some or all of its partnership CFCs with respect to some or all of its partners. The separate basis for each partner will depend on (i) whether the partner is a U.S. shareholder partner of the particular CFC, (ii) if so, whether it is able to utilize the tested losses of the partnership CFC in the calculation of its own GILTI inclusion amounts, and (iii) if not, whether or not it is a U.S. shareholder in other partnership CFCs.

Separate bases will create considerable complexity. If a purchaser buys a partnership interest without a Section 754 election being in effect, does the purchaser succeed to the basis that the selling partner had in each of the partnership CFCs? If a partnership distributes stock in a partnership CFC to a partner in a nonliquidating distribution, what does it mean for Section 732 to give the partner a carryover tax basis in the distributed property?

These rules will also increase the complexity of applying Sections 734 and 743 to partnership CFCs. For example, if Section 754 applies to a partner's purchase of its partnership interest, normally the partner would be treated as having a basis in the stock of each partnership CFC equal to the portion of the purchase price allocated to that stock.

Logically this rule should apply even to a partnership CFC for which the particular partner is a non-U.S. shareholder, even though the partnership computes a GILTI inclusion for that partner with respect to that CFC at the partnership level.

However, as discussed in the preceding paragraph, the partnership may have a different tax basis in each CFC with respect to each partner, and this basis will need to be taken into account in determining the amount of the Section 754 step up for the particular CFC for the particular partner. This determination will be particularly complicated where a U.S. shareholder partner sells some or all of its partnership interest to a non-U.S. shareholder partner and, as a result, transforms the (now former) non-U.S. shareholder partner into a U.S. shareholder of a partnership CFC. Finally, it is also not clear how Section 734 can be applied to a distribution of a CFC to a partner, when the partnership may have a different basis in that CFC with respect to each partner.

Implementing these rules would be extremely complicated, although some of these issues might come up today with CFCs held through a foreign partnership. The partnership would calculate the basis of each partnership CFC for each non-U.S. shareholder partner of the CFC. This calculation would require a separate running determination of the various partnership GILTI inclusion amounts for each such partner. (Fortunately, there would be no need for the partnership to track used tested losses and offset tested income of a CFC for these calculations, assuming as we discuss elsewhere that those concepts are not applicable to partners of a partnership that are not themselves U.S. shareholders of the CFC.) The calculation of basis of a partnership CFC for U.S. shareholder partners of the CFC would have to be done by the partners rather than the partnership, because the basis depends upon tested income, tested loss and NDTIR of other CFCs owned by the partner.

(c) *Prior Report Hybrid Approach*

The Preamble rejects the Prior Report Hybrid Approach because it might "be interpreted by taxpayers to exempt small partners of a domestic partnership from the GILTI regime entirely."[75] We do not understand this reasoning. Regulations adopting such an approach could explicitly state that partners of a U.S. shareholder partnership are required to report their share of CFC tested items regardless of their percentage ownership of the partnership.

Rather, we view the trade-offs between the Prior Report Hybrid Approach and the Proposed Regulations Hybrid Approach to be the following. The Prior Report Hybrid Approach has the major benefit of allowing non-U.S. shareholder partners of a U.S. shareholder partnership to aggregate the CFC tested items arising from partnership CFCs with other CFC tested items arising from non-partnership CFCs. This approach does not materially increase the complexity to them of GILTI tax reporting, since they are already making a GILTI calculation based on the CFC tested items of their non-partnership

[75] Federal Register GILTI at 51079.

CFCs. Adding additional CFCs to the calculation does not materially increase the complexity of the calculation.

However, this benefit under the Prior Report Hybrid Approach to non-U.S. shareholder partners that own non-partnership CFCs is offset by the increased complexity of tax filing obligations under that approach to non-U.S. shareholder partners that do not own any non-partnership CFCs. Those partners are not obtaining any economic benefit under the Prior Report Hybrid Approach, yet under that approach they must calculate their own GILTI inclusions based on the CFC tested items of the partnership CFCs, rather than receiving a simple pass-through allocation of a partnership GILTI inclusion.

On an overall basis, we view the Proposed Regulations Hybrid Approach as being more complex than the Prior Report Hybrid Approach. This is largely, as discussed above, because of the complexity of the GILTI calculations and basis calculations that might be required under that approach. While we do not believe that the Prior Report Hybrid Approach could be characterized as simple, we believe that on an overall basis, it is significantly less complex than the Proposed Regulations Hybrid Approach.

We also believe that the Prior Report Hybrid Approach could be made less burdensome to small partners of U.S. shareholder partnerships. For example, regulations might permit partners to irrevocably elect into the Pure Entity Approach, subject to an anti-abuse rule, if they own less than a de minimis share of the partnership (e.g., 2%). This would permit small partners avoid individualized calculations of the GILTI inclusion amount and outside basis. Given a small de minimis threshold and an anti-abuse rule, the potential for abuse (and the potential revenue loss to the fisc even in nonabusive situations) seems limited, even if the election were allowed on a partnership-by-partnership basis.

(d) *Pure Entity Approach*

The Pure Entity Approach is by far the simplest. However, it is clearly rejected in the Preamble,[76] and, we believe, for good reasons. The Preamble recognizes that fragmenting the ownership of U.S. shareholder partners in partnership CFCs can significantly change results under Section 951A, which presents an "inappropriate planning opportunity as well as trap for the unwary."[77] We agree that the Pure Entity Approach is unfair to U.S. shareholder partners because it does not allow aggregation with CFC tested items from outside the partnership. We rejected this approach in the Prior Report and we continue to agree that it should not be adopted.

We acknowledge that this approach would be similar to the existing treatment of Subpart F income under Section 951. However, Subpart F does not involve the blending

[76] Federal Register GILTI at 51079.

[77] *Id.*

of CFC-level items such as tested income and loss, NDTIR, and specified interest income and expense at the shareholder level, so that approach under Subpart F does not create the discontinuities that it would create for GILTI.

(e) *Conclusions*

As a policy matter, we support the Pure Aggregate Approach. If this approach is not adopted, we do not take a position between the Proposed Regulations Hybrid Approach and the Prior Report Hybrid Approach. While the reporting obligations under the former approach will be simpler for many partners in U.S. shareholder partnerships, that approach will also be less fair to many such partners that own interests in CFCs through more than one partnership, or both through partnerships and directly. The Proposed Regulations Hybrid Approach also introduces complexities at the partnership level that are not present in the Prior Report Hybrid Approach. We do not support the Pure Entity Approach.

Finally, whichever approach is adopted, it is essential that the same rules apply for both Subpart F and GILTI. Moreover, under any approach, final regulations should clarify that the partnership rules are unchanged except for the purposes of calculating Subpart F income and GILTI inclusions. For example, all items that are ordinarily determined at the partnership level, such as deductions of the partnership, should be determined on an entity basis, just as today.

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

This section of the Report discusses aspects of the -51 regulation that do not relate to tax basis. Tax basis issues are discussed in Part IV.

1. *Background*

The Proposed Regulations determine how GILTI inclusions are calculated by members of a consolidated group. In general, the aggregate of the GILTI inclusions by group members will be the same as if the group was a single corporation. We strongly commend the Treasury for adopting this approach. The Prior Report discussed the potential disadvantages to taxpayers, and the possibility for taxpayers to engage in nonproductive tax planning, in the absence of such single entity treatment for a consolidated group.[78] We urge that no changes be made in the final regulations that will weaken this single entity treatment.

The following terminology will be used in this section and the remainder of the Report:

(a) P is the parent of a consolidated group.

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[78] Prior Report at 17-27.

> (b) M is a member of the group. If more than one member is involved, they will be referred to as M1, M2, etc. For simplicity, unless otherwise indicated, any M is a first tier wholly owned subsidiary of P.

Each member of the group is allocated the tested income arising from the stock it owns in CFCs with positive tested income (a tested income CFC). All tested losses from CFCs with tested losses (a tested loss CFC), NDTIR from tested income CFCs, and specified interest are aggregated, and then reattributed back to the members with tested income in proportion to that tested income. Each member then calculates its own GILTI inclusion.[79]

> **Example 20**. *Allocation of tested loss in a group*. M1 owns CFC1 with $100 of tested income and CFC2 with $100 of tested loss. M2 owns CFC3 with $100 of tested income. M1 and M2 each retains its gross tested income of $100. However, the tested loss of CFC2 is allocated 50% to M1 and 50% to M2, even though M1 owns 100% of CFC2. As a result, M1 and M2 each has a GILTI inclusion of $50. The same would be true if CFC2 was instead a subsidiary of CFC1, or CFC1 was instead a subsidiary of CFC2, or if CFC2 was instead owned by M2.

As discussed in Part IV, the CFC basis reduction rule applies to reduce the tax basis of the stock of the CFC in the hands of a member, upon the member's disposition of the stock, by the member's net used tested loss amount in the stock.[80] However, for a CFC owned by any group member, used tested losses and offset tested income are calculated and apportioned on a group-wide basis taking account of the reallocation of tested losses.[81] In Example 20, CFC1 and CFC3 each has offset tested income of $50, and CFC2 has a used tested loss of $100.

2. *Comments*

(a) *Foreign Tax Credits and Section 250*

It is critical that the single entity treatment arising under the Proposed Regulations also apply to foreign tax credits and the Section 250 deduction. It is important, therefore, that future regulations allow a group to have an FTC based on the overall tested income of tested income CFCs of the group, the overall tested loss of tested loss CFCs, the overall foreign taxes paid by tested income CFCs, and an overall inclusion percentage for the group under Section 960(d)(2).

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[79] Prop. Reg. § 1.1502-51(b).

[80] Prop. Reg. § 1.1502-51(c)(1).

[81] Prop. Reg. §§ 1.1502-51(c)(2), (c)(3).

In addition, the Section 250 deduction is limited to 50% of the taxable income of the U.S. corporation with the GILTI inclusion. Regulations under Section 250 should allow the Section 250 deduction on the basis of the taxable income and GILTI inclusion of the group as a whole. Logically that deduction would be allocated to members in the same manner as tested losses, etc. are allocated, so that even a member with no separate taxable income can be allocated a Section 250 deduction.

For example, suppose M1 has a CFC with tested income of $100, M1 has an unrelated loss of $100, the group as a whole has taxable income of $100 before any Section 250 deduction (i.e., other members of the group have $100 of unrelated income), and there are no other CFCs. M1 has a GILTI inclusion of $100. The Section 250 deduction should be $50 based on the $100 of taxable income of the group as a whole, even though M1 has no taxable income of its own. Likewise, the deduction of $50 should be allocated to M1, leaving M1 with a separate company loss of $50. This does not violate the rule in Section 172(d)(9) that a Section 250 deduction cannot create a net operating loss, since no net operating loss is being created for the group as a whole or is being carried to a different year.

(b) *Allocation of Tested Losses*

We have considered whether, as a policy matter, tested losses of a CFC owned by a member M should instead be allocated first to M to the extent M has tested income from other CFCs, with any excess tested loss of M's CFCs allocated proportionately to other members with tested income (the "**priority allocation rule**"). In Example 20, the question is whether the tested loss of CFC2 should instead be allocated entirely to M1, so that M1 has no GILTI inclusion and M2 has a $100 GILTI inclusion.

The priority allocation rule allocates to each member an amount of GILTI inclusion that better reflects the economic results to the members. On the other hand, the rule in the Proposed Regulations (the "**pro rata allocation rule**") prevents the location in the group of a tested loss CFC from affecting the amount of GILTI inclusion to any member, or the amount of used tested loss and offset tested income for any CFC.[82] The pro rata allocation rule therefore reduces the benefit of, and need for, uneconomic tax planning and is more consistent with single entity treatment of a consolidated group.

The priority allocation rule would also require reconsideration of the allocation of QBAI. In Example 20, suppose M1 has $1000 of QBAI. Under a single entity approach there is $100 of net tested income and $1000 of QBAI giving rise to $100 of NDTIR, so there is no GILTI inclusion. Under the pro rata allocation rule in the Proposed

[82] Under the priority allocation rule, any particular CFC might have a different used tested loss or offset tested income than under the pro rata rule. In Example 22, CFC1 would have $100 of offset tested income and CFC3 would have no offset tested income. The allocation of used tested losses could also differ under the two methods if tested losses exceeded tested income, and some members had both tested income and tested loss CFCs.

Regulations, the NDTIR is allocated in proportion to gross tested income, i.e., $50 to M1 and $50 to M2, so there is still no GILTI inclusion.

However, under the priority allocation rule, it would not be possible to allocate QBAI or NDTIR in proportion to tested income of tested income CFCs and still achieve the same result as if the group was a single entity. In Example 20, since M1 has no *net* tested income, any allocation of QBAI to M1 would "waste" the QBAI and the total GILTI inclusion would exceed the inclusion under single entity principles and the Proposed Regulations.

Rather, to achieve the single entity result under the priority allocation method, QBAI would have to be allocated among members in proportion to the net tested income of each member. The same would be true for specified interest expense, which reduces NDTIR. These group-wide allocations, without priority to the member generating the QBAI or specified interest expense, are inconsistent in principle with allocating tested losses of a member's CFC first to the tested income of the same member. Likewise, to achieve the equivalent of single entity treatment under the priority allocation rule, foreign tax credits would still have to be determined on a group wide basis with a single inclusion percentage for the group, without priority to the member generating the credits.

The priority allocation rule is also more economically correct, and fairer, to minority owners of members of a group, assuming the group has a typical tax sharing agreement among members. In Example 20, a minority shareholder in M1 would have an economic detriment from the tax liability allocable to M1 notwithstanding M1's lack of net income from CFC1 and CFC2. Likewise, a minority shareholder in M2 would get an economic windfall from the reduced tax liability on M2 arising as a result of a tested loss in a subsidiary of M1. However, similar uneconomic results could arise to minority shareholders even under the priority allocation rule, e.g., if one member has a CFC subsidiary with tested income, and another member has a CFC subsidiary with a tested loss.

The solution to this problem under the approach of either the Proposed Regulations or the priority allocation rule would be a revised tax sharing agreement among members. The revised agreement would provide that a member receiving the benefit of a tested loss from another member's CFC would reimburse that member for the resulting tax benefit, just as it would typically reimburse another member for the use of the member's NOL.

Finally, the priority allocation rule is more economically correct for purposes of the SRLY rules, since it better reflects the economic income of each member of the group. If a member has a SRLY loss carryover to a taxable year, the pro rata allocation rule may permit too much, or too little, of the SRLY loss to be absorbed in the taxable year as compared to the economically correct amount.

Taking these factors into account, we believe that on balance the pro rata allocation approach of the Proposed Regulations is the better approach, and we support it.

We also note that in a consolidated group with wholly owned subsidiaries, it appears to us that the location of GILTI inclusions is only relevant for SRLY and basis purposes. The Proposed Regulations make enormous efforts to deal with the basis consequences arising from the pro rata approach. With the modifications we suggest in Part IV, we believe that the Proposed Regulations would adequately deal with basis issues arising from the pro rata allocation method. As a result, we do not believe that the economic distortions caused by the pro rata allocation method are a sufficient reason to reject it.

IV. Adjustments to Tax Basis

A. Introduction

As discussed in more detail in this Part, the Proposed Regulations create a detailed and complex set of rules that require, in some circumstances, (1) a reduction in the basis of the stock of a CFC immediately before the stock in the CFC is sold, (2) if the stock in the CFC is owned by a member M of a consolidated group, with P owing M, a reduction in P's basis in M at the time the CFC has a tested loss, even before the stock in the member or the CFC is sold and before M reduces its basis in the stock of the CFC, and (3) an increase in P's basis in M either on a current basis when the CFC has tested income, or in other cases immediately before the stock in the CFC is sold.

Because of timing differences between item (1) and item (2), these rules create disparities between the inside asset basis and outside stock basis in M, and these disparities raise additional complexities. Yet more complexity arises because item (3) provides a basis increase in M stock when there is not an equivalent basis increase in the CFC stock.

The theory behind the Proposed Regulations is that if a corporation is a U.S. shareholder of two CFCs, one with tested income and the other with tested loss, the tested loss can potentially give rise to a double tax benefit to the shareholder. First, the tested loss offsets the tested income, thereby reducing the GILTI inclusion of the shareholder and allowing the CFC with tested income to pay a tax-free dividend to the shareholder. Second, the tested loss will generally correspond to an economic loss in the stock of the CFC with the tested loss, and allow that stock to be sold with a tax loss.

We accept the general desire of the Treasury to prevent what may be viewed as loss duplication, although we suggest certain changes to the Proposed Regulations below. More fundamentally, however, we believe there are at least three arguments for excluding all of these nonstatutory basis adjustments from final regulations.

First, as discussed below, it is by no means clear that the Code and the applicable case law authorize regulations to adjust the tax basis of stock in a CFC in this manner. Moreover, while Section 1502 no doubt authorizes the consolidated return basis adjustments, those adjustments would be illogical and create inconsistencies in the absence of the underlying basis adjustments in the stock of the CFC.

Second, even if a court would say that the adjustments to CFC stock basis are valid, there is no express authority in the Code for regulations to adjust tax basis of stock in a CFC in this manner, nor any statutory guidance as to how basis should be adjusted. There are several choices that can be made to adjust basis and/or e&p at the CFC level, including the method in the Proposed Regulations and other alternatives we discuss below. All of the choices are inherently overinclusive and underinclusive. Arguably these policy decisions should be made by Congress rather than by the Treasury.

Finally, the issue of loss duplication from tested losses is but one version of a broader set of fact patterns involving the recognition of loss on the sale of stock of a foreign corporation. All of these fact patterns arise because in many cases, the Code now allows for the tax-free return under Section 245A of untaxed profits of a foreign corporation, at the same time a loss on the sale of stock of a foreign corporation is allowed subject to Section 961(d).[83] None of these other fact patterns are subject to special rules under either the Code or the Proposed Regulations.

For example, if a U.S. corporation is a 10% shareholder of a foreign corporation that is not a CFC, the shareholder is not subject to a GILTI inclusion but can withdraw its share of the profits tax free under Section 245A. If the shareholder happens to own stock in another foreign corporation with an equal amount of allocable loss, the shareholder can sell the stock in that corporation at a loss. This combination of tax-free income and recognized loss is in substance the same result that the Proposed Regulations are trying to prevent in the GILTI context. Similarly, if a U.S. shareholder owns a CFC with a tested loss, the stock can be sold at a loss, while if the CFC has tested income that is sheltered by NDTIR, the corresponding gain is tax-free to the extent of e&p. The Code makes no attempt to eliminate this lack of symmetry. To be sure, in none of these cases is the shareholder using a loss in one CFC to shelter income in another CFC that would otherwise be taxable to the shareholder, and so arguably the considerations are different.

Arguably Congress rather than Treasury regulations should determine the extent to which basis adjustments are appropriate to change the results in these different fact patterns. On the other hand, it can be argued that the specific issue addressed by the Proposed Regulations is the clearest case of the double use of a loss, will frequently come up under GILTI, and should be addressed by regulations even though a more comprehensive solution to the problems created by Section 245A must necessarily await Congressional action.

In the remainder of this Part IV, we first describe the basis adjustment rules in the Proposed Regulations and provide a detailed set of comments. Then, with this background, we describe in Part IV.G two alternative approaches to ameliorate or eliminate loss duplication. We prefer those other approaches to the approach in the Proposed Regulations because we believe they are simpler and generally achieve the

[83] Section 961(d) effectively disallows a loss to the extent of distributed earnings that were eligible for Section 245A.

goals of the Proposed Regulations in preventing loss duplication. We acknowledge, however, that they may raise additional issues of authority. We have not had time to fully consider all the detailed rules that would be necessary under these alternative approaches, but we would be happy to consider these issues further if the Treasury is interested in pursuing these approaches.

B. Proposed Regulation Section 1.951A-6: The CFC basis reduction rule

1. *Summary of Proposed Regulation*

This Proposed Regulation introduces several key concepts. The "**offset tested income amount**" of a CFC for a particular year with respect to a U.S. shareholder is the tested income of the CFC allocable to the shareholder that is offset at the shareholder level by tested losses of other CFCs allocable to the shareholder.[84] Likewise, the "**used tested loss amount**" of a CFC for a particular year with respect to a U.S. shareholder is the tested loss of the CFC allocable to the shareholder that offsets tested income of other CFCs allocable to the shareholder. Tested losses of CFCs with tested losses are allocable proportionately against tested income of CFCs with tested income.

In addition, for any U.S. shareholder and any CFC, (a) the CFC's aggregate used tested loss amount with respect to the shareholder for all taxable years to date, is compared to (b) the CFC's aggregate offset tested income amount with respect to the shareholder for all taxable years to date. If (a) exceeds (b), the excess is the "**net used tested loss amount**" of the CFC with respect to the shareholder at that time. If (b) exceeds (a), the excess is the "**net offset tested income amount**" of the CFC with respect to the shareholder at that time.[85]

As a substantive matter, immediately before the disposition of Section 958(a) stock of a CFC owned directly or indirectly by a domestic corporation that is a U.S. shareholder, the tax basis of the stock of the CFC is reduced by the net used tested loss amount, if any, attributable to the stock that is disposed of. If the basis reduction exceeds the basis in the stock immediately before the disposition, then such excess is treated as gain from the sale of such stock. This rule is referred to as the "**CFC basis reduction rule**."

The CFC basis reduction rule can be illustrated by the following examples. Unless otherwise indicated, all examples assume that U.S. shareholder S is a domestic corporation that directly owns 100% of CFCs indicated as CFC1, CFC2, etc.[86]

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[84] Prop. Reg. § 1.951A-6(e)(1)(i).

[85] Prop. Reg. §§ 1.951A-6(e)(2), (e)(3).

[86] The considerations are different for individuals, who (at least in the absence of a Section 962 election) are not entitled to the deduction under Section 245A in the case of a tested income CFC, and are not required (and, as discussed below, should not be required) to reduce basis in a tested loss CFC.

> **Example 21.** *Used tested loss and offset tested income; single year.* In year 1, CFC1 has $100 of tested income and CFC2 has $100 of tested loss. Therefore, S has no net tested income and no GILTI inclusion. However, CFC1 has $100 of offset tested income, and CFC2 has $100 of used tested loss. The net used tested loss amount for CFC2 is $100 at the end of the year. Moreover, since there is no GILTI inclusion, there is no change in S's basis in the stock of CFC1 or CFC2 under Section 961.

> **Example 22**. *Used tested loss and offset tested income; two years*. Same facts as Example 20 in year 1, but in year 2, CFC1 has $100 of tested loss and CFC2 has $100 of tested income. For year 2, CFC1 has $100 of used tested loss and CFC2 has $100 of offset tested income. At the end of year 2, both CFCs have a $0 net used tested loss amount and net offset tested income amount, since in each case, the CFC has an equal used tested loss in one year and offset tested income in the other year.

In Example 21, if S sells the stock of CFC2 at the end of year 1, the tax basis of CFC2 will be reduced by the net used tested loss amount of $100. The stated rationale for this reduction in basis is the following. Absent additional facts (discussed in Part IV.B.2(a)), the tested loss of CFC2 reduces the GILTI inclusion of S by $100. In addition, CFC1 would normally have $100 of e&p that it can distribute to S on a tax free basis under Section 245A, without any reduction in S's basis in CFC1.[87] The value of CFC1, and the tax basis in CFC1, would be the same as before year 1, and so any built-in gain is unchanged. If no dividend was paid but the stock of CFC1 was sold, the gain attributable to the $100 of tested income would be tax free under Section 1248(j).

[87] An exception is Section 961(d), which would effectively disallow a loss on the stock to the extent of the Section 245A dividend.

In addition, CFC2's tested loss would reduce the value of CFC2, assuming a corresponding economic loss. Absent the Proposed Regulations, S could sell the stock of CFC2 at an increased loss or reduced gain on account of such tested loss. On these facts, the tested loss has thus provided a double tax benefit to S. As noted above, the purpose of the Proposed Regulations is to prevent this double tax benefit.

Notably, the Proposed Regulations do not eliminate the incentive to taxpayers to create income in one CFC and an equal loss in another in order to obtain this tax benefit. In particular, any time S is planning on selling the stock of CFC1, it can first have CFC1 sell its assets at a gain equal to the stock gain, and avoid the GILTI inclusion by having another CFC such as CFC2 sell its own assets at an equal loss. There is no GILTI inclusion, the cash proceeds on the sale of CFC1 are received tax-free, and the basis reduction in CFC2 stock is deferred.

2. *Policy Issues*

(a) *Not Always a Double Tax Benefit*

The Preamble justifies the basis reduction on the ground it is necessary to prevent the double tax benefit from the tested loss. We consider first exactly what is meant by preventing a double benefit. Even in the simple case in Example 21, the used tested loss of CFC2 eliminates a GILTI inclusion that would otherwise be taxed to S at 10.5%. Absent the Proposed Regulations, the capital loss on the sale of stock of CFC2 would potentially result in a tax savings of 21% to S if it had other capital gain.

The Proposed Regulations are therefore reducing this potential tax savings of 31.5% of the net used tested loss amount to a tax savings of 10.5% of the net tested loss amount. This is more than eliminating a double benefit from the tested loss—it is eliminating the potential 21% benefit that would arise in the absence of tested income, and converting that into a deduction against income otherwise taxable at 10.5%.

Put another way, the basis reduction is causing S to pay tax at a 21% rate on the increased gain or reduced loss on the sale of the CFC (assuming no exempt gain under Section 1248), while the tested loss only provided a benefit at the 10.5% rate. S would actually be better off if CFC1 had tested income, and CFC2 had tested loss, in different taxable years, since that might lead to income taxed at 10.5% and a loss on the CFC2 stock providing a 21% benefit.[88]

On the other hand, arguably it is correct to say that rate differentials should be disregarded in determining whether net used tested loss without a basis reduction gives rise to a double tax benefit. After all, tested income, whether or not offset, is taxed at 10.5% but can result in reduction of corporate tax of the U.S. shareholder at the 21% rate.

[88] The Proposed Regulations would not provide a basis reduction in the stock of CFC2, assuming the tested loss was not a used tested loss in the year it arose.

In any event, accepting the Preamble's concept of a double tax benefit from a tested loss, a key aspect of the Proposed Regulations is that it reduces basis of a CFC *without regard to whether, as a factual matter, the net used tested loss amount provides both (i) the "first" tax benefit to the U.S. shareholder by offsetting tested income of the shareholder, and (ii) the "second" tax benefit by allowing the stock of the tested loss CFC to be sold at an increased loss or reduced gain*. As will be seen below, in many cases the shareholder with tested income will receive no net tax benefit from a reduction in its tested income, and it might even receive a net detriment. Likewise, in many cases the shareholder will receive no net tax benefit from owning stock of a CFC that had a used tested loss.

In those cases, the net used tested loss amount of a CFC does not provide a double tax benefit to the shareholder, and the need to prevent such a double benefit does not provide a justification for the basis reduction. This result can arise in a number of situations based on the simple fact pattern of Example 21:

NDTIR/QBAI: Suppose that S had enough NDTIR, from the QBAI held by its CFCs with positive tested income, to eliminate its entire GILTI inclusion. The tested loss from CFC2 then provided no tax benefit to S.

To be sure, there might be other good policy reasons for the Proposed Regulations to reduce basis in CFC2 in this case. Absent such reduction, there would be an incentive for S to arrange its business activities so that some of its CFCs had positive tested income and NDTIR, and others had tested losses. The tested losses would be "wasted" if they were in the same CFCs as the tested income and NDTIR, but a loss in a different CFC could give rise to a tax loss on sale of the stock of that CFC. The basis reduction in the Proposed Regulations would eliminate the incentive for this uneconomic tax planning, but could not be justified by the need to prevent double deductions.

Foreign tax credits: Suppose S had enough foreign tax credits from CFC1 to wipe out its U.S. tax liability on its $100 GILTI inclusion from CFC1 standing alone. On these facts, in Example 21, the foreign tax inclusion percentage for S under Section 960(d) would be zero because of the offsetting tested income and tested loss. In form, the tested loss of CFC2 is reducing the GILTI inclusion of S. However, in substance, the tested loss is not reducing the taxes of S below what they would have been in the absence of the tested loss, so there is no double benefit from the tested loss.

Section 956: Suppose the tested income of CFC1 was inadvertently used to acquire a Section 956 asset in the current year, and, if the recently proposed regulations under Section 956 apply,[89] Section 245A would not apply to a dividend from CFC1 (e.g., because S's stock in CFC1 is debt for foreign tax purposes and thus the dividend would

[89] REG-114540-18, Federal Register Vol. 83, No. 214, November 5, 2018 at 55324-55329. This proposed regulation turns off Section 956 to the extent the U.S. shareholder of CFC1 would be eligible for Section 245A on a dividend from CFC1.

be a hybrid dividend not eligible for Section 245A). Absent the tested loss in CFC2, the GILTI inclusion would be $100, the tax would be $10.50, and the Section 956 amount would be tax-free PTI. With the tested loss, there is no GILTI inclusion, and the $100 is taxed to S at the ordinary 21% rate. (Foreign tax credits might reduce both the GILTI and Section 956 calculations.) The tested loss has actually increased the tax liability of S before foreign tax credits. While this detriment would be offset by a tax loss on the sale of the stock of CFC2, there is no double benefit from the tested loss.

No e&p: Suppose CFC1 has no e&p, because of an expense that reduces e&p but is not allowed as a deduction in computing tested income. Assume S sells the CFC1 stock for $100 in excess of its preexisting basis. If CFC2 has tested loss of $100, there is no GILTI inclusion and there is no deemed dividend on the sale because of the lack of e&p. Therefore, S has $100 of capital gain on the sale taxed at 21%. Absent the used tested loss, S would have a $100 GILTI inclusion from CFC1, the basis in CFC1 would increase by $100, and there would be no gain on the sale of the stock. The tested loss has increased S's tax liability by converting $100 of GILTI inclusion to $100 of capital gain. Again, a loss on the sale of the stock of CFC2 would offset this increase in tax liability but would not be a double benefit from the tested loss.

Section 1059: Suppose CFC1 pays a dividend of its $100 of e&p, and that dividend is an extraordinary dividend under Section 1059. Section 1059 applies if a dividend of sufficient size is paid by CFC1 to S before S has held the CFC1 stock for two years. In that case, the dividend is still tax free to S under Section 245A, but S's tax basis in CFC1 is reduced by $100. As a result, the tested loss of CFC2 has prevented an upfront GILTI inclusion of $100 from CFC1, but at the cost of the basis reduction. When the stock of CFC1 is sold, overall there has been no second benefit to S from the tested loss, except for timing.

This example illustrates the complexity of determining whether a double tax benefit of a tested loss arises. At the time the CFC2 stock is sold, if the dividend of the CFC1 tested income has not yet been paid, it may not yet be clear whether it will be later paid in a manner subject to Section 1059. Even if the dividend has been paid and the basis in CFC1 was already reduced under Section 1059, the failure to reduce the basis in CFC2 will cause the CFC2 tested loss to result in a double tax benefit upon the sale of the CFC2 stock. However, this second tax benefit would be offset upon a sale of the CFC1 stock at its reduced basis. Therefore, any basis reduction in the stock of CFC2 designed to prevent a double use of the tested loss on sale of CFC2 would logically have to be either not made in the first place, or else reversed upon the sale of CFC1 with a reduced basis.

Sale of Tested Income CFC at a Loss. The tested loss of CFC2 will likewise not provide a double tax benefit if S sells the CFC1 stock with a loss effectively disallowed under Section 961(d). That section provides that if CFC1 pays a dividend to S to which Section 245A applies, then (unless Section 1059 applies), S's basis in CFC1 is reduced by the amount of the dividend for purposes of calculating loss on a sale of CFC1.

For example, assume S owns a single CFC1 with an initial basis of $100 and value of $100. Assume $100 of tested income, and a distribution of the tested income as PTI. The shareholder has a GILTI inclusion of $100 and an ending tax basis of $100. If the shareholder sells the stock for $0, a tax loss of $100 is allowed. If instead S also owns CFC2 with a tested loss of $100, there is no GILTI inclusion. The distribution of $100 from CFC1 is eligible for Section 245A, and assuming no extraordinary dividend, the basis of $100 remains unchanged. However, if the stock is sold for $0, Section 961(d) disallows the loss.

The existence of the tested loss in CFC2 has allowed S to avoid upfront tax on $100 of tested income from CFC1, but at a cost of a disallowed loss of $100 on sale of the stock of CFC1. Of course, since Section 961(d) only reduces basis for purposes of determining loss, if the stock is sold for $100 or more, the tested loss has offset the tested gain with no further detriment to S.

As a result, if the CFC1 stock is sold at a disallowed loss before the CFC2 stock is sold, it would be clear at that time that the tested loss would not be providing a double tax benefit. If the CFC2 stock is sold first, as in the discussion of Section 1059 above, it would not be clear at that time whether a loss would be disallowed on a future sale of CFC1 stock, thereby preventing a cumulative double benefit from arising from the tested loss of CFC2.

The same denial of a double tax benefit can arise if the CFC1 stock is sold at a loss, even in the absence of a Section 245A dividend that causes Section 961(d) to apply. Return to the example where S owns CFC1 with a basis and value of $100, and CFC1 has $100 of tested income. If the tested income results in a GILTI inclusion, the stock basis increases to $200, and if the stock is later sold for $100, there is an allowed loss of $100. No provision disallows this loss. On the other hand, if CFC2 has a tested loss of $100 that offsets the tested income of CFC1, there is no GILTI inclusion, the basis in CFC1 remains at $100, and there is no tax loss on the sale of that stock for $100. The tested loss in CFC2 has provided no benefit to the U.S. shareholder in connection with the tested income and sale of CFC1.

Inside/outside basis differences. The tested loss of CFC2 also may not provide a double tax benefit where there are disparities in inside and outside stock basis in CFC1 or CFC2. For example, suppose S bought the stock of CFC2 for $100 when CFC2 had a single asset with a basis of $200 and value of $100. CFC2 sells the asset for $100, and the tested loss of $100 offsets $100 of tested income of CFC1. The tested loss does not create a potential loss on the sale of the CFC2 stock, because that tested loss is already reflected in the cost basis of that stock. To be sure, there is arguably a policy reason to reduce S's basis in CFC1 by the amount of the tested loss, as would be the case if CFC1 were a consolidated subsidiary of S or a partnership that had S as a partner. However, the argument for such a basis reduction is arguably distinct from the duplicated loss issue in *Ilfeld* that is the claimed source of authority for the CFC basis reduction rule.

The same issue would arise if CFC1 had an asset with a basis of $0 and value of $100, S bought the CFC1 stock for $100, and then CFC1 sold the asset for $100. Absent the tested loss of CFC2, S would have a $100 GILTI inclusion that would increase the basis in CFC2 to $200, allowing the stock to be sold for $100 at a tax loss of $100. As a result, as long as S has other gain that can be sheltered with the $100 loss on the stock sale, S has obtained no net tax benefit from the tested loss of CFC2, and so logically the basis in CFC2 should not be reduced.[90]

No economic loss to match tested loss. Suppose the tested loss of CFC2 arises from an expense that does not reduce the value of the stock of CFC2, e.g., an r&d expense, or deductible start-up costs that create value. In this case, the tested loss does not create a potential second tax benefit in the form of a capital loss on the sale of the CFC2 stock. In this case, reducing the tax basis of CFC2, and creating gain when it is sold for its unchanged value, would even eliminate the single tax benefit from the tested loss that arose from offsetting the tested income of CFC1.

Future exempt income in tested loss CFC. Suppose that CFC2 has exempt income (not offset tested income) in a future year equal in amount to the tested loss in the example. The exempt income might be from a GILTI inclusion reduced by NDTIR, or from high-taxed Subpart F income. If that income is not distributed out of current e&p in the year earned, and if the tested loss in the example created negative e&p, the negative e&p will prevent such exempt income from resulting in accumulated e&p in years after the exempt income was earned. As a result, the tested loss will prevent the payment of Section 245A dividends in future years out of such exempt income, and prevent the sale of the stock at a tax-free gain on account of such exempt income. In this situation, the shareholder has not received a second benefit from the tested loss in the example.

(b) *Authority for the CFC Basis Reduction Rule*

The Code does not contain any explicit authority for the Treasury to write regulations to reduce the tax basis in stock of a CFC. In fact, Section 961 provides explicit rules for adjusting the basis of stock of a CFC. Moreover, Section 951A(c)(2)(B)(ii) (which increases e&p by tested losses for purposes of the e&p limitation on Subpart F income) is entitled "Coordination With Subpart F To Deny Double Benefit of Losses." There is no indication in the Code or legislative history that additional basis adjustments may be made by regulations to prevent duplicated losses or otherwise.

[90] As previously noted, if the stock loss offsets gain otherwise taxed at 21%, S is worse with the tested loss than without it.

The Preamble relies on the *Ilfeld* and *Skelly Oil* cases decided by the Supreme Court.[91] However, there are several reasons that these cases might not be considered determinative in this context.

First, *Ilfeld* involved a double deduction of a single economic loss on a consolidated tax return and is generally cited in that context. It is true that the double tax benefit from a tested loss can arise in the context of a consolidated return, but that is only because a consolidated group is treated as a single corporation under the Proposed Regulations. Conceptually, the issue arises when a single U.S. corporation has multiple CFCs, some with tested income and some with tested loss.

In fact, the *Ilfeld* doctrine was recently discussed at length in the *Duquesne Light* case in the Third Circuit.[92] The court affirmed the application of *Ilfeld* to a consolidated group. It also discussed the uncertainty of whether *Ilfeld* applies outside a consolidated group, and cited several cases that arose before *Gitlitz* (discussed below) where the doctrine was so applied.

Second, *Skelly Oil* involved the common law claim of right doctrine, and neither *Ilfeld* nor *Skelly Oil* involved a specific statutory scheme that on its face provided for a double deduction. In fact, *Ilfeld* stated that "*in the absence of a provision in the Act or regulations that fairly may be read to authorize [a double deduction]*, the deduction claimed is not allowable" (emphasis added). When the Code or regulations deal specifically with the subject matter, the courts are much more willing to defer to the literal language of the Code or regulations.

For example, in *Gitlitz*,[93] the government objected to the taxpayer's proposed interpretation of the Code on the ground that it would give a "double windfall" to taxpayers. The Supreme Court summarily rejected this argument, stating that "[b]ecause the Code's plain text permits the taxpayers here to receive these benefits, we need not address this policy concern."[94] Even in the consolidated return context, courts reject reliance on *Ilfeld* when the regulations are clear and specific.[95] Arguably the existence of Section 961, dealing specifically with tax basis, is enough to satisfy this requirement.

Third, the *Ilfeld* line of cases deals with a double deduction. The consequences of a used tested loss are both a single deduction to the shareholder (through offset of tested

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[91] *Charles Ilfeld Co. v Hernandez,* 292 U.S. 62 (1934); *U.S. v Skelly Oil Co,* 394 U.S. 678 (1969).

[92] *Duquesne Light Holdings, Inc. v Comm'r*, 861 F.3d 396 (3d Cir. 2017), *cert denied* (138 S. Ct. 2651).

[93] *Gitlitz v Comm'r*, 531 U.S. 206 (2001).

[94] *See also Brown Shoe Co. v. Comm'r,* 339 US 583 (1950) (property contributed to capital by a nonshareholder had a depreciable basis). This result was changed by Section 362(c).

[95] *See, e.g., Woods Investment Co. v Comm'r*, 85 T.C. 274 (1985).

income) and the failure to reduce basis of the loss CFC. However, the failure to reduce basis may not give rise to an actual loss on the sale of the stock of the loss CFC, but rather to a reduced gain on the sale of the stock.[96] The Code and regulations clearly make this distinction in various rules.[97] We are not aware of *Ilfeld* being applied to require the creation of income or gain, as opposed to denying a loss considered to be duplicative (although the Supreme Court has arguably characterized *Ilfeld* in broader terms).[98] Therefore, it is possible that *Ilfeld* would at most justify a rule disallowing losses on the sale of the stock of the tested loss CFC, as opposed to a basis reduction rule that also increases the amount of taxable gain on the sale.

On the other hand, if *Ilfeld* applies to disallow duplicative losses in a consolidated group, the logic seems even more applicable for disallowing duplicative losses in a single corporation. Here, the U.S. shareholder first obtains the benefit of a reduction in its tested income inclusion, then it has a potential capital loss on the stock of the tested loss corporation. In fact, the regulations have long prohibited double deductions in a single corporation[99] and this principle was recently applied by the Federal Circuit.[100] Moreover, notwithstanding Section 961, it can be argued that Congress was not purporting to exclusively prescribe all the collateral effects of the GILTI rules and did not intend to preclude regulations that would deny a double tax benefit to taxpayers.

Fourth, as discussed in Part IV.B.2(a), a used tested loss will often not give rise to a double tax benefit. Nevertheless, the only rationale for the CFC basis reduction rule provided in the Preamble is to prevent a double tax benefit, and there is no explanation of why a narrower rule would not be sufficient to prevent double tax benefits. This disconnect between the rule and the explanation for the rule could prevent the rule from satisfying the Administrative Procedure Act, even if a good explanation would have

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[96] As noted above, a tested loss may not give rise to *either* an increased loss or reduced gain to the shareholder, if the shareholder's stock basis is purchased basis that already reflects the loss.

[97] *E.g., compare* Section 1059 (reducing basis by the nontaxed portion of a dividend), *with* Section 961(d) (reducing basis by the amount of a Section 245A dividend only for purposes of calculating loss on a sale of the CFC stock).

[98] *See McLaughlin v. Pac. Lumber Co.*, 293 U.S. 351, 355 (1934) ("But a consolidated return must truly reflect taxable income of the unitary business and consequently it may not be employed to enable the taxpayer to use more than once the same losses for *reduction of income*. Losses of [taxpayer] that were subtracted from [taxpayer's] income are not *directly or indirectly* again deductible." (emphasis added)).

[99] *See* Treas. Reg. § 1.161-1 ("Double deductions are not permitted. Amounts deducted under one provision of the Internal Revenue Code of 1954 cannot again be deducted under any other provision thereof.").

[100] *See Sunoco, Inc. v. United States*, No. 2017-1402 (Fed. Cir. Nov. 1. 2018) ("Congress does not generally allow taxpayers to receive a tax benefit twice.") (denying the taxpayer an increase in cost of goods sold for an excise tax liability that was offset by a tax credit).

validated the rule.[101] As a result, the rule might be held invalid even as to a taxpayer that does have a double tax benefit.

In light of the foregoing, if the final regulations will retain the CFC basis reduction rule or a similar rule, we suggest that the Treasury request a statutory amendment to confirm its authority to issue regulations to modify the basis rules of Section 961. Absent such legislation, the preamble to the final regulations should further explain the nature of the double tax benefit the Proposed Regulations are designed to prevent. Moreover, unless the CFC basis reduction rule is narrowed as we suggest in Part IV.B.2(c), the preamble to the final regulations should also explain why the rule applies to all used tested losses without regard to whether an actual double tax benefit is obtained by the U.S. shareholder.

(c) *Proposed Modification of the Rule*

The Proposed Regulations generally follow the approach of the statute of treating each CFC as a separate entity, and then apply principles similar to consolidated return principles to achieve economically correct results. Within the framework of the Proposed Regulations, we have the following comments.

We agree with the fact that the Proposed Regulations do not require an upfront reduction in the basis in a tested loss CFC to the extent of its used tested loss amount, even when the U.S. shareholder clearly derived a benefit from the tested loss. We acknowledge that an immediate basis reduction would be administratively simpler than to wait until the CFC stock is sold, and would more closely match the adjustments in Proposed Regulation Section 1.1502-32 described in Part IV.D.1. However, such a basis reduction would create upfront gain any time there was not sufficient basis, would still allow a CFC to recognize loss to offset tested income of another CFC any time there was sufficient basis in the former CFC, and would raise significant additional authority issues. Congress clearly did not intend there to be a net income inclusion, from a basis reduction or otherwise, merely because CFC1 has tested income and CFC2 has tested loss.

Moreover, no approach to preventing the double use of a tested loss will be fully satisfactory. The plausible times for an income inclusion are when the shareholder has taken advantage of Section 245A for its offset tested income, or taken advantage of its unreduced stock basis following a Section 245A distribution, or (as in the Proposed Regulation) disposed of the CFC2 stock.

As noted in Part IV.A, we recommend that the fundamentally different approach in Part IV.G be adopted. However, if the CFC basis reduction rule is retained, we believe it should be modified to allow an exception in at least the first of the following circumstances, and possibly the second.

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[101] *See, e.g.*, *Altera Corp. v Comm'r*, 145 T.C. 91 (2015) (currently pending before the Ninth Circuit).

First, a U.S. shareholder should be permitted to eliminate all or part of the used tested loss amount for purposes of the CFC basis reduction rule to the extent it can show, as of the time of the sale of the CFC stock, that it had not received any tax benefit from the net used tested loss amount and could not reasonably expect to receive any benefit in the future.[102] This calculation would be made on a "but for" basis, and could take into account any actual or expected offsets to the double benefit because of Section 1059 or Section 961(d). As a protection for the government against future benefits not originally taken into account, there could be a recapture rule designed to reach the same result as if those future benefits had been taken into account at the time of the sale of the CFC2 stock.[103]

We believe this is the theoretically correct rule to protect both the government and taxpayers. We acknowledge it would result in considerable additional complexity. However, the burden would be on taxpayers if they wished to take advantage of this rule, and in many cases taxpayers would be more than willing to do so. The rationale for the additional complexity is that it is quite unfair to taxpayers to require a basis reduction in the CFC stock (even below zero) if the used tested loss has not provided any tax benefit to the shareholder, or if any benefit is expected to be temporary because of future increased gain or disallowed loss on the sale of CFC1. While the purpose of the CFC basis reduction rule was to avoid a *double* benefit from a tested loss, in these cases the tested loss is providing *no* tax benefit as a result of the basis reduction.

Simplified versions of this rule would also be possible, although by looking only at a single tax year of the shareholder, they might not protect the interests of the government and taxpayers in all cases. For example, the future basis reduction could be eliminated if, solely taking account the year in which the used tested loss arose, the shareholder could show it has sufficient NDTIR to eliminate a GILTI inclusion, and/or sufficient foreign tax credits to eliminate tax on a GILTI inclusion, without regard to any used tested losses.

We also believe that this exception to the CFC basis reduction rule would make the rule less vulnerable to challenge by taxpayers. Since the rule would only apply when the taxpayer actually received a double benefit from a tested loss, or could not show otherwise, the argument for basing the rule on *Ilfeld* is strengthened.

Second, in addition to the foregoing, consideration should be given to a rule that a U.S. shareholder would be permitted to elect to forego the tax benefit of a tested loss.

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[102] A rule that also looks to the receipt of an actual tax benefit is Prop. Reg. § 1.951A-3(h)(1), stating that temporarily held specified tangible property will be disregarded if, among other things, the acquisition of the property reduces the GILTI inclusion amount of a U.S. shareholder.

[103] The dual consolidated loss rules are somewhat analogous. *See* Treas. Reg. §§ 1.1503(d)-6(d), (e), providing an elective regime under which an annual certification is made that a loss used in the U.S. has not been used abroad, with a recapture of the U.S. use of the loss if a foreign use later occurs.

The result would be as if the tested loss had not occurred.[104] This would prevent a double benefit (or even a single benefit) from directly arising from the tested loss, and there would be no net used tested loss amount to cause a basis reduction under the CFC basis reduction rule.

This elective elimination of tested loss is analogous to the rules in Treasury Regulation Section 1.1502-36(d), which is designed to prevent a duplicated loss from arising in both the stock and assets of a member of a consolidated group. For example, suppose P contributes $100 to new member M, M buys an asset for $100, and the asset declines in value to $60. Absent the regulation, P could sell the stock for $60, and M could subsequently sell the asset for $60, resulting in a double tax loss for a single economic loss.

The regulation prevents this result by requiring a reduction in the basis of the assets of M, at the time of sale of the M stock, by the duplicated loss of $40, so the M asset basis becomes $60. In addition, there is an election to cause all or any portion of the reduction in asset basis to be replaced by a reduction in stock basis. For example, the asset basis could remain at $100 if the stock basis is reduced to $60, eliminating the entire loss on the stock.

Another analogous election in the consolidated return regulations allows a group acquiring a corporation with an NOL carryover to elect to waive the carryover. The election prevents the group from suffering adverse consequences if the carryover expires (under old law) while the purchased member is in the group.[105]

Several issues would have to be addressed in developing this election to forego the use of a tested loss. As an initial matter, it would have to be determined whether the election could be for part rather than all of the tested loss of a particular CFC for a particular year, whether a U.S. shareholder with multiple tested loss CFCs in a particular year must make consistent elections for each, whether an election is binding for a particular CFC in future years, whether a consistent election must be made by all related U.S. shareholders, and so on. It can be argued that to the extent the waiver of a tested loss merely eliminates the double benefit associated with the particular loss, the election should be available in whole or in part, CFC by CFC, and year by year. However, to the extent the election is more favorable to the taxpayer than eliminating the double benefit of a tested loss, as discussed below, there is greater justification for a consistency requirement.

Moreover, Section 951A states that the GILTI inclusion takes account of the tested income of tested income CFCs, reduced by the tested loss of tested loss CFCs.

[104] We do not intend, however, that a CFC with a “real” tested loss would thereby no longer be a tested loss CFC, so that QBAI and foreign tax credits from the CFC would be available for use against the tested income of other CFCs.

[105] Treas. Reg. § 1.1502-32(b)(4).

There is no provision for an election to disregard tested losses. If the Treasury believes that a waiver is appropriate as a policy matter, we suggest that it request a statutory change.

Next, even if the election was adopted, some version of the CFC basis reduction rule would be needed for taxpayers that do not make the election. As a result, the complexity of the CFC basis reduction rule would remain, although it would apply to fewer taxpayers. The decision would then have to be made whether our first proposal above should also be adopted, both for fairness to taxpayers and to strengthen the validity of the CFC basis reduction rule under *Ilfeld*.

Finally, this election might provide a greater tax benefit to the U.S. shareholder than merely eliminating the double tax benefit from a tested loss. The election might be made even if the taxpayer has no plan to ever sell the stock in the tested loss CFC, and therefore is relatively indifferent to the CFC basis reduction rule. Note that a tested loss reduces the U.S. shareholder's FTC inclusion percentage under Section 960(d). As a result, the FTC benefit from the waiver might be greater than the reduction in net tested income from the waiver.

Similarly, if the tested income CFC was to be sold at a loss, the U.S. shareholder might elect to waive the use of tested loss in order to create a GILTI inclusion and a basis increase in the tested income CFC. This would increase tax basis at a 10.5% cost (or less if FTCs are available), thereby increasing the tax loss on the stock at a 21% benefit. In addition, unless the e&p of the CFC with the tested loss was reduced in the normal way notwithstanding the election, the election could increase the untaxed e&p of the CFC and allow the shareholder to take increased advantage of Section 245A to that extent.

The tax planning opportunities created by the rule should be taken into account in the decision of whether to adopt the rule. However, such opportunities could be mitigated by adopting various consistency requirements for the making of elections, as discussed above.

As a result, further consideration would need to be given to this proposal. We would be happy to consider it further if the Treasury believes it would be useful.

3. *Technical Issues*

(a) *The Netting Rule for Basis Reductions*

As noted above, the basis on disposition of CFC stock is reduced by the net used tested loss amount. This is the shareholder's share of the aggregate used tested loss of the CFC for all years over its share of the aggregate offset tested income of the CFC for all years. Consider Example 22 above, where CFC1 has offset tested income of $100 in year 1 and used tested loss of $100 in year 2, and CFC2 has the reverse. When the CFC1 stock is sold, the net used tested loss amount is $0, and there is no basis reduction.

This failure to reduce basis might be considered incorrect, because CFC1 could pay a tax-free dividend in year 1 without a basis reduction. The result for both years would be a decrease in value of the stock of CFC1 ($100 income and distributed earnings in year 1, $100 loss in year 2) with no reduction in stock basis. Thus, a built in loss has been created in the stock of CFC1 as a result of offset tested income.

However, we believe the netting approach in the Proposed Regulations is appropriate. In year 1, when CFC1 has offset tested income, CFC2 has a used tested loss. As a result, the basis of CFC2 will be reduced whenever it is sold in the future (and before taking account of CFC2's offset tested income in year 2) to take account of the fact that CFC1 might pay a tax exempt dividend. Since that future basis reduction already takes account of the assumed dividend, there is no reason for any further basis reduction when the dividend is actually paid. In year 2 when CFC1 has a used tested loss and CFC2 has offset tested income, the usual rules would apply.

(b) *Basis Reduction Upon the Sale of a U.S. Shareholder*

Clarification should be provided concerning the basis consequences of the sale of stock of the U.S. shareholder of a CFC. In Example 21, suppose corporation C owns all the stock of S, and C sells the stock of S to a buyer (Buyer). Assume C and S do not file a consolidated return.[106] The Proposed Regulations trigger a basis reduction in CFC2 upon the disposition of stock of a CFC owned directly or indirectly by a domestic corporation under Section 958(a). Since C does not own Section 958(a) stock of CFC2, the Proposed Regulations by their terms do not require a reduction in the tax basis of CFC2 upon the sale of S, notwithstanding the net used tested loss amount in CFC2.

The final regulations should contain an example illustrating this point to avoid any doubt. We believe this is the correct answer assuming, as discussed in the following paragraph, that the potential basis reduction continues following the sale of S. Outside of a consolidated group, S and C should be treated as separate entities, and S's basis in CFC2 should not depend upon transactions in the S stock.

The Proposed Regulations also appear to provide that even after S is acquired by Buyer, S's disposition of CFC2 will result in a basis reduction in the CFC2 stock. In other words, it appears that the attribute of net used tested loss amount stays with S even when S is owned by a new buyer. This appears to be the correct answer as an economic matter. The CFC2 net used tested loss amount reduced the tested income of CFC1 and tax liability of S before S was sold. In addition, the cash from such offset tested income could be withdrawn from CFC1 to S, and (except if Section 1059 applies) from S to C, without any further tax or basis reduction.

On the sale of S at its reduced value, C has received a second tax benefit from the used tested loss, and it is reasonable to offset that benefit with a reduction in the basis in

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[106] The issues when C and S file a consolidated return are discussed separately in Part IV.D.

CFC2 when it is sold. Moreover, it would be very unusual, if not unique, outside the consolidated group and partnership contexts, for the tax basis of an asset at a lower tier (i.e., S's basis in CFC2 upon the sale of CFC2) to be affected by a transaction occurring at a higher tier (i.e., C's sale of S stock).

However, continuing to apply the CFC basis reduction rule after the purchase of the S stock creates a trap for the unwary. Any purchaser of a U.S. shareholder of a CFC would be taking the risk that the stated tax basis in the CFC is good "for today only." When the basis really matters, i.e., when the stock in the CFC is sold, the basis could go down by an undetermined amount. Knowledgeable purchasers will protect themselves with new language in many if not most acquisition agreements. However, to put unsuspecting taxpayers on notice of this new concept, we believe it is very important that the final regulations make very clear, ideally through a simple example, that the potential basis reduction in stock of a CFC can occur following a sale of the stock in the U.S. shareholder of the CFC.

(c) *Collateral Effects of Stock Basis*

Until the stock of the CFC is disposed of, there is no reduction in the basis of its stock. This could have collateral effects.

(i) *Allocation of Interest Expense*

Depending on future regulations concerning allocation of interest expense of the U.S. shareholder, the unreduced basis may result in an allocation of interest expense to the CFC for foreign tax credit purposes determined by reference to this unreduced stock basis.

This result does not seem justified, since the U.S. shareholder will not be able to take advantage of the unreduced basis when the CFC stock is sold. Moreover, the basis reduction upon a sale represents a net used tested loss amount, which would normally represent a true decline in value of the CFC. Regulations should clarify the consequences to a U.S. shareholder of unreduced basis in the stock of a CFC, where the basis will be reduced immediately before a disposition.

(ii) *NUBIG and NUBIL*

Likewise, under Section 382(h)(1), if S has a change in ownership under Section 382, net unrealized built in gain (NUBIG) and loss (NUBIL) is based on the difference between the tax basis and fair market value of the assets of S at that time.[107] In particular, recognized NUBIG of S increases the Section 382 limit of S for the year, and recognized NUBIL is treated as a loss carryover subject to Section 382.

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[107] NUBIG and NUBIL are also relevant for Section 384 and the "separate return limitation year" rules relevant to consolidated groups.

The NUBIG and NUBIL rules are designed to put the taxpayer in the same position as if it had sold its assets on the day before the change in ownership. Gains on such assets could be offset by current NOLs without limitation, and losses on such assets that carried over to the post-acquisition period would be subject to Section 382. As a result, it seems most consistent to apply the NUBIG and NUBIL rules to a U.S. shareholder of a CFC by taking into account the future basis reduction in the stock of the CFC that would arise if the CFC were sold immediately before the change in ownership of the U.S. shareholder.[108] This would increase NUBIG, and reduce NUBIL to the extent of the potential basis reduction.

In fact, Notice 2003-65[109] defines NUBIG and NUBIL in terms of the gain or loss that would be recognized in a hypothetical sale of assets of the loss corporation immediately before the ownership change. While this Notice was obviously not drafted with the CFC basis reduction rule in mind, we believe the principle is correct and that this rule would take account of the CFC basis reduction rule. Final regulations should confirm this result.[110]

(iii) *Exempt COD income*

Regulations should also clarify the relationship between the CFC basis reduction rule and Section 108(b)(2)(E), under which a taxpayer's basis in its property can be reduced (but not below \$0) to the extent of the taxpayer's exempt cancellation of indebtedness ("**COD**") income.

For example, suppose the taxpayer is a corporation whose only asset is stock of a CFC with a basis of \$100 and net used tested loss amount of \$80,[111] and the shareholder has exempt COD income of \$60. If the unreduced basis of \$100 is taken into account under Section 108(b), then that section currently reduces the basis by \$60 to \$40. Then, the CFC basis reduction rule reduces the basis by \$40, to \$0, and creates additional gain of \$40, all at the time of sale of the CFC stock. However, if the cap on the Section 108(b) basis reduction is the reduced basis of \$20 rather than the unreduced basis of

[108] These results would be analogous to the rules for "built-in items" under Section 382(h)(6), under which items of income and deduction that are taken into account after an ownership change, but that are attributable to periods before the change date, are treated as built-in gain or loss.

[109] 2003-2 C.B. 747.

[110] A similar issue arises if a CFC has untaxed e&p on the day before the change in ownership, such as from offset tested income or from tested income sheltered by NDTIR. The U.S. shareholder's gain on a sale of the stock of the CFC would be a dividend eligible for Section 245A to the extent of the untaxed e&p. Section 1248(j). However, Section 1248(a) treats the gain as recognized gain. Since Notice 2003-65 defines NUBIG and NUBIL in terms of gain or loss recognized on a hypothetical sale, it appears to treat that gain as NUBIG even though it is effectively tax-exempt. Treasury should consider whether an upward basis adjustment for NUBIG and NUBIL purposes is appropriate in this situation.

[111] Assume the taxpayer previously disposed of the CFC with the offset tested income.

$100, then the Section 108(b) basis reduction is $20, so the unreduced basis becomes $80 and the reduced basis on a sale becomes $0 without any additional gain recognition.

It can be argued in favor of the second approach that while the shareholder has tax basis of $100 in the stock of the CFC, it will never be able to take advantage of that tax basis. Moreover, the Section 108(b) basis reduction should be limited to the tax basis that the shareholder can ultimately use. This is the result that would arise if the tax basis in the CFC had been reduced immediately rather than deferred. The second approach is also consistent with Section 1017(b)(2), which provides that the aggregate basis of the assets of the taxpayer is never reduced below the amount of liabilities of the taxpayer. This in effect gives the debtor a “fresh start” by preventing gain recognition even if all the taxpayer’s assets are disposed of solely for assumption of the taxpayer’s debt.

(d) *Noncorporate U.S. Shareholders*

The Preamble requests comments concerning whether the CFC basis reduction rule should be extended to non-corporate U.S. shareholders, taking into account that they are not entitled to a dividends received deduction under Section 245A. For example, suppose that S in Example 21 is an individual.

We do not believe the CFC basis reduction rule should apply in this case. It is true that the tested loss in CFC2 both offsets the tested income in CFC1 and can result in a loss on the sale of the CFC2 stock. However, the tested income in CFC1 will be taxable to the shareholder when distributed or when the CFC1 stock is sold, so the sheltering of tax on the tested income of CFC1 is only temporary. It does not seem fair to permanently deny a real economic loss on CFC2 stock in exchange for a deferral in the taxation of earnings of CFC1.

(e) *Definition of “Disposition”*

The Preamble asks for comments on whether the definition of “disposition” of CFC stock should be broadened to include transactions that do not involve a transfer of stock, but rather take advantage of the tax basis of the stock, for example Section 301(c)(2) or Section 1059. We discuss that issue here.

First, Section 165(g) allows a loss for worthless stock and is treated as a sale of the stock for “zero.” This should be treated as a disposition of the stock that reduces tax basis, since there will generally be no further opportunity to avoid the double tax benefit from the tested loss.

Next, suppose S has a “regular” tax basis of $100 in the stock of a CFC2, and a net used tested loss amount of $80 in CFC2 from its tested loss that offset tested income of CFC1. On a sale of the CFC2 stock, the tax basis is reduced to $20. Suppose now that CFC2 has no e&p, and there is a Section 301(c)(2) distribution of $20. It could be argued that this is in substance a disposition of a percentage of the stock of CFC2, based on the ratio of $20 to the fair market value of CFC2. However, we do not believe that a Section

301(c)(2) distribution of even $1 should trigger taxation of the entire net used tested loss amount of $80, or that proration requiring a valuation of CFC2 is practicable.

As a result, to the extent the distribution is no more than the reduced basis that would arise in the CFC2 stock on a sale of the stock, we do not believe any gain should be triggered on account of the CFC basis reduction rule. In the example, the tax basis would be reduced to $80 under Section 301(c)(2), and the basis upon a sale would be $0.

Now, assume the distribution to S is $100 rather than $20. If the result in the prior paragraph is accepted, that same result must also apply to the first $20 of the $100 distribution. The only question is the treatment of the additional $80. That $80, as well as the original $20, is a Section 301(c)(2) distribution based on the $100 unreduced tax basis of the CFC. However, $80 is a Section 301(c)(3) distribution based on the $20 reduced tax basis of the CFC.

It can be argued that this $80 should be taxable to S. The tax free recovery of cash in this situation would arguably be a double benefit from the $80 of the used tested loss. First, the loss reduced the tested income otherwise taxable to S by $80, and then the unreduced basis allowed a tax free distribution of $80 of cash. Moreover, if S sold all the stock of CFC2 for $100, S would recognize gain of $80. Arguably S should not be in a better tax position than this by receiving a distribution of $100 from CFC2 and *keeping* all the stock. Moreover, a distribution of the cash, combined with the issuance of new stock to a third party by CFC2, is economically equivalent to a sale of part of the CFC2 stock by S to the third party, and the CFC basis reduction rule would apply in the latter case.

Finally, CFC1 can make tax-free distributions of its $80 of e&p under Section 245A, plus an additional amount equal to S's basis in CFC1. Allowing full basis recovery in CFC2 means that CFC2 can make a tax-free distribution of the unreduced tax basis of $100. Yet if CFC1 and CFC2 were a single corporation, there would be no net e&p from offsetting tested income and loss, and the total tax-free distributions would equal the combined tax bases in CFC1 and CFC2. As a result, if Section 301(c)(2) applies to the unreduced basis in CFC2, the effect is to increase the combined available tax-free distributions by the amount of the tested income and tested loss ($80 in this case) as compared to single entity treatment of CFC1 and CFC2. This is arguably an unjustifiable result.

Under this approach, S would recognize gain of $80, and the regular tax basis would be reduced to $0.[112]

[112] Under this approach, if the net used tested loss amount exceeded S's tax basis in the CFC2 stock, there would at that point in substance be a hypothetical negative basis for purposes of Section 301(c)(2). Then, any cash distribution would be fully taxable, but the potential gain from the hypothetical negative basis would remain unchanged rather than being triggered in full. Likewise, if S transfers stock in a CFC in a Section 351 transaction or reorganization transaction and receives back boot, under this approach, the boot should be taxable if, and only if, it would be taxable based on the reduced tax basis that S would have

On the other hand, it can be argued that the $80 should not be taxable to S. Unlike in the case of Section 165(g), which is often the final disposition of the stock, a Section 301(c)(2) distribution does not generally result in the final disposition of stock. Thus, CFC basis reduction rule can apply to the stock of CFC2 when it is sold. Moreover, there is not necessarily a double benefit from the tested loss just because the distribution exceeds the reduced basis in CFC2. The reduced basis is merely a protective measure to prevent a double benefit from arising, but this does not mean that a double benefit in fact arises every time such basis is used for some purpose by S (as discussed in Part IV.B.2(a)). For example, taxing the $80 to S could overstate the ultimate amount of duplicated benefit from the tested loss, since after the distribution, CFC2 might have offset tested income that reduces or eliminates the pre-distribution net used tested loss amount.

Furthermore, if only the reduced basis is taken into account and S had a different basis in different shares of stock of CFC2, S might have Section 301(c)(3) gain on the low-basis shares even before its aggregate reduced basis was fully recovered, since a distribution is treated as pro rata with respect to each share.[113] Regardless of the appropriateness of this pro rata rule in a typical situation involving different blocs of stock, the failure to allow full recovery of the reduced basis in this case seems inconsistent with the purpose of the CFC basis reduction rule. The result is obviously also worse than if S had sold its high basis shares, undercutting the analogy of a Section 301(c)(2) and (c)(3) distribution to a sale of a portion of the shares.

Moreover, to the extent that S should not be taxed on distributions before it would be taxed if CFC1 and CFC2 were divisions of a single corporation, S should not be taxed on distributions from CFC2 unless and until the total distributions by CFC1 and CFC2 of (1) non e&p amounts, and (2) e&p amounts eligible for Section 245A, exceed S's aggregate unreduced basis in CFC1 and CFC2. Yet it would be extremely burdensome to require this calculation to be made every time a distribution is made by CFC2, and further adjustments would be needed if the Section 301(c) distribution was made by CFC2 before the non e&p amounts were distributed by CFC1. Thus, this argument runs, it is reasonable to use the unreduced basis of CFC2 for purposes of Section 301(c)(2) and (c)(3), and apply the CFC basis reduction rule when the CFC2 stock is sold.

Under this approach, no gain would be recognized by S on the distribution of $100, and S's basis in CFC2 on a sale would be $0 (reflecting the original $100 minus the $100 distribution under Section 301(c)(2)) and there would be $80 of gain pursuant to the CFC basis reduction rule, reflecting the $80 used tested loss.

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in the CFC under the CFC basis reduction rule, but any potential gain from the hypothetical negative basis should not otherwise be triggered.

[113] *Johnson v. United States*, 435 F.2d 1257 (4th Cir. 1971); *Illinois Tool Works Inc. v Comm'r*, T.C. Memo. 2018-121 (Aug. 6, 2018).

We do not take a position on which of these alternatives should be adopted in final regulations. However, whichever rule is adopted, we believe the same rule should apply to Section 1059 in determining whether gain would be recognized when the reduced basis (or the unreduced basis) would be reduced below $0 by that section.

(f) *Tax Free Dispositions of CFC Stock*

The Proposed Regulations do not purport to override the provisions of the Code for tax free transactions, even to the extent that the CFC basis reduction rule results in the equivalence of a negative basis. Rather, they preserve the net used tested loss amount whenever possible.

For example, suppose US1 transfers the stock of CFC1 to a foreign corporation F in exchange for stock in F, in a tax free transaction. Assume that CFC1 remains a CFC and US1 remains a U.S. shareholder of CFC1, regardless of the status of F. In that case:

- If F sells the stock of CFC1, the basis in CFC1 is reduced by US1's net used tested loss amount in CFC1,[114] and, if F is a CFC and US1 does not own 100% of F under Section 958(a), any resulting increase in Subpart F income of F is specially allocated to US1.[115]

- If US1 sells the F stock, F is a CFC, and US1 is a U.S. shareholder of F, then US1's net used tested loss amount in F is adjusted upwards or downwards to reflect US1's net used tested loss amount or net offset tested income amount in CFC1.[116]

- If US1 sells the F stock but F is not a CFC, then F is treated as a CFC with no net used tested loss amount or offset tested income amount, and US1's basis in F is reduced by CFC1's net used tested loss amount.[117]

However, the Proposed Regulations do not by their terms trigger a basis reduction upon disposition of a CFC if, at that time, the U.S. shareholder with the net used tested loss amount in the CFC is no longer a Section 958(a) U.S. shareholder of the CFC, or if the CFC is no longer a CFC.

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[114] Prop. Reg. § 1.951A-6(e)(1)(i).

[115] Prop. Reg. § 1.951A-6(e)(7).

[116] Prop. Reg. § 1.951A-6(e)(1)(ii). In addition, although not affecting the gain or loss to US1, immediately before such basis adjustment, F's basis in CFC1 is reduced by US1's net used tested loss amount in CFC1. Prop. Reg. §§ 1.951A-6(e)(1)(i), (iv).

[117] Prop. Reg. § 1.951A-6(e)(1)(iii). In addition, although not affecting the gain or loss to US1, immediately before such basis adjustment, F's basis in CFC1 is reduced by US1's net used tested loss amount in CFC1. *Id.*

For example, suppose that US1 is a Section 958(a) U.S. shareholder of CFC1 and has a net used tested loss amount in CFC1. CFC1 issues additional stock to a third party and either ceases to be a CFC, or remains a CFC but US1 ceases to be a Section 958(a) U.S. shareholder owning 10% of CFC1. It appears that US1 can then sell the stock of CFC1 without any basis reduction.

Similarly, suppose that US1 is a Section 958(a) U.S. shareholder of CFC1, and transfers the stock of CFC1 to foreign corporation F that might or might not be a CFC. Suppose that CFC1 ceases to be a CFC, or it remains a CFC but US1 ceases to be a Section 958(a) U.S. shareholder of CFC1.[118] It appears that F can sell the stock of CFC1 without any basis adjustment for US1's former net used tested loss amount in CFC1. Alternatively, it appears that US1 can sell the stock of F without any adjustment for its former net used tested loss amount in CFC1. The same result would arise on a Section 332 liquidation of CFC1 into US1, where the tax basis of the stock of CFC1 disappears.

Regulations should clarify the results in these cases. Under FIRPTA and Section 367, gain is triggered before an asset leaves the taxing jurisdiction of the relevant Code sections. On the other hand, those results are based on clear Code provisions or clear grants of regulatory authority. The Code does not contain such a rule for the basis reduction amount of CFCs, nor is there a specific grant of regulatory authority for such a result.

Consequently, it appears that under the Proposed Regulations, a U.S. shareholder of a CFC can avoid the adverse consequences of a net used tested loss amount in a CFC by having the CFC issue new stock to an unrelated party and cause the U.S. shareholder to lose such status. However, if a net used tested loss amount can be eliminated using this or similar methods, considerable tax planning will be possible.

Regulations should also clarify the result where US1 has a net used tested loss amount in CFC1, and CFC1 transfers assets to newly formed CFC2 and spins off CFC2 to US1 in a transaction described in Section 368(a)(1)(D) and Section 355 (a "**divisive D reorganization**"). It is not clear whether the net used tested loss amount remains with CFC1 or is allocated between CFC1 and CFC2.

(g) *Section 381 Transactions*

The Proposed Regulations[119] apply if a U.S. shareholder US1 has a net used tested loss or offset tested income amount with respect to a CFC (the "**acquired CFC**") that is the distributor or transferor to another CFC (the "**acquiring CFC**") in a Section 381 transaction. Then, "the domestic corporation's net used tested loss amount or net offset

[118] Treas. Reg. § 1.367(b)-4(b) would require US1 to include in income, as a deemed dividend, the Section 1248 amount with respect to CFC1 in these cases, although the dividend would presumably be eligible for Section 245A.

[119] Prop. Reg. § 1.951A-6(e)(5).

tested income amount with respect to the acquiring CFC is increased by the amount of the net used tested loss amount or net offset tested income amount of the acquired CFC." This raises a number of questions.

First, the final regulations should clarify that the reference to "the domestic corporation" is to the U.S. shareholder of the acquired CFC.

Second, the formula in the Proposed Regulations assumes that the acquired CFC and the acquiring CFC both have a net offset tested income amount, or both have a net used tested loss amount. The formula does not contemplate that one of the CFCs might have a net offset tested income, and the other a net used tested loss. In that case, the two numbers should be netted to get an overall net used tested loss amount or overall net offset tested income amount.

Third, as discussed in Part IV.B.3(f) concerning exchanges of stock, the Proposed Regulations do not apply if the acquired CFC merges into a foreign corporation F that is not a CFC. Alternatively, if F is a CFC but US1 is not a U.S. shareholder of F, the Proposed Regulations literally treat US1 as having a net used tested loss amount or net offset tested income amount in F. However, there is no provision that would trigger a basis adjustment upon the disposition of the stock of F by a shareholder of F that is not a U.S. shareholder of F. If the intent of the Proposed Regulations is that the net used tested loss amount in F not be triggered in this case, the Proposed Regulations would be clearer if it only applied in the first place when the U.S. shareholder of the acquired CFC is a U.S. shareholder of the acquiring CFC immediately after the transfer.

We also observe that these rules are different than the rules for "hovering deficits" that apply to a CFC that is acquired in a Section 381 transaction.[120] However, hovering deficits relate to e&p deficits of the CFC itself, and separate tracking of pre-acquisition e&p deficits of the transferor CFC is possible. Those rules would not work for a shareholder level concept such as combining the U.S. shareholder's net used tested loss amount in the acquired CFC with its net offset tested income amount in the acquiring CFC.

As a result, while the need for an additional set of rules is unfortunate, we see no alternative. We also note that these rules will likely lead to at least partially tax-motivated mergers designed to reduce or eliminate the basis reduction attributable to the net used tested loss amount of a CFC.

(h) *Special Allocation of Subpart F Income*

As noted above, a special rule (the "**special allocation rule**") applies if CFC1 sells stock in CFC2, a U.S. shareholder owns less than 100% of CFC1 under Section 958(a), and the basis in the stock of CFC2 is reduced because of a net used tested loss

[120] Treas. Reg. § 1.367(b)-7(d)(2).

amount in CFC2 allocable to the shareholder. In that case, any increase in Subpart F income of CFC1 attributable to the increased gain on the CFC2 stock is allocated solely to the U.S. shareholder rather than pro rata among all shareholders of CFC1.

The special allocation rule is logical. If CFC1 has additional Subpart F income because of a basis reduction in its stock in CFC2 attributable to a particular U.S. shareholder (US1), it makes sense to allocate that Subpart F income solely to US1. Moreover, it makes sense for that rule to apply only when US1 owns less than 100% of CFC1 under Section 958(a). If US1 owns 100%, it would be allocated all the Subpart F income anyway and there would be no need for the special allocation rule.

We note, however, that while the rule specially allocates an increase in Subpart F income resulting from a shareholder's net used tested loss amount in CFC2, it does not specially allocate the effects of a reduced tax loss arising on the stock sale. This can shift the burden of a net used tested loss amount from the shareholder that is allocated that amount to other shareholders of CFC1.

For example, suppose that CFC1 is owned 50% by US1 and 50% by US2, CFC1 has a basis of $100 in the stock of CFC2, US1 has a net used tested loss amount of $70 in its indirect 50% interest in CFC2, US2 has no net used tested loss amount or offset tested income amount in its indirect 50% interest in CFC2, and CFC1 sells all the stock of CFC2 for $30.

It appears that the basis of CFC1 in CFC2 is reduced from $100 to $30, resulting in no gain or loss to CFC1 on the sale. Regulations should confirm that CFC1 has an overall gain or loss taking into account its own tax basis reduced by net offset tested losses from all its U.S. shareholders. Since there is no Subpart F income to reallocate, neither US1 nor US2 has any gain or loss. Yet if US1 did not have any net used tested loss amount, US1 and US2 would each benefit from $35 of CFC1's $70 loss on the stock sale (e.g., through a reduction in Section 951(a) inclusions from CFC1's gains on other sales of stock). In effect, US2 has borne the tax cost of 50% of the basis reduction attributable to the net used tested loss amount of US1. Regulations should confirm that this is the intent of the rule. The alternative would be to allocate the entire basis reduction to US1, resulting in US1 being attributed gain of $35 on the stock sale (possibly resulting in a Subpart F inclusion) and US2 being attributed a $35 loss on the stock sale (potentially offsetting $35 of other Subpart F income allocable to US2).

As a separate matter, we note that while the Proposed Regulations specially allocate additional Subpart F income arising from the net used tested loss amount of CFC2, there is no special allocation of exempt gain to shareholders of CFC1 on the basis of their share of the net offset tested income amount of CFC2. Such tested income would normally give rise to tax exempt e&p in CFC2, and as a result the corresponding gain to

CFC1 on the sale of stock of CFC2 would be tax exempt income to the shareholders of CFC1.[121]

However, different shareholders of CFC1 may have used their own tested losses to offset different amounts of the tested income of CFC2, and so the tax exempt e&p in CFC2 may not be allocable pro rata to the different shareholders of CFC1 as an economic matter. We recognize the difficulty of specially allocating exempt gain to shareholders of CFC1. However, it seems anomalous that there is a special allocation of increased gain from net used tested losses of some shareholders, but no special allocation of exempt gain corresponding to net offset tested income allocable to other shareholders.

(i) *CFCs Held by Partnerships*

The Proposed Regulations apply the CFC basis reduction rule to Section 958(a) stock of a CFC held directly or indirectly by a domestic corporation. Section 958(a) stock is stock held by any U.S. shareholder, whether a corporation or not. The Proposed Regulations do not discuss the extent to which the CFC basis reduction rule applies to stock in a CFC held by a partnership that is a U.S. shareholder of the CFC. The ambiguity arises because the partnership, as a U.S. shareholder, is a holder of Section 958(a) stock, and a corporate partner of the partnership is indirectly holding that Section 958(a) stock through the partnership.

Final regulations should clarify this issue. We believe the following principles should apply:

First, as discussed in Part III.F.1(b), if a corporate partner of the partnership is a U.S. shareholder of the CFC, Proposed Regulation Section 1.951A-5 applies aggregate principles and requires the partner to determine its own GILTI calculations. As a result, the CFC basis reduction rule should apply to the partner, just as it would if the CFC stock were held directly by the partner. This should be true if the corporate partner sells the partnership interest, or the partnership sells the stock in the CFC. It would make no sense to allow a corporate U.S. shareholder of a CFC to be able to avoid the CFC basis reduction rule by merely holding the stock in the CFC through a partnership.

Second, if an individual partner of the partnership is a U.S. shareholder of the CFC, Proposed Regulation Section 1.951A-5 applies aggregate principles and requires the partner to determine its own GILTI calculations. As a result, the CFC basis reduction rule should apply to the partner to the same extent as it would if the partner owned stock in the CFC directly. As discussed in Part IV.B.3(d), we believe that an individual that is a direct U.S. shareholder of a CFC should not incur a basis reduction, since an individual is not eligible for Section 245A on dividends form the CFC, and we believe the same is true for the individual U.S. shareholder holding the CFC through a partnership.

[121] Sections 964(e)(1) and (e)(4).

Third, consider the corporate and individual partners of a partnership that are not themselves U.S. shareholders of the CFC. Under Proposed Regulation Section 1.951A-5, the GILTI calculation is done entirely at the partnership level and the GILTI inclusion is allocated to such partners. It can be argued that absent the application of the CFC basis reduction rule, the partnership and these partners would obtain a double benefit from the tested loss of a CFC, since the tested loss reduces the GILTI inclusion and also allows the partnership to sell the stock in the CFC at a loss.

However, none of these partners is eligible for Section 245A if the CFC with offset tested income pays a dividend of its earnings. The reason is that Section 245A only applies to 10% corporate shareholders. As a result, the benefit of the used tested loss to shelter the offset tested income from tax is somewhat illusory. Tax will have to be paid on the income when it is distributed or the stock of the CFC with tested income is sold. Consequently, we believe that the CFC basis reduction rule should not apply to the partnership level calculation of GILTI inclusion for its partners that are not U.S. shareholders of the CFC. Likewise, the CFC basis reduction rule should not be relevant for such a partner selling its interest in the partnership.

(j) *Retroactivity of Basis Reduction Rule*

The CFC basis reduction rule applies even to losses that arose before the Proposed Regulations were published. As a result, taxpayers may have unexpectedly large gains on prior stock sales, and this rule could change before being finalized. Regulations should provide relief from estimated tax penalties for underpayments attributable to not properly applying the CFC basis reduction rule for dispositions of CFCs prior to 30 days after the rule is finalized.

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

1. *Summary of Proposed Regulations*

Under Proposed Regulation Section 1.1502-51(c), the CFC basis reduction rule described in Part IV.B.1 applies in the usual manner to stock of a CFC that is owned by a member M of a consolidated group. In particular, the CFC basis reduction rule reduces the tax basis of stock in the CFC in the hands of M by M’s net used tested loss amount in the stock.[122] However, as would be expected, a member’s net used tested loss amount or offset tested income amount in a CFC is based on the allocation of tested loss to tested income among members as determined under the usual rules for allocating tested loss to tested income among members of a consolidated group.[123] See Part III.G.1.

[122] Prop. Reg. § 1.1502-51(c)(1).

[123] Prop. Reg. §§ 1.1502-51(c)(2), (c)(3).

To illustrate, in Example 20 in Part III.G.1, CFC1 (owned by M1) and CFC3 (owned by M2) each has tested income of $100 and offset tested income of $50, and CFC2 (owned by M1) has a used tested loss of $100. Thus, under the CFC basis reduction rule, M1's basis in CFC1 goes up by M1's GILTI inclusion of $50, M2's basis in CFC3 goes up by M2's GILTI inclusion of $50, CFC1 and CFC2 each has $50 of untaxed e&p that can be distributed under Section 245A, and M1's basis in CFC2 goes down by $100 when the CFC2 stock is sold.

2. *Comments*

(a) *Single Entity Principles*

The effect of applying the CFC basis reduction rule in this manner in the consolidated return context is to make the basis reduction in a CFC the same regardless of where in a group the particular CFC is located. Moreover, the total basis reduction is always the same as if a single corporation owned all the CFCs owned by various group members. Thus, this rule carries out the single entity concept of a consolidated group, and we applaud the result.

(b) *Effects of Sale of Member Stock*

Final regulations should clarify the effects of the CFC basis reduction rule upon and following a sale of the M stock, and examples should be provided.

> **Example 23**. *Consolidated P sells M stock.* Assume that P owns M, and M owns a CFC with a used tested loss of $100. Under "Rule 1" of the -32 Proposed Regulations, discussed in Part IV.D.1, P's basis in M is reduced currently by the net used tested loss amount in the CFC. P sells the stock of M. P's gain is increased (or P's loss is reduced) by $100 under Rule 1.

As discussed in Part IV.B.3(b), outside the consolidation context, the CFC basis reduction rule does not appear to reduce M's basis in the CFC by $100 at the time of the sale of M, but appears to continue to apply to M if M leaves the P group and then sells the CFC.

Assuming this is correct, final regulations should clarify whether the same rules apply under -51(c)(1) when M was a member of the P group when the net used tested loss amount in the CFC arose, and M later leaves the P group and sells the CFC. If so, M retains its net used tested loss amount in the CFC when M leaves the group, and the CFC basis reduction rule will apply to M upon its later sale of the CFC stock.

As a technical matter, -51(c)(1) incorporates by reference the CFC basis reduction rule that applies outside the consolidated return context. Moreover, tax basis in the CFC is an attribute of M rather than the P group, and nothing in the Proposed Regulations states that the potential basis reduction is turned off when M leaves the group in which the net used tested loss amount arose.

In addition, as a policy matter, we believe that M's basis in the CFC should be treated the same after the purchase of M regardless of whether the net used tested loss amount in the CFC arose while M was a member of another group (or a nonmember of any group). It would be administratively complex and cause considerable confusion if M's tax basis in the CFC after the purchase of M depended upon whether M had previously been a member of a group (any group) when the net used tested loss amount arose.

Arguably there is less reason to apply the CFC basis reduction rule to M if the net used tested loss amount arose while M was a member of a prior group, since in that case the basis of the M stock to group members would have been reduced (and the gain on the sale of the M stock by group members increased) under Proposed Regulation Section 1.1502-32(b)(3)(iii)(C) (discussed as "Rule 1" in Part IV.D.1). However, under that rationale, the further distinction would have to be made to continue to apply the CFC basis reduction rule to M if M had been the parent of a group, since the -32 basis reduction would not apply to stock in a parent corporation and so there would not have been increased gain on the sale of the M stock.

On the other hand, as a technical matter, "tested loss amount" and "net used tested loss amount" are defined as the stated amounts "with respect to a member." Arguably, when the "member" ceases to be a "member" of the group in which the net used tested loss amount arose, its net used tested loss amount while it was in the group ceases to exist. Under this reading, the treatment of the basis of the CFC in the hands of the buyer of M would depend upon whether M had been a member of a group when the net used tested loss amount arose (without regard to whether M was the parent of the group, if the old group terminated upon the purchase of M).

As an economic matter, when M is a subsidiary in a consolidated group, there is less reason for the net used tested loss amount to carry over after M leaves the P group than if M is not a group member. In the former case, but not the latter, P's basis in M is reduced by the net used tested loss amount in the CFC under Rule 1 (discussed in Part IV.D.1). As a result, P has an increased gain on the sale of the M stock that does not exist in the nonconsolidated case. As a result, while the tested loss was used to offset tested income in the group, the basis reduction in the M stock avoids the creation of a second benefit to the group from the tested loss.

On the other hand, even in the case of a consolidated seller, the failure to reduce the basis of the CFC on its sale by M after M leaves the P group would result in an overall double benefit from the tested loss, once in the P group and once outside the P group. The P group would get a benefit from the offset of tested income, with Rule 1 denying the second benefit of loss on the sale of M, but M (and any group buying the stock of M) would get a benefit of the unreduced basis if M sold the CFC stock after leaving the P group.

An analogous situation would be the case where, instead of M owning a CFC with a tested loss of $100 that offset other group tested income of $100, M owned a U.S.

group member M2 that had a current loss of $100 that offset other group tested income of $100. When that loss was used to offset the tested income, M's basis in M2 would be reduced by $100 under the existing -32 regulations, and this basis reduction would tier up to reduce P's basis in M. When P sold the stock of M, there would be additional gain of $100. Nevertheless, in the hands of the buyer of M, M's basis in M2 would retain its reduced basis and would not "snap back" when M left the P group. Based on this analogy, it would be logical for the basis reduction in -51(c)(1) to continue to apply to M after it leaves the P group.

Moreover, if -51(c)(1) provided for an immediate reduction in the basis of the CFC at the time M received the benefit of a net used tested loss amount, there is no doubt that the resulting reduced basis in the CFC would continue with M after M left the P group. It would be odd if the deferral of the reduction in basis until the sale of the CFC were to result in no basis reduction at all if the sale occurred after M left the P group, when the deferral was intended as a mere timing benefit.

On balance, therefore, we believe final regulations should retain the basis reduction rule upon the disposition of the CFC after M leaves the P group.

If final regulations adopt this approach, they should also clarify whether, if M joins a new group, the basis reduction of the CFC in the new group tiers up under -32 to members within the group. This basis reduction should not tier up in the P group because the resulting basis reduction would duplicate the Rule 1 basis reduction in the stock of M.[124] No such duplication exists in the buying group.

However, the buying group would have paid fair market value for the M stock, M's basis in the CFC would decrease on the sale of the CFC by the used tested loss amount, and M's gain would increase (or loss would decrease) by the same amount. M's gain or loss would tier up to its shareholder (New P) under the usual rules. If New P's basis in M was increased by the additional gain (or reduced loss) recognized by M as a result of the reduction in basis in the CFC stock, but was not decreased by the basis reduction itself, New P would have a net increase in tax basis in M without any corresponding economic profit.[125] As a result, the reduction in CFC basis to M at the time of sale of the CFC should tier up to New P.

(c) *Taxable Intra-Group Dispositions of a CFC*

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[124] Treas. Reg. § 1.1502-32(a)(2) prohibits duplicative adjustments to the stock of a member.

[125] For example, assume New P buys M for $100, and M's only asset is CFC1 with a value of $100 and net used tested loss amount of $100. If M immediately sells the CFC1 stock for $100, it will have gain of $100. If the gain, but not the basis reduction, tiers up to New P, P will have a basis of $200 in M even though M has a value of $100. Likewise, if the value of CFC1 declines and M sells the CFC1 stock for $0, M will have no gain or loss. If the basis reduction does not tier up to New P, New P will have a basis of $100 in stock of M that is worth $0. In both cases, the effect of the CFC basis reduction rule would be negated if the amount of the CFC basis reduction did not tier up.

Regulations should clarify the results when stock of a CFC is sold from one member of the group to another member of the group, or distributed in a taxable transaction to another member. An example in the final regulations would be helpful.

> **Example 24**. *Intra-group sale of CFC*. P owns M1, and M1 has a CFC with a $100 net used tested loss amount. Under -32, P's basis in M1 has been reduced by $100, and M1's basis in the CFC will be reduced by $100 upon its disposition of the CFC. M1 sells the CFC to M2. Assume the CFC has no untaxed e&p, so there is no Section 1248 issue.

Presumably the M1 basis in the CFC is reduced by the net used tested loss amount, even though the sale is to another group member, but this should be clarified. If this is correct, M1's gain is increased, and the gain is deferred under the -13 consolidated return regulations. Regulations should clarify that the gain to M1 is deferred even if the gain is due to the used tested loss amount being greater than M1's basis in the CFC. The uncertainty arises because, strictly speaking, that gain arises on the basis reduction rather than on M1's sale of the CFC. However, the CFC basis reduction rule treats this gain as additional gain on the sale of the stock of the CFC, and this result is necessary in order for the consolidated group to be treated as a single entity. Moreover, the intercompany transaction rules apply to items that arise "directly or indirectly" from an intercompany transaction.[126]

In addition, final regulations should clarify that M2 does not inherit the net used tested loss amount in the CFC in the hands of M1. The basis in the CFC has already been reduced by that amount in the hands of M1 and has increased M1's gain on the sale to M2.

(d) *Special Allocation of Subpart F income*

Under the Proposed Regulations, for purposes of determining the application of the special allocation rule described in Part IV.B.3(h) to a consolidated group, the amount of stock considered to be owned by a member of a group within the meaning of Section 958(a) includes any stock the member is deemed to own under Section 958(b) (the "**consolidation modification**").[127]

The consolidation modification raises significant questions. First, final regulations should confirm that the consolidation modification relates only to determining the applicability of the special allocation rule. That is, it only applies to the "on/off" switch in the special allocation rule that applies the rule only when the shareholder with the net used tested loss amount (the "**responsible shareholder**") owns less than 100% of the stock in CFC1 under Section 958(a).

[126] Treas. Reg. § 1.1502-13(b)(2)(i).

[127] Prop. Reg. § 1.1502-51(c)(4).

For example, if the responsible shareholder owns 50% of CFC1 under Section 958(a), and 50% under 958(b), then it is clear that the special allocation rule does not apply and the Subpart F income of CFC1 is allocated pro rata to all Section 958(a) shareholders. Moreover, if the responsible shareholder owns 50% of CFC1 under Section 958(a) and 40% under Section 958(b), it is clear that the special allocation rule applies. Once it applies, the consolidation modification should be irrelevant, and the Subpart F income of CFC1 should be specially allocated to stock owned under Section 958(a) by the responsible shareholder, not stock owned under Section 958(b) by that shareholder. The latter category might even include stock directly held by non-group members, such as by an individual owner of the parent of the group, yet it would not include stock held under Section 958(a) by third parties where the responsible shareholder was not a Section 958(b) owner. These distinctions would defeat the purpose of the special allocation rule and would be quite illogical.

Second, the purpose of the 100% trigger for the consolidation modification is unclear. If the group as a whole owns 100% of CFC1 under Section 958(a) and thus the responsible member owns 100% under Sections 958(a) and (b), there is no special allocation of the additional Subpart F income to the responsible member. Then, when CFC1 sells CFC2, all members of the group that own CFC1 immediately before the sale are allocated proportionately, based on their ownership of CFC1, the Subpart F income of CFC1 attributable to the responsible member's net used tested loss amount in CFC2. In fact, multiple members might be responsible members, with the result that the aggregate net used tested loss amount of the group in CFC2 is allocated to all the members in proportion to their Section 958(a) ownership in CFC1.

This approach is consistent with the rule that allocates tested losses of a tested loss CFC proportionately to all members with tested income, without a priority allocation to a shareholder of the CFC that has tested income. However, this approach is inconsistent with the fact that when multiple members own a first tier CFC, and they all sell their stock in the CFC, the net used tested loss amount attributable to each member increases the gain of the member itself and is not allocated pro rata to all members holding stock in the CFC.

Moreover, if a pro rata allocation of the additional Subpart F income among group members owning CFC1 is appropriate when the group owns 100% of CFC1 under Section 958(a) and (b), it seems equally appropriate when the group owns less than 100% of CFC1. The existence of non-group interests in CFC1 should not affect the methodology for the members to share their own aggregate net used tested loss amounts among themselves. In fact, the 100% ownership requirement for turning off the special allocation rule makes that rule elective. If the group owns 100% of CFC1 but desires the special allocation rule to apply, it can have CFC1 issue one share of its stock (perhaps nonvoting preferred stock) to an unrelated third party.

The 100% ownership requirement to turn off the special allocation rule also creates an undesirable cliff effect. If the responsible member has 99.9% Section 958 ownership in CFC1, the increased Subpart F income attributable to that member is allocated entirely to that member. The rule changes dramatically if the member reaches 100% ownership. The rule can also be a trap for the unwary. A third party that is unexpectedly determined to own one share of CFC1 (even debt treated as preferred stock for tax purposes) can cause the special allocation rule to apply when it was not expected to.

Third, it is not logical for the 100% ownership test under the consolidation modification to count stock held outside the group towards the requisite 100% ownership. Suppose the members together own 50% of the stock of CFC1 and the individual owner of the parent corporation owns the other 50%. On the sale of CFC2, the consolidation exception applies, so the individual is allocated 50% of the Subpart F income from all the members' net used tested loss amounts. This is so despite the fact that the group members obtained all the benefit of those tested losses.

Moreover, if the individual shareholder owned 49% instead of 50% of CFC1, and an unrelated party held the other 1%, the special allocation rule would apply and all the additional Subpart F income would be allocated solely to the responsible members. There is no logical reason that the allocation of Subpart F income to the responsible members should depend upon the level of ownership of a non-group member, or why there should be such a benefit to the non-group member from selling one share of stock of CFC1 to an unrelated third party.

Fourth, by counting stock held outside the group, the consolidation exception treats a shareholder of a CFC that is a member of a consolidated group differently than a shareholder of a CFC that is not a member of a group. If a U.S. shareholder owns less than 100% of CFC1 under Section 958(a), but constructively owns all the remaining stock under Section 958(b), the special allocation rule will apply if the U.S. shareholder is not a member of a consolidated group, but will not apply if the U.S. shareholder is a member of a consolidated group.

For example, suppose US1 owns 50% of CFC1 under Section 958(a), and 50% of CFC1 under Section 958(b) through an individual shareholder of US1. If US1 is not a member of a group, the special allocation rule applies and there is a special allocation of 100% of the additional Subpart F income to US1. If US1 is a member of a group, even though no other member of the group owns any stock in CFC1, the consolidation exception applies, and there is a 50/50 allocation of the Subpart F income to US1 and to the individual shareholder of the CFC. This result is inconsistent with treating the group in the same manner as a single corporation, and the results seem quite illogical.

Fifth, the consolidation modification is presumably intended, at a minimum, to cause the special allocation rule not to apply if all the stock of CFC1 is held by group members. However, this result will not always be achieved, because the group member with the net used tested loss amount in CFC2 may not own, under Section 958(b), all the stock in CFC1 held by other group members. The reason is that the Section 1504(b)(4) disregards straight nonvoting preferred stock for purposes of the 80% vote and value test for consolidation, but the Section 318 attribution rules, incorporated by reference (with modifications) by Section 958(b), are based solely on the value of stock without any such exclusion for preferred stock.

For example, if M1 owns stock in CFC1, and more than half the value of M1 is in the form of preferred stock held outside the group, M1 will not own under Section 318(a)(2)(C), and therefore under Section 958(b), any stock in CFC1 owned by any other group member. As a result, to achieve single entity principles for the group, any test for the consolidation modification should be based on all CFC1 stock held by group members, without regard to Section 958(b).

Based on the foregoing, we believe that the consolidation modification should be either eliminated or substantially revised. If it is retained, its purpose should be stated in the preamble to the final regulations. We also believe that if it is retained, it should provide that any time the special allocation rule would apply to one or more members of a group, the total Subpart F income specially allocable to particular members under that rule will instead be allocated pro rata to group members based on their relative ownership in CFC1. However, even that rule, while logical on a stand-alone basis, is inconsistent with the result that arises when multiple members of a group own stock in a CFC and sell that stock simultaneously.

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

1. *Summary of Proposed Regulations*

As background, if a member of a consolidated group has a subsidiary that is also a group member, the -32 consolidated return regulations generally adjust the basis of the member in the stock of the consolidated subsidiary to reflect income and loss of the subsidiary (and lower tier subsidiaries). For example, if P owns M and M has taxable income or loss, P’s basis in M increases or decreases, respectively, by M’s income or loss. If M has income, this avoids a second tax on the income if P sells the stock of M. If M has a loss, this avoids the taxpayer receiving a second deduction for the loss when P sells the stock of M.

If M has tax exempt income (such as a dividend from a CFC exempt under Section 245A, or a domestic dividend entitled to the dividends received deduction), P’s basis in M generally increases in the amount of the exempt income, to retain the exemption upon P’s sale of the stock of M. Likewise, if M has a noncapital, nondeductible expense (e.g., a nondeductible fine or penalty), P’s basis in M decreases by such amount to prevent the deduction in effect being allowed when P sells the stock of M.

The proposed amendments to the -32 regulations contain three new rules for adjustments to P’s basis in the stock of M, to reflect M’s ownership of stock in a CFC:

1. M has a noncapital, nondeductible expense (i.e., P's stock basis in M is reduced) for the net used tested loss amount of M's CFCs at the time the net used tested loss arises.[128] This rule is referred to herein as "**Rule 1**".

> **Example 25**. *Rule 1*. P owns M1 and M2, M1 owns CFC1 with $100 of tested loss, and M2 owns CFC2 with $100 of tested income. There is no GILTI inclusion. M1 has $100 of used tested loss. Under the CFC basis reduction rule, M1's basis in CFC1 goes down by $100 when M1 sells the CFC1 stock. But under Rule 1, P's basis in M1 goes down by $100 immediately.

Under this rule, so long as M1 continues to own the stock in CFC1, there is a mismatch between the lower outside basis of P in the M1 stock, and of the higher inside basis of M1 in the CFC1 stock. This mismatch is very unusual in the consolidated return context, since the -32 regulations are generally designed to cause a match between inside asset basis of M and the outside basis in the stock of M (except for purchased basis in M stock). The mismatch in the group ends when either P disposes of the M1 stock (in which case there is no longer a mismatch within the group) or when M1 disposes of the stock of CFC1 (in which case the basis in CFC1 goes down immediately before the disposition under the CFC basis reduction rule.

2. M has tax-exempt income (i.e., P's stock basis in M is increased) in the amount of M's offset tested income amount for a particular CFC, but the aggregate of such increases in basis cannot exceed the aggregate of the decreases in basis under Rule 1 for the used tested losses of the same CFC.[129] This rule is referred to herein as "**Rule 2**."

> **Example 26.** *Rule 2*. P owns M, which owns CFC1. In year 1, CFC1 has used tested loss of $100, and under Rule 1, P's basis in M goes down by $100 (although M's basis in CFC1 only goes down by $100 when CFC1 is sold). In year 2, CFC1 has offset tested income of $150. Under Rule 2, P's basis in M goes up by $100, the offset tested income not in excess of the prior basis reductions under Rule 1. Alternatively, if CFC1 had the offset tested income in year 1 and used tested loss in year 2, there would be no positive basis adjustment under Rule 2 in year 1 (because of the cap on positive adjustments) and no negative adjustment under Rule 1 in year 2 (because at that point there is no cumulative net offset tested loss).

3. M has tax-exempt income (i.e., stock basis in M is increased) immediately before the disposition of M stock by a group member to the extent that a CFC of M has net offset tested income that could be distributed to M immediately before the disposition

[128] Prop. Reg. § 1.1502-32(b)(3)(iii)(C).

[129] Prop. Reg. § 1.1502-32(b)(3)(ii)(E).

and that would be eligible for Section 245A (and not subject to Section 1059).[130] This rule is referred to herein as "**Rule 3**".

The basis increase under Rule 3 is the basis increase that P would have in the M stock under the existing -32 regulations if the CFC had hypothetically distributed the stated amount to M. The theory for Rule 3 appears to be that P should be able to achieve the same increase in basis in the M stock (and reduced taxable gain) without the need for an actual distribution by the CFC to M.[131]

Note that unlike Rule 2, the basis increase in the M stock with respect to a CFC can exceed prior negative adjustments with respect to the same CFC. For example, a basis increase can apply even if the CFC has had offset tested income but has never had a used tested loss.

2. *Comments*

(a) *Rule 1 and the Timing for Basis Reduction*

As noted in the discussion of Rule 1 above, that rule creates a mismatch between P's basis in M1 and M1's basis in CFC1 until the sale of CFC1. The Preamble asks for comments on whether the timing of the outside basis adjustments in M1 stock under Rule 1 should be conformed to the timing of the inside basis adjustments in the CFC1 stock under the CFC basis reduction rule. This concept is referred to herein as "**modified Rule 1**". Of course, the basis reduction in modified Rule 1 is necessary to prevent the P group from obtaining a second benefit from the used tested loss of CFC1 at the time of the sale of the M stock, to conform the result to the denial of the second benefit under the CFC basis reduction rule. As a result, the only difference in tax result between Rule 1 and modified Rule 1 is when P's basis in M is relevant before a sale of M.

We discuss in Part IV.B.3(c) in the context of the CFC basis reduction rule our view that for the purposes of several Code sections such as Section 382, M's basis in the CFC should be treated as reduced immediately because this better reflects the economics of M holding the stock in the CFC. Likewise, we discuss in Part IV.D.2 our view that the same should be true for certain purposes of the -36 consolidated return regulation. Since the purpose of modified Rule 1 is to achieve parity in the inside and outside basis of M, we believe that if modified Rule 1 is adopted, it should reduce P's basis in M immediately for purposes of the same Code provisions for which the CFC basis reduction rule would reduce M's basis in the CFC immediately.

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[130] Prop. Reg. § 1.1502-32(b)(3)(ii)(F).

[131] The same rationale would support applying Rule 3 to tested income of a CFC that is not taxed to the U.S. shareholder because of QBAI (or income such as high-taxed Subpart F income that is neither Subpart F income nor tested income). There is no GILTI inclusion, and a distribution to M of such income would be eligible for Section 245A and would increase P's basis in M. Consideration should be given to extending Rule 3 to these cases.

If this approach is adopted, the difference between Rule 1 and modified Rule 1 would be the default rule that would apply in the absence of a specific rule reducing basis under modified Rule 1 (and under the CFC basis reduction rule itself) for purposes of applying a particular Code section. The default rule would be a reduced basis under Rule 1 and an unreduced basis under modified Rule 1. The scope of the default rule might be significant, since it would be impossible (and an inefficient use of resources) for the Treasury to attempt to identify all Code sections for which P's basis in M is relevant.

As noted above, we are aware of several Code sections where we believe that P's basis in M (and M's basis in the CFC) should be treated as reduced immediately. In fact, except in cases involving spinoffs where basis must be allocated, we are not aware of any Code sections where we believe that P should be treated as having an unreduced basis in M during the period before P sells the M stock. This reason for the latter statement is that references to tax basis in the Code are by definition references to the calculation of gain or loss that would arise on a sale of the underlying asset. Of course, the same is true for M's basis in the CFC, but as noted in the Preamble, there are significant problems with an immediate reduction in basis for all purposes outside the consolidated return context.

If modified Rule 1 were to be adopted, it would cause P to have an unreduced basis in M for purposes of all Code provisions unless the modified rule created a specific exception. However, we believe it would not be practicable to identify all cases where an exception would be appropriate. Moreover, as noted above, except in situations involving spinoffs, we are not aware of any Code sections for whose purpose an unreduced basis in M would be appropriate.

Finally, the immediate basis reduction in Rule 1 does not trigger immediate gain in a consolidated group even if the amount of the reduction exceeds P's basis in M. Rather, the excess reduction creates an excess loss account in the M stock that is generally taxed on the disposition of that stock. This is in contrast to the gain that could be triggered on a reduction in basis in the stock of a nonconsolidated subsidiary in excess of the initial tax basis.

As a result, we support the approach of the Proposed Regulations (Rule 1) rather than modified Rule 1. The latter rule would require exceptions, and any list of exceptions would likely not be complete.

(b) *Rule 1 Conformity to Basis Reduction Rule*

Rule 1 reduces P's basis in M by the net used tested loss amount that M has in a CFC. We suggest above that the CFC basis reduction rule should not apply in certain circumstances where the group has not achieved a double benefit from the used tested loss of the CFC. If final regulations create any exceptions to the deferred basis reduction under the CFC basis reduction rule, the same exceptions should apply to the immediate basis reduction provided in Rule 1.

As a policy matter, there is no justification to apply Rule 1 if the CFC basis reduction rule does not apply because the group has been determined not to have realized a double benefit from the used tested loss. For example, if the used tested loss has provided no benefit because of QBAI in the CFC with tested income, the group should be entitled to achieve a single benefit from the tested loss, either on the sale of the CFC with tested loss (as discussed in Part IV.B.2(a)), or on the sale of the stock of the member owning the CFC.

(c) *Rule 2 and Section 245A Dividend Payments*

Final regulations should modify Rule 2 to take account of Section 245A dividend payments made by the CFC in question.

> **Example 27**. *Rule 2 with Section 245A dividend*. Assume CFC1 has $100 of used tested loss in year 1 and $100 of offset tested income in year 2. P's basis in M decreases by $100 in year 1 under Rule 1, and increases by $100 in year 2 under Rule 2. Suppose that in addition, CFC1 pays a Section 245A dividend in year 2 out of its offset tested income (which generated current e&p to M).

The dividend in year 2 should create tax exempt income in M and increase P's basis in M.[132] The result is a duplicative increase in P's basis in M in year 2, once under Rule 2 because of the offset tested income in year 2, and again under existing -32 because of the dividend of that offset tested income. The final regulations should eliminate this duplication. Logically, all offset tested income would still count against the "cap" for basis increases under Rule 2. However, a basis increase under Rule 2 should not occur if it would result in duplication with basis increases from prior Section 245A distributions of the related tested income.

We note that the issue raised by Example 27 does not arise from the fact that the dividend paid in year 2 is a nimble dividend, i.e., where the dividend is paid out of current earnings even though the accumulated earnings are negative or zero. The same issue would arise if the offset tested income and dividend were in year 1, and the used tested loss was in year 2. In that case, at least absent the dividend, there would be no basis adjustment under Rule 1 or Rule 2 in either year 1 or year 2. As in Example 27, the effect is that the dividend first increases P's basis in M in year 1, and the same earnings in year 1 then prevent a decrease in basis in year 2 that would otherwise arise from the year 2 tested loss.

We also note that, assuming conformity between e&p and tested income, a Section 245A dividend can result in a basis increase that is duplicative of a Rule 2 basis increase only if the dividend is paid by the CFC in the year the offset tested income arises, or in a later year before the year of the tested loss. Once the year with the tested

[132] We ask for clarification of this point in the Section 245A Report at 40.

income and the year with the tested loss have both passed, the tested income of the CFC in one year and the tested loss of the CFC in the other year will generally result in no net e&p and no ability to pay a Section 245A dividend out of the tested income. As a result, the rule proposed above would not in practice require a look-back period to determine whether Rule 2 and a Section 245A dividend had resulted in a duplicative basis increase.

It should also be noted that Rule 3 avoids this duplication issue for Section 245A dividends. It provides for a basis increase in M only for distributions that would be eligible for Section 245A. If earnings are actually distributed and are eligible for Section 245A, this reduces the remaining earnings that could be so eligible, and so the basis increase under Rule 3 is automatically decreased by the amount of the dividend.

(d) *Rule 2 and the "Same CFC" Limitation*

As noted above, Rule 2 allows an offset to the basis reduction for the net used tested loss amount of a CFC only on account of offset tested income of the same CFC. We have considered whether the offset should be expanded to apply to offset tested income of other CFCs owned by the same U.S. shareholder.

> **Example 28**. *Rule 2 and netting*. Suppose M owns CFC1 with $100 of tested income and CFC2 with $100 of tested loss. P's basis in M is reduced by $100 under Rule 1 because of the used tested loss in CFC2, without offset for the offset tested income in CFC1. There is no increase in the basis in M under Rule 2 on account of CFC1, because no net positive adjustments for a particular CFC are allowed under that rule.

If an offset was allowed, there would be no reduction in P's basis in M in that year. This would reduce the taxpayer-unfavorable mismatch that arises when the basis in M is reduced for used tested losses of one of its CFCs notwithstanding the existence of offset tested income in another of its CFCs.

On the other hand, the lack of netting in Rule 2 is in many cases not disadvantageous to the taxpayer. In the example, if M sells the stock of CFC1 and CFC2, M has no gain on the sale of CFC1 because of Sections 1248 and 245A, and M has no loss on the sale of CFC2 because of the CFC basis reduction rule. If P sells the stock of M, the same result would arise under netting, but it would also arise under the existing Proposed Regulations. P's basis had initially been decreased by $100 under Rule 1 on account of CFC2, but immediately before the sale of M, it would be increased by $100 under Rule 3 on account of CFC1.

Moreover, the lack of netting in the Proposed Regulations has the significant advantage of making irrelevant the location of different CFCs within the consolidated group for purposes of making the adjustments under -32. With netting, the overall tax basis in the group can be significantly higher if the same member own CFCs with both offset tested income and used tested loss. This is true notwithstanding the pro rata allocation of tested losses among members with tested income in the Proposed

Regulations. In Example 28, netting would result in no basis decrease in the M stock, but if CFC1 and CFC2 were held by M1 and M2, respectively, there would be a basis decrease in the M2 stock and no adjustment in the M1 stock.

In addition, if netting was allowed, the effect is an increase in basis to reflect the offset tested income of CFC1 and a decrease in basis to reflect the used tested loss of CFC2. This would increase the complexity of Rule 2 and Rule 3, since if offset tested income of CFC1 arising from a tested loss in CFC2 is deemed to give rise to a basis increase in M, it cannot give rise to another basis increase under Rule 2 or Rule 3. For example, since Rule 3 is based on M's net offset tested income amount in the CFC being sold, this would depend not only on prior tested income and losses of the same CFC (as under the Proposed Regulations), but on tested income and losses of all other CFCs owned by M.

Netting would also require the adoption of prioritization rules for purposes of the CFC basis reduction rule. For example, suppose that in year 1, CFC1 had used tested loss of $100 and in year 2, CFC1 had tested income of $100 and CFC2 had tested loss of $100. Under Rule 1, there would be a basis reduction in M of $100 in year 1, and no basis increase or decrease in year 2. The issue would be whether, for purposes of the CFC basis reduction rule, the CFC1 tested income in year 2 is "matched" with the CFC1 tested loss in year 1 (reducing M's net used tested loss amount in CFC1) or whether it is matched with the CFC2 tested loss in year 2 (reducing M's net used tested loss amount in CFC2).

As a result, netting would not avoid the need to trace of the separate offset tested income and used tested loss amounts of all the CFCs owned by the particular U.S. shareholder. It would not promote simplification, and in fact would likely increase the complexity of the already-complex basis regime adopted in the Proposed Regulations.

On balance, we believe the most important factor is that the location of a CFC within the group should not matter, consistent with the other results in the Proposed Regulations. As a result, we support the lack of netting in Rule 2.

(e) *Rule 3 Following a Sale of M Stock*

The final regulations should clarify several aspects of Rule 3 that arise in connection with the sale of the M stock.

> **Example 29**. *Rule 3 upon sale of M stock.* M owns CFC1 with $100 of offset tested income and e&p. Assume Section 245A would apply, and Section 1059 would not apply, to a dividend of such income. The stock of M is sold, and under Rule 3, P's basis in M is increased by $100.

P gets the benefit of this basis increase on the sale of M, just as it would if CFC1 had paid a $100 Section 245A dividend before the sale, or if M had sold CFC1 and recognized $100 of Section 1248 gain eligible for Section 245A.

Assume now that the buyer (Buyer) of the stock of M is a member of a different consolidated group, the "Buyer group." Immediately before and after the purchase, M holds stock in CFC1, and immediately before the purchase, CFC1 had $100 of net offset tested income. Regulations should clarify whether the attribute of net offset tested income continues to reside with M after its purchase by Buyer, so that immediately before Buyer sells M in the Buyer group, Buyer's basis in M is increased by the amount of net offset tested income that arose in the P group.

This question on its face is similar to the question discussed in Part IV.C.2(b) of whether the net used tested loss amount of a CFC should carry over into a new group under Rule 1 to increase the gain when the CFC is sold. However, the considerations here are very different.

On the one hand, if CFC1 paid a dividend of the net offset tested income amount to M in the Buyer group, Buyer would increase its basis in the M stock by the same amount. To the extent the purpose of Rule 3 is to make such a dividend unnecessary, Rule 3 should apply to increase the basis of the Buyer's stock in M. To be sure, this might cause Buyer's basis in M to exceed its fair market value, since the cost basis is the fair market value of the M stock and this basis would be increased by the then-existing net offset tested income amount of CFC1. However, the -36 consolidated return regulations will potentially disallow any noneconomic or duplicated loss arising from this basis increase.

On the other hand, the P group got the benefit of Rule 3, and the purchase price for M already reflects the existing undistributed earnings in CFC1. Allowing a basis increase each time a new buyer acquires the M stock could result in an unlimited number of basis increases in the M stock in the hands of each buyer. While Treasury Regulation Section 1.1502-36(c) would generally disallow a loss to the buyer on the sale of the M stock to the extent the loss arose from this basis increase, the basis increase could still shelter post-sale appreciation in the M stock. This would be an ironic result for a rule designed to put P in the same position as if CFC1 had paid out all its earnings in the P group. After all, a CFC can only pay out the same earnings once, and a single amount of earnings of $100 cannot justify an unlimited number of $100 basis increases through the successive applications of Rule 3.

As a result, we recommend that the final regulations make clear that the basis increase in Rule 3 only applies to the consolidated group in which the net offset tested income amount arises.

Even this rule, though, would not be sufficient. In Example 29, P's basis in M is increased by $100 to reflect the fact that CFC1 could have paid a tax-free dividend of $100 before the sale. However, this is not treated as a real dividend and, in particular, does not reduce the e&p of CFC1. As a result, if P2 was the parent of another consolidated group and bought the M stock, CFC1 could pay an *actual* dividend of the same $100 to M after the purchase by P2. This would be tax-free to M under Section

245A and increase the basis of P2 in M. The double increase in tax basis would be unjustified for the reasons discussed in the second preceding paragraph.

Moreover, Treasury Regulation Section 1.1502-36(c) would not have any effect in this case. There would be no "disconformity amount" under that regulation as a result of the dividend because P2's increased basis in M from the dividend would match M's increase in inside tax basis from the receipt of the cash dividend. One possible way to avoid this result would be an amendment to the -32 regulations to prevent the tiering up of dividend income from a CFC if the dividend is paid from e&p that had resulted in a prior basis increase in a different group under Rule 3. Such a rule would, however, require a buyer of the stock of M to know the history of the Rule 3 basis increases in the selling group, and the rule would frequently cause buyers in acquisition transactions to require representations and/or indemnities from sellers concerning such basis increases in the selling group.

(f) *Sale of M Stock in Middle of Year*

We believe that final regulations should further clarify and illustrate certain aspects of the sale of stock of M in the middle of a tax year.

> **Example 30**. *Rule 3: Sale of stock mid-year*. P owns M, which owns CFC1. CFC1 has no attributes from prior years, but has $100 of tested income in 2019. P sells M to unrelated Buyer on June 30, 2019. M remains the sole shareholder of CFC1 for all of 2019, so CFC1 remains a CFC for all of 2019. All parties have a calendar year tax year.

First, since CFC1 remains a CFC through the end of 2019, and the tax year of M ends when it leaves the P group, we believe that the U.S. shareholder inclusion year is the tax year of the Buyer group that includes December 31, 2019. Assume first that the Buyer group has no other CFCs. Then, the Buyer group has a GILTI inclusion of $100 for 2019, there is no offset tested income to M from CFC1 for any part of 2019, and Rule 3 has no application to the P group during 2019. Regulations should illustrate these conclusions.

Second, assume that for 2019, the Buyer group has $100 of tested income from CFC1 and $100 of tested loss from another of its CFCs. It therefore has no GILTI inclusion for 2019, and CFC1 has untaxed e&p of $100 for calendar year 2019. Rule 3 assumes a hypothetical distribution to M of the net offset tested income amount of the CFC allocable to the transferred shares immediately before the sale of the M stock, to the extent a dividend of such amount would be eligible for Section 245A.

A shareholder that is not a U.S. shareholder of the CFC on the U.S. shareholder inclusion date would not include in income any portion of the tested income for the year. Thus, there appears to be no net offset tested income amount allocable to the P group for the year. As a result, there is no hypothetical distribution to M under Rule 3. More generally, Rule 3 could never apply to any tested income that arises in the year of sale of a CFC, if the CFC remained a CFC after the sale. The result in this situation should be clarified in the final regulations, perhaps by an example.

Third, consider the same facts as Example 30, except that CFC1 pays a dividend of $50 to M on June 30, 2019, just before the sale of the M stock. The U.S. shareholder inclusion year is still the Buyer tax year that includes December 31, 2019. However, this fact pattern raises additional questions:

> (a) Assume the Buyer group has no tested losses. Then, the general GILTI inclusion amount would be $100. However, Section 951(a)(2)(B) reduces the GILTI inclusion to the U.S. shareholder on the last day of the year by the amount of distributions received by "any other person," subject to certain limitations. In form, M is the "person" that both received the dividend on June 30, 2019 and is the U.S. shareholder on December 31, 2019. Thus, arguably, the GILTI inclusion to the Buyer group should not be reduced by the amount of the dividend, and the distribution to M on June 30 would be PTI.
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> However, this result would not make sense. In reality, the P group is the economic shareholder before the sale, and the Buyer group is the economic shareholder after the sale. Moreover, if "person" is defined without regard to treating consolidated groups as a single "person", then a transfer of CFC stock within a single group would be a transfer to a different "person." Regulations under Section 951(a)(2)(B) should clarify that the relevant "person" in respect of a member of a consolidated group is the common parent of the group.
>
> (b) Next, assume that the Buyer group has $100 of tested income and e&p from CFC1 and an equal tested loss from another CFC. Then, there is no GILTI inclusion to the Buyer group and Section 951(a)(2)(B) is irrelevant. It seems that a dividend of $50 (or even $100) paid to M before the sale would a dividend out of current e&p, would be eligible for Section 245A, and would increase P's basis in M under existing -32. There is not necessarily a policy objection to this result, since the Buyer group will have a used tested loss that corresponds to the offset tested income distributed to M. However, the Buyer group is then bearing the cost, through a basis reduction in M equal to the used tested loss, of providing exempt income and an increased tax basis in M to the P group. This would be a very surprising result, and, if intended, should be discussed explicitly in the final regulations.

(g) *Rule 3: Creating a Tax Loss on M Stock*

Regulations should explicitly state, or provide an example showing, that the basis increase provided in Rule 3 can create or increase a tax loss in the M stock. Arguably this is already clear, since the rule states that M is treated as having tax-exempt income immediately prior to a transaction in which P recognizes income, gain, deduction or loss with respect to M stock. If P recognized loss before taking Rule 3 into account, the only possible effect of Rule 3 would be to increase such loss, so this indicates that there is no limit on the basis increase under Rule 3.

However, to avoid the need to make such an inference on a very significant issue, an explicit statement or an example such as the following should make this point.[133]

> **Example 31**. *Tax loss on M stock*. P forms M with a cash contribution of \$1000, and M forms CFC1 with a cash contribution of \$1000. Thereafter, CFC1 has offset tested income of \$100. Suppose P sells the M stock for \$1060. Rule 3 will increase P's basis to \$1100, and P will have a tax loss of \$40 subject to the loss limitation rules in -36.

(h) *Avoiding the Loss Disallowance Rule*

An example to the final regulations should also illustrate the following fact pattern.

> **Example 32**. *Rule 3 avoiding loss disallowance*. M holds stock in a CFC with a tax basis and value of \$200 at a time when the CFC has \$100 of offset tested income. Suppose also that P's basis in M is \$100, so that P would recognize a gain of \$100 (before applying Rule 3) on the sale of the M stock for \$200. In fact, if P sells the M stock, under Rule 3, P's basis in M increases by \$100 to \$200, and P has no gain on the sale.

If the CFC had actually paid a Section 245A dividend of \$100 to M, M's basis in the CFC would not change, and M would have a loss of \$100 on the sale of the CFC stock for \$100. That loss would be disallowed under Section 961(d). However, Rule 3, like an actual dividend, increases the basis of P in the M stock and thereby avoids the loss disallowance rule and eliminates P's gain on the sale of the M stock. We believe this is the correct result, but it is not intuitive and an example would be helpful to confirm the result.

(i) *Rule 3 and Second Tier CFCs*

Under Rule 3, a hypothetical distribution that would be a dividend subject to Section 1059 does not create a basis increase in the M stock. This result makes sense, since an actual dividend subject to Section 1059 would not result in such a basis increase. In the case of offset tested income of a second tier CFC, it is not clear how the Section

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[133] An example should also illustrate a discontinuity between Rule 3 and an actual dividend eligible for Section 245A. A basis increase in M under Rule 3 can result in a tax loss subject to -36 but not to Section 961(d), since the latter provision only applies when an actual dividend is subject to Section 245A. An actual dividend would give rise to the same basis increase, but in that case a loss in the stock would also be subject to Section 961(d).

1059 test in Rule 3 is to be applied. Similarly, it is not clear how the requirement that the distribution would be eligible for Section 245A is applied. For example, there might be intermediate entities with hybrid stock, with dividends on such stock not eligible for Section 245A.

Regulations should clarify whether these tests are applied solely to a dividend from the second tier CFC to the first tier CFC, whether they are based on whether the cash could be returned to the U.S. with Section 245A applying and without Section 1059 applying at either level, or whether they are based on whether, on the return of the cash to the U.S., there would in fact be a basis increase in the M stock taking Sections 245A and Section 1059 into account. The latter appears to be the most logical interpretation.

(j) *Rule 3 and PTI*

The test in Rule 3 is how much of a hypothetical distribution equal to the net offset tested income amount of the CFC would be a dividend eligible for Section 245A. However, if the CFC has any PTI, any distribution will first be out of PTI and will not be a dividend eligible for Section 245A. This will skew the calculation under Rule 3. For example, if the net offset tested income amount is $100, and there is also unrelated PTI of $90, the size of the deemed distribution is the net offset tested income amount of $100. On a hypothetical distribution of $100, $90 would be PTI and only $10 would be a dividend eligible for Section 245A, so the Rule 3 basis increase would only be $10.

This is clearly not the intent of Rule 3. As a result, the hypothetical distribution should either assume that the CFC has no PTI, or else the size of the deemed distribution should be the sum of the net offset tested income amount plus the PTI. We prefer the former formulation because it is more targeted. However, the latter formulation will be equivalent as long as the hypothetical PTI distribution is not counted towards the threshold tests for an extraordinary dividend under Section 1059, which we believe is the correct result.

(k) *Tiering Up of CFC Basis Reductions*

Regulations should confirm that if P owns M and M owns a CFC, a downward basis adjustment in the stock of the CFC under the CFC basis reduction rule does not tier up under -32 to reduce P’s basis in M. P’s basis in M has already been reduced for the net used tested loss amount under Rule 1, and another reduction would be duplicative.

(l) *E&P Adjustments*

Regulations should clarify whether a reduction of P’s basis in M under Rule 1 decreases the e&p of P. Arguably there should not be a current decrease in e&p, since there is no current increase in P’s e&p on account of offset tested income of a CFC held by M, unless the income is distributed. On the other hand, a decrease in P’s e&p to reflect the Rule 1 basis decrease in the M stock would better match M’s inside e&p with the outside tax basis in M.

When a CFC is sold, M's ending e&p balance should not generally be affected by whether the reduction in the basis of the CFC stock under the CFC basis reduction rule is a reduction in M's e&p. Any such reduction in e&p should reduce the tax basis of the stock for e&p purposes, and so the reduction in e&p would normally be offset by increased e&p to M arising from increased gain (or reduced loss) on the sale as a result of the basis reduction.

Correspondingly, on the disposition of the CFC, any increased gain to M as a result of the CFC basis reduction rule should not increase the e&p of P unless P's e&p has been reduced on account of Rule 1.

Regulations should clarify these results.

(m) *Predecessor/Successor Rule*

Regulations should confirm that the predecessor/successor rule in existing Treasury Regulation Section 1.1502-32(f) applies to a member's interest in a CFC's net used tested loss amount and net offset tested income amount, when a member of the group transfers the CFC to another member in a nonrecognition transaction.

(n) *Loss Duplication under -36(d)*

Treasury Regulation Section 1.1502-36(d) is designed to prevent "loss duplication." Loss duplication arises when M1 sells stock of M2 at a loss to the extent that such loss is also reflected in built-in loss in the assets M2. In that case, if M2 were to sell its assets immediately after the stock sale, a second tax loss would be allowed even though there is a single economic loss on the assets. The regulations prevent this result by reducing the basis of the assets in M2 to eliminate the duplication, with an election to instead reduce the basis in the stock to the extent of the loss duplication amount. The loss duplication amount is, simply stated, the lesser of the loss on the stock and the net loss that would arise if the assets were sold for the sale price of the stock (disregarding for simplicity liabilities of M2, NOLs and other factors).

The final regulations should state that in applying this rule on the sale of M, if a CFC has a net used tested loss amount, the tax basis of the CFC stock to M for this purpose is its basis after taking the CFC basis reduction rule into account. This is necessary to prevent -36(d) from disallowing tax losses that are not duplicated losses.

> **Example 33**. *The CFC basis reduction rule and loss duplication*. Suppose P buys M stock from a third party for $100, and M's only asset is stock of CFC1 with a tax basis of $60 and no prior history. Assume that CFC1 then has a net used tested loss amount of $40, reducing P's basis in M to $60 under Rule 1. The value of CFC2 goes down to $20, and P then sells the M stock for $20.

P has a real economic loss of $80 on the sale, and $40 of the corresponding tax loss was used to offset the tested income of other CFCs. However, if M is treated as having an unreduced tax basis of $60 in CFC1, P's remaining unused economic loss of $40 is duplicated by M's built-in loss of $40 in the stock of CFC1, which has a basis of $60 and value of $20. As a result, -36(d) would require either that P's loss be disallowed or that M's basis in CFC1 be reduced to $20 at the time of the sale of the M stock (in addition to a further reduction of $40 when M sells the CFC1 stock).

These results make no sense as an economic matter. Immediately after P sells the M stock, if M were to sell the CFC1 stock for $20, M's basis in CFC1 would be reduced from $60 to $20 and so M could not obtain a tax loss on the sale of the stock. There is simply no potential for a duplication of P's loss on the sale of the M stock, and there is no logical reason for -36(d) to apply in this case. The correct answer is reached only if M is treated as having a tax basis of $20 in the CFC, i.e., the basis that it would have immediately before a sale of the CFC stock, in testing for loss duplication under -36(d).[134]

We note that the problem is not solved by the election in -36(d) to allow P its $40 loss on the M stock at the cost of reducing the basis in the CFC stock by the duplicated loss of $40. This election would not prevent another reduction in the basis in the CFC stock under the CFC basis reduction rule immediately before the sale of the CFC stock, resulting in a double reduction in basis for a single net used tested loss amount.

Moreover, it would not be adequate for a regulation to prevent this second reduction in basis. For example, regulations might say that to the extent that M's unreduced basis in the CFC causes a loss disallowance under -36(d) that would not otherwise arise, there is no additional basis reduction when M sells the stock of the CFC. In fact, P's tax loss of $40 should not be disallowed in the first place, there should be no reduction in M's $60 basis in the stock of the CFC under -36(d), and M should only be subject to the usual CFC basis reduction rule upon the sale of CFC1. The only way to achieve this result under -36(d) is to apply the CFC basis reduction rule in determining the tax basis of M's stock in a CFC for purposes of -36(d).

A similar issue arises under -36(d) if M owns a CFC with a net offset tested income amount. Under Rule 3, P's basis in M will increase by such amount immediately before the M stock is sold. This increased basis should be taken into account in determining whether there is loss duplication under -36(d).

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[134] This application of -36(d) when there is in reality no duplicated loss would also arise frequently if P bought the stock of M at a time when M already had a net used tested loss amount in a CFC that it owned. For example, assume P buys stock of M for $100 when M owns a CFC with a basis of $100 and net used tested loss amount of $100. If M's basis in the CFC is $100 for purposes of -36(d), any loss by P on the sale of M will be a duplicated loss. In reality, no such loss is a duplicated loss because M has a basis of $0 immediately before the sale of the CFC and so can never recognize a loss on the sale.

> **Example 34**. *Rule 3 and loss duplication.* P buys the stock of M for $50. At that time, M's only asset is stock in CFC1 with a basis of $100. CFC1 has no prior tax history. CFC1 then generates a net offset tested income amount of $40. P then sells the stock of M for $50. Under Rule 3, P's basis in M increases from $50 to $90 immediately before the sale, resulting in a $40 loss to P on the sale before application of -36(d).

If P's basis in M is determined without regard to Rule 3, P has a basis of $50 in the stock, so it has no loss on the sale of the stock for $50 for purposes of -36(d). As a result, there could not be a duplicated loss under -36(d). Yet P in fact had a loss of $40 on the sale of M because of the basis increase from $50 to $90 under Rule 3.

Moreover, if M then sold the stock of CFC1 (basis $100) for $50, there would be a loss of $50 to M. This would result in a double loss of $40, to both P and M. The only way to carry out the purpose of -36(d) is to treat P as having a basis in M that is increased as it would be under Rule 3. In that case, P's loss for purposes of -36(d) would be $40, and this would duplicate $40 of the built in loss of $50 in the M assets.

As a result, to carry out the purposes of the loss duplication rule in -36(d), when P sells the stock of M and M is a U.S. shareholder of a CFC, we believe it is necessary to take account of both (1) the CFC basis reduction rule in determining M's tax basis in the CFC, and (2) Rule 3 in determining P's basis in M. We note that the former rule will reduce the amount of duplicated losses under -36(d) and the latter rule will increase the amount of such duplicated losses, but we believe both results are appropriate.[135]

(o) *Loss Disallowance under -36(c)*[136]

Under -36(c), loss is disallowed on P's sale of stock of a consolidated subsidiary M to the extent of the lesser of (1) the "disconformity amount," which is the excess of P's outside basis in M stock over M's inside basis in its assets and its other tax attributes and (2) the net positive increase in P's basis in M under -32 (disregarding distributions) while M was held by P.

The purpose of -36(c) is to prevent a "son of mirror" transaction, where P buys the stock of M at a time when M has assets with unrealized gain. P's basis therefore already reflects the unrealized gain in the M assets. M then sells the assets at a taxable

[135] In theory, the application of -36(d) should also depend upon whether an M loss on the sale of CFC1 would be disallowed under Section 961(d). If so, there is no loss duplication and no need to disallow P's loss on the sale of M stock. However, -36(d) currently determines loss duplication under a formula that is based solely on the tax basis of assets, not on whether a loss on a hypothetical sale assets held by M would be disallowed under any provision of the Code. If Section 961(d) were to be taken into account for purposes of -36(d), other loss disallowance provisions of the Code for all assets held by M should also be taken into account. This narrowing of -36(d) is beyond the scope of this Report, and we take no position on it.

[136] The issues arising under -36(c) are discussed further in the Section 245A Report, at 41-44.

gain, increasing P's basis in M above fair market value of the stock. Absent -36(c), P could then sell the stock of M at a tax loss, with no economic loss, and that tax loss would offsets M's gain on the asset sale. The result is a tax free step up in the basis of the M assets in the hands of the buyer. To prevent this result, -36(c) would disallow P's loss on the sale of the M stock.

We believe that for purposes of determining the disconformity amount under -36(c), the basis of the stock of a CFC in the hands of M should take into account the CFC basis reduction rule as well as Rule 3.

> **Example 35**. *The CFC basis reduction rule and -36(c).* P buys the stock of M for $100 at a time when M's only asset is stock of a CFC with a basis of $100 and with a used tested loss amount of $100.

If the CFC basis reduction rule is disregarded under -36(c), the disconformity amount is $0, since the outside basis in M stock and inside basis in the M assets are both $100. As a result, -36(c) cannot apply. Then, M can sell the stock of the CFC for $100 and recognize $100 of gain, and this will increase P's basis in M to $200. P can sell the M stock for $100, recognizing a loss of $100 that offsets the $100 gain to M. The buyer of the CFC does not have any net used tested loss amount in the CFC. The result is that the detriment of the net used tested loss amount of $100 has been eliminated from the tax system at no cost to the P group or anyone else.

We believe this is inconsistent with the purposes of -36(c), and so the CFC basis reduction rule should be taken into account in determining the disconformity amount. Then, the disconformity amount is $100 and the net increase in basis to P is $100 resulting from the sale of the CFC. The lesser of these two numbers is $100 and so P's entire loss of $100 on the sale of the M stock is disallowed. We believe this is the correct result. In fact, if the net used tested loss amount in the CFC exceeds M's basis in the CFC, we believe that M's basis in the CFC should be treated as negative for purpose of computing the disconformity amount.

On the other hand, we do not believe that Rule 3 is relevant for purposes of -36(c). As discussed in Part IV.D.2(e), we believe that if a net offset income amount arises in one group, and P sells the stock of M to another group, it should not continue into the buying group. As noted above, -36(c) is aimed at the case where the purchase price of the M stock includes built in gain in the M assets, and the recognition of gain in those assets causes the basis in the M stock to be above fair market value. Assuming Rule 3 does not increase the basis of M stock when the new group sells the M stock, we do not believe that -36(c) requires any adjustment to take account of Rule 3.

However, if regulations were to apply Rule 3 to the net offset tested income in the buying group, additional issues would arise. Assume P buys the stock of M for $200, M has a basis of $100 in the CFC, and M has a net offset tested income amount of $100 in the CFC. If Rule 3 applies, when P sells the M stock for its purchase price of $200, M's basis would increase to $300 and it would have a loss on the sale. This is because M's purchase price already reflects the net offset tested income amount. The issue is in substance the same as the issue in the "son of mirror" transaction described above. Since Section 961(d) does not disallow a loss on the sale of the M stock, -36(c) should logically apply in this case.

(p) *Intra-group Sales of a CFC*

Regulations should confirm that the attribute redetermination rule of Treasury Regulation Section 1.1502-13(c)(1) applies to Rules 1-3. Under that rule, if M1 sells CFC1 to M2, and M2 later sells CFC1 to a third party, the attributes of M1 and M2 are redetermined if necessary to reach the same overall result for the group as if M1 and M2 were divisions of a single corporation.

For example, M1 might have increased deferred gain on the sale of the stock of CFC1 to M2 as a result of the CFC basis reduction rule. However, if CFC1 has offset tested income in the hands of M2, on an overall group basis the CFC basis reduction rule might be inapplicable when M2 sells the stock of CFC1 to a third party. In that case, the attribute redetermination rule should put the group as a whole in the same position as if the CFC basis reduction rule did not apply. As another example, if final regulations adopt our proposal that the CFC basis reduction rule does not apply in the absence of a double tax benefit from a used tested loss, this determination should be made at the time of the sale of CFC1 by M2 to a third party, and the treatment of M1 adjusted accordingly.

(q) *Rule 1 and Internal Spin-offs*

We believe that the final regulations should modify the rules for allocation of basis following an internal spin-off within a consolidated group, when the member receiving a spin-off distribution has had its basis in the distributing company reduced under Rule 1.

Suppose M1 has a CFC with a net used tested loss amount, and P has a reduced basis in M1 under Rule 1. M1 transfers some of its assets (which may or may not include the stock in the CFC) to newly formed M2, and spins off M2 to P in a divisive D reorganization. P's basis in M1 would be divided between its post-spin stock in M1 ("**New M1**") and M2 based on the relative fair market values of New M1 and M2.[137] Absent any special rule, P's original basis reduction in M1 becomes, in effect, partly a basis reduction in New M1, and partly a basis reduction in M2, in proportion to the relative values of New M1 and M2.

However, the prior reduction in P's basis in M1 was entirely attributable to the CFC, which is now held by either New M1 or by M2. We refer to the member owning the CFC as the "**CFC owner**" and to the other member as the "**non-CFC owner**". If P's reduced basis in M1 is allocated between New M1 and M2, it will result in a partial

[137] Treas. Reg. § 1.358-2(a)(2)(iv).

disassociation of the prior basis reduction in the M1 stock and the net used tested loss amount in the CFC stock that is now held by the CFC owner. This is inconsistent with the idea that Rule 1 and the CFC basis reduction rule are intended to result in merely a different timing for basis reduction, rather than shifting part of the consequences of the Rule 1 basis reduction to a party other than a direct or indirect shareholder of the CFC.

A closer match of the Rule 1 basis reduction with the net used tested loss amount in the CFC could be achieved if (1) the unreduced basis of P in M1 was initially allocated between New M1 and M2 under Section 358, and (2) the resulting basis in the CFC owner was then reduced by the Rule 1 amount (the "**alternative approach**").

> **Example 36**. *Rule 1 and internal spinoffs*. M has two assets, land with a basis of $100, and a CFC with a basis of $100 and net used tested loss amount of $100. P's basis in M is $200 minus the Rule 1 reduction of $100, or $100. Assume the land and CFC stock is each worth $100, and the value of the M stock is therefore $200. Disregarding the substantive spin-off requirements under Section 355, assume P transfers the land to M2 and spins M2 off to P.

After the spin-off, New M1's inside basis (after taking account of the CFC basis reduction rule) is $0 and M2's inside basis is $100. Under the Proposed Regulations, P's $100 basis in M is allocated $50 to New M1 and $50 to M2, creating a disparity in basis. The alternative approach eliminates this disparity: P would be viewed as having a $200 basis in M that would be allocated $100 to New M1 and $100 to M2, and Rule 1 would then apply to P's basis in New M1, leaving P with a basis of $0 in New M1 and $100 in M2. The Rule 1 basis reduction in New M1 then exactly matches the future basis reduction that New M1 will have in the CFC under the CFC basis reduction rule.

It can be argued that the alternative approach should not be adopted because, as a general matter, no special adjustments under Section 358 are made for other deductions of M that are allocable to specific assets of M. For example, if M has a Section 168(k) expense deduction for a capital asset, P's basis in M is reduced by the amount of the expense, but there is no comparable adjustment under Section 358 to initially disregard that basis reduction in the M stock. More generally, because the allocation of the basis in M stock under Section 358 is based on the values of New M1 and M2 rather than their inside asset basis, the allocation inherently creates differences between the inside and outside basis of New M1 and M2.

On the other hand, the situation here is unique, because the Proposed Regulations themselves create the pre-spin disparity between higher inside tax basis of the CFC and the lower outside tax basis in M. Normally, any change to the inside basis of the M assets would result in an equal change to the outside basis of the M stock. It therefore seems reasonable to temporarily "undo" the disparity created by the Proposed Regulations in order to recalculate basis allocations following a spinoff.

A more significant problem with the alternative approach, however, is that it may make the disparity between inside and outside basis *worse* than under the normal application of Section 358. For example, assume the same facts as in Example 36, except the land is worth $900 so the M stock is worth $1000. Again, after the spin-off, New M1's inside basis (after taking account of the CFC basis reduction rule) is $0 and M2's inside basis is $100. Under the Proposed Regulations, P has a basis of $10 in New M1 and $90 in M2.[138]

Yet under the alternative approach, P has an excess loss account of $80 in New M1 and a basis of $180 in M2.[139] This result makes no sense. It arises because the increase in the M basis by the Rule 1 adjustment is mostly allocated to the M2 stock, which has 90% of the combined value, and yet the second step Rule 1 basis reduction is made entirely to the New M1 stock. To be sure, this is the result that would have arisen if Rule 1 only applied when the CFC stock is sold. However, the result would make no more sense if in fact the Rule 1 basis reduction was deferred in that manner.

These examples illustrate that the alternative approach appears to reach the "proper" result in some cases, retaining the match between the net used loss amount of the CFC and the outside tax basis of the CFC owner. However, in other cases it reaches results that are clearly incorrect. As a result, we do not recommend it in the form we have discussed so far.

However, we believe a variation of the alternative approach would be appropriate. Under that variation, initially, as in the alternative approach, the unreduced basis of P in M1 would be allocated between New M1 and M2 under Section 358. However, in the second step, the resulting basis in the CFC owner would then be reduced by the Rule 1 amount, but (unlike in the alternative approach) this basis reduction would be limited to an amount that would not reduce the basis in the stock of the CFC owner below the inside basis of the assets of the CFC owner (taking into account the CFC basis reduction rule). Any remaining basis reduction would be allocated to the non-CFC owner. We believe that this approach fairly balances the goals of undoing the new basis disparities created by the Proposed Regulations, and not having a revised basis allocation system create new basis disparities that would not otherwise exist.

Under this approach, in the variation of Example 36, since the inside basis of the New M assets is $0 (after taking account of the CFC basis reduction rule), the $20 of basis initially allocated to New M1 would not be reduced by $100 (as under the alternative approach), but would only be reduced by $20. The remaining $80 of basis reduction would apply to the stock in M2, reducing it from $180 to $100. As a result, the final basis in New M1 would be $0 and the final basis in M2 would be $100. On these

[138] P's $100 basis in M is allocated 10% to New M1 ($10) and 90% to M2 ($90).

[139] P's $100 basis in M is initially considered $200, of which 10% ($20) is allocated to New M1 and 90% ($180) is allocated to M2, and the basis in New M1 is then be reduced by $100 to an excess loss account of $80.

facts, inside and outside basis match for both New M1 and M2. This approach would also not change the result in Example 36, since there the alternative approach already resulted in a match of inside and outside basis in both New M1 and M2.[140]

(r) *Rule 1 and External Spin-offs*

We believe that final regulations should provide rules for the application of Rule 1 when P spins off the stock of M to the shareholders of P in an external spin-off.

First, consider the case where P's unreduced basis in M is $100, but because of a net used tested loss amount of $150 in a CFC held by M, Rule 1 has reduced P's basis in M to an excess loss account (ELA) of $50. P then spins off M in a Section 355 spin-off or divisive D reorganization. Under Section 355(c) or Section 361(c), P would not recognize a gain on the distribution, but the ELA of $50 would be taxable under the consolidated return regulations. However, no such ELA would have existed, and no gain would have been taxable, in the absence of Rule 1.

We believe that except in the situations involving cash distributions described below, final regulations should provide that no gain is recognized on the spin-off of a member if the gain represents the triggering of an ELA that would not have existed absent the application of Rule 1. The reason for Rule 1 is that an unreduced basis in M allows P to obtain a second tax benefit from the single tested loss in the CFC. Here, even without the application of Rule 1, P is not obtaining any tax benefit from its basis in M, and it will never be able to in the future. In addition, except in the situations described below, P is not receiving any cash on account of its interest in M.

Of course, if it is assumed that the basis reduction is the "norm", and that the failure to reduce basis results in avoidance of tax on the ELA gain, it could be argued that this is a double benefit. However, this argument assumes the conclusion. In fact, the reason to reduce basis is to prevent a reduction in value of M resulting from the net used tested loss amount from allowing a taxable disposition of M at a reduced gain or increased loss to P. Here, no tax benefit or cash is being received by P on the spin-off of the M stock, so there is no reason to reduce the tax basis of M.

Next, consider the case where P's unreduced basis in M is $100, its reduced basis under Rule 1 is $20, and in a divisive D reorganization, P contributes M to a new Spinco in exchange for Spinco stock and $50 of cash, and then P spins off Spinco. P would not recognize gain under Section 361(b) if P distributed the cash to its shareholders or creditors. However, the cash would nevertheless reduce P's basis in Spinco, and any resulting ELA would be taxable to P.

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[140] Note that the various approaches to allocating basis may create discontinuities with the allocation of e&p, which is generally allocated in proportion to fair market value. See NYSBA Tax Section Report No. 1333, *Report on the Allocation of Earnings and Profits in Connection with Divisive Transactions* (Dec. 1, 2015).

The question here is whether P's unreduced or reduced basis in M should be used to determine whether (and to what extent) the cash distributed to P creates an ELA. We believe it is appropriate here to use the reduced basis, taking account of Rule 1. The reason is that when cash is actually received by P, P is obtaining the benefit of a tax-free receipt of cash to the extent of P's tax basis in M. Unless the Rule 1 basis is used for this purpose, a second benefit of tax-free cash is being received from the unreduced basis. This situation is similar to the issue involving Section 301(c)(2) and (c)(3) discussed in Part IV.B.3(e). However, here unlike there, P will no longer own the stock of M, so the time of the spin-off is the last opportunity for P to be taxed on the receipt of cash from M.

Finally, consider the case where the CFC basis reduction rule creates an ELA not on account of cash received as part of a reorganization transaction, but because of a debt financed distribution of cash, or debt financed losses that give rise to a tax benefit to P. By way of illustration, assume that P forms M with $100 and M forms CFC1 with $100. CFC1's assets then appreciate to $200. In a later year, M borrows $30 and distributes the $30 to P. CFC then has $100 of used tested loss (offset against tested income of another CFC in a different chain).

Under Rule 1, P's basis is reduced so that it has an ELA of $30 in the stock of M. P distributes M to its shareholders under Section 355. Arguably, if there is no ELA recapture, the P group has achieved two benefits from the tested loss and associated stock basis, once upon offset against the tested income and once to "shelter" the debt-financed distribution. The result is in substance no different than the result in the preceding paragraph. Arguably the same issue arises if M borrows the $30 and creates a tax loss that is used by the P group and reduces P's basis in M. (By contrast, if P had simply acquired M for $70 and there were no debt-financed distributions before the spin-off, there would be no "double benefit.") Regulations should clarify the result in this case.

E. Basis Issues in Intra-Group Reorganizations

1. *The Proposed Regulations*

Under Proposed Regulation Section 1.1502-51(c)(5), if M1 engages in a nonrecognition transaction with another group member M2 and receives stock in exchange for CFC stock held by M1, M1's basis in the stock received (which normally would be the basis in the CFC stock) is reduced by the net used tested loss amount of the CFC. This rule complements Rule 1. The purpose of the -51 rule is to mirror P's existing reduced basis in M1 with a new reduced basis by M1 in the member stock acquired in exchange for the CFC.

> **Example 37**. *Intercompany Section 351 transaction*. P's initial basis in M1 is $150, and M1's initial basis in the CFC is $150. The CFC has a used tested loss of $100, reducing P's basis in M1 to $50, but not changing M1's basis in CFC of $150. Then, M1 contributes the CFC to M2 in exchange for M2 stock. Under the general rules, M2 obtains a carryover basis of $150 in the CFC, and M1 obtains a substituted basis of $150 in

> the M2 stock. The Proposed Regulations require that the M1 basis in M2 be reduced by $100, to $50, to be the same as P's basis in M1.

2. *Comments on Proposed Regulation Section 1.1502-51*

The -51 Proposed Regulation makes sense in this example. However, it does not work if it is intended to apply to an intercompany asset reorganization.

> **Example 38**. *Intercompany asset reorganization*. P owns M1 and M2. P's initial basis in M1 is $150, and M1's initial basis in the CFC is $150. The CFC has a used tested loss of $100, reducing P's basis in M1 to $50, but not changing M1's basis in the CFC of $150. M1 merges directly into M2, with P deemed to receive additional M2 stock in exchange for its M1 stock. Absent the rule in -51, P's basis in the new M2 stock would be its old basis in M1, or $50. However, if the Proposed Regulation applies, it would reduce this basis again by another $100, the used tested loss of the CFC.

This double reduction of basis would not make sense. It is possible to interpret this Proposed Regulation so that it does not affect P's basis in M2. Under this interpretation, the basis of the new M2 stock deemed received by M1 in the reorganization would be reduced in the hands of M1, but this reduced basis would "wash out" on the deemed liquidation of M1 into P. Then, P's basis in the M1 assets (including M2 stock) would be a substituted basis from P's basis in the M1 stock under Section 358.

This Proposed Regulation could be modified to state that it does not apply to asset reorganizations. However, it is doubtful that this exclusion was intended, because Proposed Regulation Section 1.1502-51(c)(5) goes on to describe the application of the regulation to an intercompany transaction that is an all-cash D reorganization (as discussed below). It is possible that this Proposed Regulation is thought to be needed in case there is an asset reorganizations in which a basis reduction has not already occurred. To address this possibility, this Proposed Regulation could be modified so that the basis reduction for a used tested loss only applies to the extent that the used tested loss of the CFC has not already been reflected as a reduction in the basis of the stock received in the nonrecognition transaction involving the CFC.

Moreover, as noted, Proposed Regulation Section 1.1502-51(c)(5) goes on to say that in the case of an intercompany transaction that is an all-cash D reorganization, the basis reduction under (c)(5) is made prior to the application of the rule in the consolidated return regulations that an intra-group reorganization with boot is treated as an all-stock reorganization, followed by a separate distribution of cash.[141] If this rule is needed at all, it is not clear why it should only apply to an all-cash D reorganization, as opposed to any intra-group reorganization. In addition, it is not clear why this rule is necessary. It is

[141] Treas. Reg. § 1.1502-13(f)(3).

especially difficult to see a situation involving an all-cash D reorganization in which the basis of the transferring member in the stock of the transferred member would not have already been reduced under Rule 1.

Finally, regulations should clarify the application of the -51 regulation to a net used tested loss amount that arises in the year that the stock of the CFC is transferred. Since a GILTI calculation is only made at the end of the tax year of the CFC, it appears that the -51 adjustments do not take account of a pro rata portion of the current-year net used tested loss amount. Rather, the CFC reduction rule and Rule 1 would apply at the end of the tax year, and to the shareholders at that time, on the basis of the net used tested loss amount for the entire year.

3. *Comments on Proposed Regulation Section 1.1502-13(f)(7)*

The Proposed Regulations modify Example 4 in Treasury Regulation Section 1.1502-13(f)(7) to reflect the modification to the -51 Proposed Regulation discussed immediately above.

Example 4 involves an "all-cash D" reorganization in which the transferor member S in the reorganization is deemed to receive stock in the transferee corporation B, followed by S's liquidation into its shareholder member M. In the example, M has a tax basis in S of $25, S has a value of $100, S's only asset is stock in a CFC, and the CFC has a net used tested loss amount of $15. B pays $100 to S for the stock in the CFC and S liquidates into M. Under the all cash D regulations, B is first treated as paying $100 worth of stock to S, with S then liquidating and M taking a basis in the B stock equal to its old $25 basis in the S stock. The revised example states that M now owns stock in B and B owns the CFC, M's basis of $25 in the B stock must be reduced by $15, the used tested loss amount of B.

This last point does not appear to be correct. In the example, M's initial basis in S ($25) should already have been reduced under Rule 1 by the $15 of net used tested loss amount in the CFC. When S transfers the CFC to B and B issues its stock to S and S liquidates, M's basis in the B stock should be the same as its basis in the S stock (i.e., $25). That basis should not be reduced again by the CFC's used tested loss, since M's basis has already been reduced by that amount.[142] This is the same point concerning Proposed Regulation Section 1.1502-51(c)(5) discussed immediately above.

[142] The existing Example 4 also erroneously refers to S receiving B stock with a basis of $25 under Section 358 that it distributes to M in liquidation. In fact, M rather than S will have a basis of $25 in the B stock. This does not affect the conclusion of the example.

F. General Basis Issues Under the Proposed Regulations

1. *Aggregation of Shares*

The Proposed Regulations do not discuss specifically the question of whether all shares of a particular shareholder of a CFC are to be aggregated in making the calculations required by the Proposed Regulations. Alternatively, the calculations might be made on a share by share (equivalent to bloc by bloc), class by class, or shareholder by shareholder basis.

Under the Proposed Regulations, tested income and tested losses of a CFC are allocated to shareholders of the CFC based on the manner in which distributions of earnings would be made by the CFC.[143] An equal amount of tested income or loss is allocated to each share of the same class, although different amounts might be allocated to shares of different classes. On the other hand, the Proposed Regulations appear to contemplate that a U.S. shareholder of a CFC will have a single net used tested loss amount or net offset tested income amount for the CFC.[144]

However, a U.S. shareholder may have different shares in the same CFC that gave rise to different used tested loss amounts and/or offset tested income amounts while they were held by the U.S. shareholder. This could arise if the shares are of different classes, or if the shares are identical but were acquired at different times by the U.S. shareholder. Even if all of these amounts are aggregated in determining the U.S. shareholder's net used tested loss amount or net offset tested income amount at any time, it is not clear whether the underlying shares maintain their separate underlying attributes, for example if they are sold.

> **Example 39**. *Aggregation of shares*. In year 1, US1 owns 50 out of 100 shares of CFC1 (the "**year 1 shares**"), CFC1 has a tested loss of $100, and US1 uses its $50 share of the tested loss against other tested income. At the end of the year, US1 acquires the remaining 50 of the shares (the "**year 2 shares**"). In year 2, CFC1 has another tested loss of $100 that is used by US1 against other tested income. US1 sells the year 1 shares or the year 2 shares (but not both) at the end of year 2.

Under the Proposed Regulations, US1 has a net used tested loss amount in CFC1 of $150, $50 from year 1 and $100 from year 2. Under an aggregation approach, this represents $1.50 per share owned at the time of the sale, so the sale of the 50 year 1

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[143] Prop. Reg. §§ 1.951-1(e), 1.951A-1(d).

[144] *See, e.g.*, Prop Reg. § 1.951A-6(e)(2) (definition of net used tested loss amount); Prop Reg. § 1.951A-6(e) (definition of net offset tested income amount); Prop Reg. § 1.951A-6(e)(4)(i) (allocation of either of such items to particular shares); Prop Reg. § 1.951A-6(e)(1)(i) (basis on disposition of specified shares is reduced by the corporation's net used tested loss amount with respect to the CFC allocable under usual allocation rules to the specified shares).

shares or the 50 year 2 shares would result in a basis reduction of $75 in the shares sold. Under a tracing approach, the $150 of net used tested loss amount would be allocated $2 per share to the 50 year 1 shares and $1 per share to the 50 year 2 shares, so the basis reduction would be $100 if the year 1 shares were sold or $50 if the year 2 shares were sold.

The question is even more difficult if the CFC has offset tested income in some years.

> **Example 40**. *Aggregation of shares with offset tested income*. In year 1, US1 owns 50 out of 100 shares of CFC1 (again, the "**year 1 shares**"), CFC1 has a tested loss of $200, and US1 uses its $100 share of the tested loss against other tested income. At the end of the year, US1 acquires the remaining 50 of the shares (again, the "**year 2 shares**"). In year 2, CFC1 has tested income of $100 that is offset by other tested losses of US1. US1 sells the year 1 shares at the end of year 2.

US1 has a used tested loss amount of $100 from year 1, and an offset tested income amount of $100 in year 2. Therefore, on an aggregate basis, US1 has no net used tested loss amount, and there is no basis reduction when the year 1 shares are sold. However, under a share by share approach, the year 1 shares have a used tested loss amount of $100 from year 1 and a $50 offset tested income amount from year 2, while the year 2 shares have a $50 offset tested income amount from year 2. Under this approach, there is a $50 basis reduction when the year 1 shares are sold, and the year 2 shares have $50 of untaxed e&p.

The issue also arises if a U.S. shareholder holds different classes of stock, say common and preferred. Suppose first that the preferred stock is allocated tested income and the common is allocated tested loss in a single year, so that there is no GILTI inclusion. Presumably there is netting so that Rule 1 does not cause a reduction in the tax basis of the U.S. shareholder, and the CFC basis reduction rule does not apply if the U.S. shareholder sells the common stock. However, the results under both rules is less clear if the only allocations from the CFC are of tested income on the preferred stock in year 1 that is offset tested income to the U.S. shareholder, and of tested loss on the common stock in year 2 that is used tested loss to the U.S. shareholder.

Another issue would arise if the U.S. shareholder held common stock with a used tested loss, and then purchased preferred stock of the same CFC. If part of the existing used tested loss was then reallocated to the preferred stock under an aggregation approach, it would be possible for the U.S. shareholder to use this technique to avoid part of the basis reduction that would arise on a sale of the common stock.

More generally, under a bloc by bloc approach, if a particular U.S. shareholder held shares of the same class acquired at different times, or shares of different classes, the results would be the same as if each bloc was held by a different shareholder. As illustrated above, the shareholder might have a separate net used tested loss amount or net offset tested income amount in each bloc, and might even have a net used tested loss amount in one bloc and net offset tested income amount in the other bloc.

As a result, the U.S. shareholder would be required to keep track of each bloc of shares separately. This would be a significant burden. Each bloc would have its own net used tested loss amount or net offset tested income amount in each CFC held by the shareholder. The CFC basis reduction rule, which is based on the cumulative net used tested loss amount, would apply separately to each bloc, and the shareholder could presumably designate the shares that it was selling even if the shares were otherwise identical.

The complexities of the bloc by bloc approach would be even greater in the consolidated return context, since Rules 1, 2 and 3 would apply on a bloc by bloc basis. If M held some shares in a single CFC with a net used tested loss amount and other shares with a net offset tested income amount, P's basis in M would decrease by the former without an offset for the latter. A rule would also be necessary to determine whether, under Rule 1, P's basis in M is reduced equally for each share that P owns in M, in an aggregate amount equal to the total net used tested loss amounts for blocs of stock in the particular CFC. Alternatively, P could be permitted to designate particular shares in M to obtain the reduced tax basis in different amounts, corresponding to the different shares that M holds in the CFC that might have different (or no) net used tested loss amount.

The same issue would arise for offsets under Rule 2 to basis reductions under Rule 1. If offset tested income arises in different shares than those that had the used tested loss, there would be no offset to the basis reduction that arose in the shares that had the used tested loss. Likewise, Rule 3 is limited to offset tested income, and the total of the net offset tested income amounts of the shares with offset tested income might be greater or less than the shareholder's net offset tested income amount for the CFC as a whole.

Moreover, in a consolidated group, it is very common for a member to contribute cash to a subsidiary member. Under a bloc by bloc approach, a rule would be needed as to whether such a contribution that is not in exchange for stock would be deemed to be a contribution for stock and a deemed recapitalization of the existing shares,[145] requiring separate tracking of the existing and "new" shares. Absent such a deemed recapitalization, the group could electively achieve bloc by bloc or aggregation results by choosing whether to issue additional stock in exchange for the cash.

On the other hand, aggregation of all shares held by a shareholder, even on a class by class basis, would raise its own issues. As in Example 40, suppose a shareholder holds a single bloc of stock in a CFC with a net used tested loss amount or net offset tested income amount. Suppose the shareholder then acquires additional shares of the

[145] Prop. Reg. § 1.358-2(g)(3) (2009).

CFC of the same class, either from a third party or from the CFC itself. Those new shares would immediately share in the preexisting attributes from the first bloc of shares, reducing the used tested loss amount or offset tested income amount for each original share.

This would encourage tax planning prior to a planned disposition of CFC stock. The result is also somewhat peculiar, since the tax basis of the shares in each bloc would remain separate. As a result, assuming a net used tested loss amount, so the tax basis taken into account on a sale of any share would be the "real" tax basis reduced by a pro rata portion of the aggregate net tested loss amount allocated to all the shares.

It should be noted that even if the regulations were to adopt a class by class or shareholder by shareholder approach, the members of a consolidated group would still need to be treated as separate shareholders. This is necessary under the Proposed Regulations in order to determine the correct amount of net offset tested income amount and net used tested loss amount for each member in each CFC, since those amounts determine the basis increases and decreases in the stock of each member under Rules 1-3.

As a result, if the regulations provided for an aggregation of all shares in a CFC held by a particular U.S. shareholder, a group that wished to have less aggregation of shares could easily have different members of the group own different shares in the CFC. This result would be inconsistent with the idea that a group should be treated as a single entity and that the location of CFCs in the group should not matter. The only way to avoid these results would be if all the calculations were made on a share by share approach, since then the allocations to each share would be the same regardless of where in the group a particular share was located.

It must be acknowledged that even today, shareholders of any corporation, including a CFC, are in principle required to keep track of the separate basis of each share. This is relevant for calculating gain or loss on the sale of individual shares, the holding period of shares for various Code provisions (including Section 245A), amounts taxable under Section 301(c)(3), and so on. In the case of a CFC, separate tracking is also required to determine whether a distribution is PTI, since shares owned during a period of a GILTI or Subpart F inclusion would have a basis increase and PTI allocation, while shares acquired afterwards would not. However, as a practical matter, separate tracking rarely makes a difference today, and so the calculation of basis for particular shares is often not made unless and until it becomes necessary. This is in contrast to separate tracking for GILTI purposes, which if required would be far more complex and far more difficult (if not impossible as a practical matter) to do retroactively.

To conclude, we believe that a share by share, or bloc by bloc, approach is the most theoretically correct approach, and avoids electivity in a consolidated group through nonproductive tax planning. However, this approach would be quite complex and could considerably increase the basis reductions arising under the CFC basis reduction rule and under Rule 1 in the consolidated return context. The Proposed Regulations already create an enormously complex basis regime, and, absent a compelling reason, it should not be made more complex.

On the other hand, an aggregation approach lends itself to tax planning because of the ability it creates to shift net used tested loss amounts and net offset tested income amounts from some shares in a CFC to other shares in the CFC owned by the same shareholder. On balance, we suggest aggregating all shares of the same class owned by a single U.S. shareholder in a CFC, with an anti-abuse rule for transactions undertaken with a principal purpose of taking advantage of the aggregation approach to achieve noneconomic tax results that would not be achieved on a share by share approach.[146] If a U.S. shareholder owns both common and preferred stock, the preferred should be treated separately because of the significantly different ongoing allocations to the two classes of stock and the resulting uneconomic effects that could arise from aggregation.

2. *Complexity*

We cannot submit this Report without an expression of concern about the enormous amount of complexity in basis calculations created by the Proposed Regulations. It is very common, both in the consolidated group context and otherwise, for a U.S. shareholder to sell stock of a one or more CFCs. It is not even unusual for dozens or even hundreds of CFCs to be sold at one time, often in multiple chains of ownership and including cross-ownership among CFCs.

In the past, the basis in the stock of the CFCs being sold has been relatively easy to determine. Now, in light of the CFC basis reduction rule, this will be enormously complicated. A U.S. shareholder will have to know the net used tested loss amount of every CFC being sold. It will be impossible to make this calculation on a retroactive basis at the time a CFC is sold. As a result, it will be necessary for the U.S. shareholder to keep track, on an annual basis, of the tested income and loss of each CFC, and the allocation of the tested losses of tested loss CFCs to the tested income of tested income CFCs. For CFCs in the same chain, the interactions among members of the chain will add more complexity. Foreign tax credits, not discussed in this Report, will add yet another significant amount of complexity.

The complexity will increase further in the context of a consolidated group. It is very common for a group to sell stock of a member of the group that directly or indirectly owns numerous CFCs. A group will not only need to keep track of the data necessary to determine the net used tested loss amount of each CFC in case the CFCs are sold. It will also need to keep track of the data needed to determine the gain or loss that will arise on a future sale of stock of any member that owns any CFCs. Thus, a group will need to keep

[146] Similarly, we suggested simplified rules allowing aggregation of basis in many cases where proposed regulations issued in 2009 would have required calculations be made on a share-by-share basis. NYSBA Tax Section Report No. 1316, *Report on Proposed Regulations Regarding Allocation of Consideration and Allocation and Recovery of Basis in Transactions Involving Corporate Stock or Securities* (February 6, 2015).

track, on a member by member basis, of all the data needed to determine the Rule 1, Rule 2, and Rule 3 adjustments to the basis of member stock. Again, it will not be possible as a practical matter to make these calculations retroactively, so this will be an annual exercise.

As discussed in Part III.F.2(b)(vii), the rules for partnerships holding stock in CFCs are also extraordinarily complicated. It is difficult to imagine partnerships making accurate tax reports to their partners, partners reporting accurately on the CFCs they hold directly and through partnerships, and IRS agents auditing these issues.

Some of the suggestions in this Report will make the basis adjustment rules even more complicated. We make some of the suggestions in order to make the rules work properly as a technical matter, such as the need to keep track of dividends paid by CFCs in order to make adjustments under Rule 2. Other suggestions are to grant taxpayers relief from rules that seem unfair, such as our proposal not to reduce basis under the CFC basis reduction rule for tested losses that do not give rise to an actual tax benefit.

It is possible that major accounting firms will develop computer software that will allow the input of the basic underlying information and will then, in seconds, generate data concerning all tax basis adjustments in the stock of all the CFCs and stock of all members of a group directly or indirectly owning CFCs. However, not all U.S. shareholders of CFCs will have access to such software, and the need for taxpayers to rely on the algorithms in such a "black box" is unfortunate. The resulting complexities and uncertainties could even have a chilling effect on transactions if the taxpayer is concerned that the gain on a sale might be unexpectedly large.

We understand that the purpose of the rules, as well as our suggestions, are to have basis results that reflect economic accuracy. We also understand that basis rules that err on the side of simplicity rather than economic accuracy give rise to the risk of potential manipulation by taxpayers. On the other hand, if manipulation is the concern, the rules are now so complex that it is difficult to imagine how IRS revenue agents are going to audit positions taken by taxpayers anyway.

The complexity and uncertainty of the basis rules will also cause enormous difficulties in the merger and acquisition context. Sellers may be reluctant to sell stock of CFCs, or stock of members owning CFCs, because of uncertainty about the amount of gain that might arise. A buyer might be reluctant to buy the stock of corporation holding a CFC because of concern about future basis reductions in the CFC under the CFC basis reduction rule. A buyer doing due diligence on a target might also be concerned about prior transactions engaged in by the target in which basis under the Proposed Regulations was relevant. The result of these various areas of uncertainty might be increased escrow amounts, longer indemnity periods, the purchase of tax insurance, a reduction in purchase price, or even a reduction in the level of transactions.

In any event, it is unlikely that Congress, when it passed the GILTI legislation, understood the new complexity in basis calculations that it was creating.

3. *The Broader Problem Concerning -32, Section 245A, and Section 961(d)*

As we have discussed in Part IV.D.2(e) and as is discussed further in the Section 245A Report, a noneconomic basis increase under -32 will often arise when buyer buys the stock of M, M owns a CFC, and the CFC pays a dividend of then-existing offset tested income that is eligible for Section 245A. The amount of the offset tested income is already included in the buyer's basis in M, and so the dividend results in a noneconomic basis increase in the M stock just as in a son of mirror transaction. In fact, such an uneconomic basis increase can arise from any untaxed income of a CFC, such as tested income offset by NDTIR. While beyond the scope of the Proposed Regulations and this Report, the Treasury should consider a broader reexamination of the -32 regulations to account for such income.

For example, suppose that M owns a single CFC with tested income of $100 that generates $100 of NDTIR to M. There is no GILTI inclusion, and the CFC can pay a tax free dividend of $100 to M. Under the usual -32 rules, this will increase P's basis in M by $100. This will be the correct economic answer if P's basis in M does not already reflect the $100 of earnings. However, it will be an uneconomic increase in stock basis if, say, P contributed $100 to newly formed M, M bought stock in a CFC for $200, the CFC at that time had $100 of untaxed income, and the CFC pays a $100 dividend to M eligible for Section 245A.[147] P will have a $300 basis in M and can sell it for its value of $200, resulting in a $100 tax loss without a corresponding economic loss.

While this is very similar to a son of mirror transaction, the loss disallowance rule in -36(c) will not apply because P's outside basis in M ($300) is the same as M's inside basis in its assets (cash of $100 and CFC stock with a basis of $200). However, under -36(d), there is a duplicated loss, since both the stock of M and the assets of M have a basis of $300 and value of $200. On P's sale of the M stock, the loss is allowed (absent an election otherwise), but M's basis in the stock of the CFC will be reduced from $200 to $100.

By contrast, if the CFC paid a dividend of $100 to M, and M then sold the stock in the CFC for $100, the $100 loss would be disallowed under Section 961(d). As a result, the group obtains a better tax result, in effect avoiding Section 961(d), if it buys the CFC through a special purpose member M, and, if there is a loss, sells the stock of M rather than having M sell the stock of the CFC.

Yet another result is achieved if M sells the stock of the CFC. Under Section 1248, the tax exempt deemed dividend is limited to the gain on the sale of the stock, and no loss on the stock is possible as a result of undistributed earnings in the CFC.

[147] The same issue would arise if, when M bought the CFC, the CFC had an asset with unrealized appreciation of $100 and sold the asset after the acquisition, with the resulting tested income being sheltered by tested loss or NDTIR.

It will be difficult for regulations to reconcile and rationalize these different results. One possibility for consideration would be a rule that if P's loss on the sale of M stock would not be disallowed under -36(c) or (d), P's basis in M will be reduced by the amount that the CFC basis reduction rule would reduce the basis of M in the CFC stock if M were to sell that stock at the same time.[148]

G. Our Preferred Approaches to Avoid Loss Duplication

We discuss in this Part IV.G two different but related approaches to avoiding the double tax benefit that can arise from the use of a tested loss of CFC2 to offset the tested income of CFC1. These approaches, unlike the Proposed Regulations, are designed to reach results similar to those that would arise if all the CFCs owned by a single corporate U.S. shareholder were a single corporation. We believe these approaches will be simpler to implement than the Proposed Regulations, yet will generally carry out the goal of the Proposed Regulations in preventing loss duplication. We only provide an outline here of the issues that would arise under these proposals.[149]

We believe that either of these proposals would be preferable to the basis rules in the Proposed Regulations, although we prefer the first proposal below to the second. If the Treasury is interested in pursuing either of these proposals, we would be happy to assist further in this process.

1. *The Primary Proposal*

Under the primary approach that we suggest (the "**Primary Proposal**"):

(1) the e&p of CFC1 would be reduced, with respect to a corporate U.S. shareholder, by the shareholder's offset tested income amount, so in effect the offset tested income would not create e&p for the shareholder,

(2) the e&p of CFC2 would be increased, with respect to a corporate U.S. shareholder, by the shareholder's used tested loss amount, so in effect the used tested loss would not reduce e&p for the shareholder,

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[148] See Section 245A Report, at 43.

[149] We also considered an alternative approach that would merely disallow a loss on the sale of stock of a CFC to the extent of the used tested loss amount, similar to Section 961(d) or Treas. Reg. § 1.1502-36(c). However, we do not believe such a rule would be adequate at the CFC level, since it would not prevent the used tested loss amount from reducing gain on the sale of CFC stock. Also, if the same rule was the only limitation that applied on the sale of stock of M, the rule would be almost meaningless at that level, since the group would always arrange, to the extent possible, to have its CFCs owned by group members whose stock was highly appreciated. On the other hand, the automatic denial of loss on a stock sale would also be unfair to taxpayers unless they had the ability to show that the loss was not a duplicated loss.

(3) the shareholder's PTI account would not be changed on account of the adjustments in (1) or (2),

(4) the shareholder's basis in the stock of CFC2 would mandatorily shift to its stock in CFC1, to the extent of the shareholder's used tested loss in CFC2, but the amount of the shift would be limited to the shareholder's existing basis in CFC2 (this limitation, the "**cap**"),[150] and

(5) corresponding basis shifts would be made at the same time to the stock of members of a consolidated group owning stock in the tested loss and tested income CFCs, under Treasury Regulation Section 1.1502-32.[151]

2. *Discussion of Primary Proposal*

The Primary Proposal is analogous in some ways to the proposed regulations under Section 965. Those rules also result, in substance, in the elimination of e&p from the system when one CFC has positive e&p and another CFC has negative e&p.[152] However, there the basis shift is elective, is not limited by the cap, and causes gain to be recognized to the extent of any basis that would otherwise become negative. Here, the basis shift would be mandatory, but only to the extent of existing basis, so no gain is recognized at the time of the shift in basis.

Under the Primary Proposal, assuming CFC1 had no unrelated e&p, a distribution by CFC1 in the amount of its offset tested income would not be tax free under Section 245A, because no e&p would be created by such income. Rather, the distribution would be tax free under Section 301(c)(2) to the extent of the basis in the stock of CFC1, which would include any available basis shifted from CFC2. Any additional distribution would be taxable under Section 301(c)(3).

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[150] If the tested loss of a CFC was used to offset the tested income of more than one tested income CFC, and the cap applied, the basis in the tested loss CFC would be shifted to the tested income CFCs in proportion to the tested income of each such tested income CFC.

[151] Further consideration needs to be given to whether corresponding e&p adjustments should be made at the member level.

[152] More specifically, under the proposed Section 965 regulations, when e&p of a deferred foreign income corporation ("**DFIC**") is offset by an e&p deficit of another specified foreign corporation ("**SFC**"), the offset amount ("**Section 951(b) PTI**") is not included in the U.S. shareholder's income, does not increase the U.S. shareholder's basis in the DFIC, and becomes e&p described in Section 959(c)(2). The Section 951(b) PTI is generally excluded from the U.S. shareholder's income when distributed. Assuming the distribution reduces the shareholder's basis in the DFIC and results in gain to the extent it exceeds basis, the impact of creating Section 951(b) PTI is similar to the elimination of e&p from the system. Also, under the proposed Section 959 regulations, the SFC's deficit in e&p is reduced by the offset. A number of issues are raised by this Section 951(b) PTI system, some of which are discussed in recent reports of ours. *See* NYSBA Tax Section Report No. 1402, *Report on Previously Taxed Income under Section 959* (October 11, 2018); NYSBA Tax Section Report No. 1401, *Report on Proposed Section 965 Regulations* (October 5, 2018).

The Primary Proposal prevents a double tax benefit from arising from a tested loss, because no e&p is generated that is eligible for Section 245A. It is also closer to a single entity approach than would arise under the Proposed Regulations, since it in effect aggregates the basis of CFC1 and CFC2 for purpose of determining the taxability of distributions of offset tested income. It would also allow, as do the existing Proposed Regulations, the avoidance of gain in the stock of CFC1 by selling gain assets in CFC1 and loss assets in CFC2, to the extent that there was basis in CFC2 that would be shifted to CFC1. However, this result is consistent with the result that could arise if CFC1 and CFC2 were divisions of a single corporation, so perhaps it is not objectionable. Nevertheless, given the existence of two corporations, this ability to shift basis could give rise to significant tax planning opportunities.

The Primary Proposal is more favorable to taxpayers than the Proposed Regulations in some cases. In particular, it will be more favorable if the basis reduction in CFC2 is limited by the cap, there is sufficient separate basis in CFC1 to allow a full distribution of the tested income of CFC1, and if the stock of CFC2 is then sold. In that case, the Proposed Regulations will result in more gain on the sale of CFC2 than will the proposal, but the distribution of the full amount of tested income can be made tax free from CFC1 under either the Proposed Regulations or the Primary Proposal.

For example, assume shareholder M has a basis of $100 in CFC1 and $0 in CFC2. CFC1 has $100 of tested income and CFC2 has $100 of tested loss. M then sells the CFC2 stock. Under the Proposed Regulations, CFC1 can distribute the $100 of tested income tax free without any basis reduction in CFC1. However, on the sale of the CFC2 stock, the gain is $100 plus the amount realized. Under the Primary Proposal, there is no shift of basis to CFC1, but CFC1 can take advantage of M's existing basis in CFC1 to distribute $100 tax-free, reducing M's basis in CFC1 to $0. On the sale of CFC2, the gain is the amount realized.

In summary, under the Primary Proposal compared to the Proposed Regulations, there is $100 less gain on the sale of CFC2 stock, accompanied by a $100 reduction in the basis in CFC1. This is more favorable to the taxpayer than the approach under the Proposed Regulations, but again, it is consistent with single entity treatment. A single entity would have no e&p, an outside basis of $100, and outside basis reduced to $0 on the distribution from the CFC1 division, and gain on the sale of the CFC2 business.

If the cap is considered by the Treasury to give results that are too favorable to taxpayers as compared to the Proposed Regulations, a number of variations on the Primary Proposal would be possible. Each, however, would have its own shortcomings, complexities and potential authority issues that would need to be explored further.

For example, it would be possible to trigger gain on the disposition of CFC2 to the extent that a basis shift was prevented by the cap (at least to the extent that the tested loss in CFC2 that would give rise to the basis shift arose from built-in losses that existed when M purchased CFC2). However, the basis in CFC1 should then be increased by the amount of such gain, as if the basis shift had originally occurred, and the resulting rules would be complex.

Alternatively, the amount of tested loss of CFC2 that could be used to offset tested income of other CFCs of M could be limited to M's existing tax basis in CFC2. In the example, M would have a $100 GILTI inclusion from CFC1, and the CFC basis reduction rule would not apply to CFC2 because there is no used tested loss. This rule would be somewhat analogous to Section 704(d), which limits a partner's allocable share of partnership losses to the partner's tax basis in the partnership.

Finally, an anti-abuse rule could be adopted to cover the case where M buys CFC2 with built-in loss assets for the purpose of selling those assets at a loss, uses the tested loss to shelter tested income of CFC1, relies on the cap to limit the basis reduction in CFC2, and then sells the stock of CFC2 at a gain that does not reflect the full basis reduction because of the cap.

On the other hand, the Primary Proposal will give worse results for taxpayers than the Proposed Regulations in some cases. This will be true if there is less total basis in CFC1 and CFC2 than the amount of offset tested income in CFC1. The reason is that the offset tested income could be distributed tax-free under the Proposed Regulations, but not under the Primary Proposal. For example, suppose shareholder M has a $0 basis in both CFC1 and CFC2, CFC1 has $100 of tested income, and CFC2 has $100 of tested loss. Under the Proposed Regulations, CFC1 can distribute the $100 of income tax-free under Section 245A, at the price of additional gain of $100 when the stock of CFC2 is sold. Likewise, M can sell the stock of CFC1 at a gain of $100 that would be tax exempt under Section 1248.

Under the Primary Proposal, CFC1 would have no e&p, and M would have no basis in CFC1, so the $100 of tested income could not be distributed tax free and the $100 of gain would be taxable. To be sure, this result is consistent with the result that would arise if CFC1 and CFC2 were divisions of a single corporation that had no net e&p and where the shareholder had a $0 basis in the stock.

The Primary Proposal would also raise the issue of how to deal with the case where the offset tested income of CFC1 would not be taxed even without regard to the used tested loss of CFC2. For example, the U.S. shareholder might have NDTIR or foreign tax credits that would shelter the tested income even in the absence of the tested loss. This is similar to the question under the Proposed Regulations about whether there is really a duplicated loss that requires a basis reduction in CFC2. However, the issue will come up less often under the Primary Proposal because of the inapplicability of Sections 245A, 961(d), and 1059.

On the merits, under single entity principles there would be no net e&p in the single entity, no benefit from NDTIR, and no eligibility for FTCs for foreign taxes paid by the single entity. As a result, the usual basis adjustments for tested income and tested loss would logically apply without regard to NDTIR or FTCs. The loss of FTCs arises because the Primary Proposal is applying single entity principles to multiple CFCs, while foreign jurisdictions are (naturally) applying separate entity principles. There should also be less concern about the Primary Proposal applying even in the absence of loss duplication, since the result here is "only" a shift in basis as opposed to a permanent elimination of basis as under the Proposed Regulations.

Another question would arise if, say, M has a $100 basis in CFC1 and a $0 basis in CFC2, and in year 1, CFC1 has offset tested income of $100, and CFC2 has used tested loss of $100. Normally, $100 of basis would shift from CFC2 to CFC1, but there is no basis in CFC2 to shift. Suppose now that in year 2, CFC1 has $100 of used tested loss and CFC2 has $100 of offset tested income. While $100 of basis would normally shift from CFC1 to CFC2, as an economic matter that should not occur here since the two CFCs end up in the same economic position as they started. Rather, there should only be a "notional" shift of basis in year 2 from CFC1 to CFC2 that offsets the failure to make the reverse basis adjustments in year 1.

As a result, any time the cap on basis reduction applies, there would need to be created a notional account for unutilized basis reduction in the tested loss CFC, and unutilized basis increase in the tested income CFCs. Future basis adjustments would have to offset these accounts before being reflected in actual basis numbers.

As to the consolidated return regulations, the basis reduction in the stock of the member holding the CFC would match the basis reduction in the CFC stock. This would be similar to Rule 1, but with the cap on basis reduction in the CFC limiting the reduction to M's basis in the stock of the CFC. The discussion in the preceding paragraph is comparable to Rule 2, and only actual basis adjustments (not notional adjustments described therein) in the stock of the CFCs would tier up to M. Rule 3 would logically still apply, since a CFC with exempt e&p (such as arising from NDTIR without the existence of any tested losses) should not be required to distribute its e&p in order to reduce the gain on the sale of stock of the member holding the CFC.

Issues would also arise under the Primary Proposal from the failure to include the tested income of CFC1 in its e&p allocable to the U.S. shareholder, and the failure to reduce the e&p of CFC2 allocable to the U.S. shareholder by its tested loss. We note as background that under the basic GILTI regime, different U.S. shareholders of a CFC might have different GILTI inclusions because of different amounts of NDTIR or tested losses in other CFCs. As a result, different U.S. shareholders of a single CFC might have different amounts of PTI in the CFC. However, in general, each shareholder of a CFC should have, on a per share basis, the same total of e&p and PTI, representing their share of the total undistributed untaxed and taxed earnings of the CFC, respectively.[153]

This relationship would no longer be true under the Primary Proposal. If a CFC had tested income, (1) as before, some shareholders might have a full GILTI inclusion

[153] This assumes all shares are of the same class and were issued at the same time.

and an increase in PTI for their share of the income, (2) as before, shareholders with unrelated NDTIR might have no GILTI inclusion and an increase in e&p for their share of the income, and (3) under the Primary Proposal, shareholders with other CFCs with tested losses might have no increase in either PTI or e&p (although they might obtain a basis increase in the stock of the CFC). Likewise, as to a CFC with a tested loss, some shareholders would have their share of the e&p reduced by their share of the loss, and others shareholders would not. The Primary Proposal would also create new disparities between inside e&p and outside tax basis, since there is a cap on the shift of outside tax basis, but no cap on the shift of e&p.

We are not claiming that the Primary Proposal would be simple, and in fact no system of sharing attributes will be simple. Moreover, this proposal would no doubt create discontinuities by treating CFC1 and CFC2 as a single corporation for some purposes when there are in fact two corporations. However, we believe that the Primary Proposal would be significantly simpler than the existing Proposed Regulations, largely because (1) there is no tax-free e&p arising from the offset of tested income in one CFC and tested loss in another CFC, and therefore no effects from the applicability or nonapplicability of Sections 245A, 961(d), and 1059, and (2) there is no basis disparity between the stock of the CFC and the stock of a member of a consolidated group holding the CFC.

In addition, unlike the proposed regulations under Section 965, the Primary Proposal does not create upfront gain from the shift in basis of CFC2, although at the cost of less ability to distribute tax-free cash under Section 301(c)(2). The Primary Proposal could be further simplified if it only applied to U.S. shareholders with an ownership (including by related parties) of 50% or 80% of a CFC.

3. *Authority for Primary Proposal*

As to the authority of the Treasury to adopt the Primary Proposal by regulations, the Proposed Regulations already cause a reduction in basis of a CFC upon its sale. We do not believe that the reduction of basis at the time of a tested loss under the Primary Proposal is a materially greater use of existing authority, particularly because the cap prevents any gain recognition at that time.

The adjustments to e&p under the Primary Proposal also raise questions of authority. Section 964(a) provides that the e&p of a foreign corporation "shall be determined according to rules substantially similar to those applicable to domestic corporations, under regulations prescribed by the Secretary." Although the adjustments to e&p under the Primary Proposal would not be applicable to domestic corporations, Section 964(a) contemplates at least some disparity in the calculation of e&p for domestic and foreign corporations.

Moreover, such a disparity would only arise when a shareholder's tested income of one CFC offsets the shareholder's tested loss from another CFC. This is a unique situation created by Congress in the GILTI regime, and arguably a different rule for e&p

in this situation would not prevent the overall regime for determining e&p of a CFC from being considered "substantially similar" to the overall regime for a domestic corporation. Moreover, the Treasury could continue to rely on *Ilfeld* to justify this method of preventing loss duplication. Nevertheless, as we suggest in connection with Proposed Regulation Section 1.961-6(e), we acknowledge that the Treasury might wish to obtain a statutory amendment to confirm its authority to adopt this approach.

4. *The Secondary Proposal*

If the Treasury does not wish to adopt the Primary Proposal, we would propose a simplified and modified version of that proposal (the "**Secondary Proposal**"). Under this proposal, the same adjustment for e&p would be made as in the Primary Proposal. However, there would be no adjustment to tax basis (or PTI). As a result, if CFC1 had tested income and CFC2 had tested loss, CFC1 would not have any e&p as a result of its tested income, and there would be no basis shift from CFC2 to CFC1.

The Secondary Proposal is obviously simpler than the Primary Proposal. Moreover, just as does the Primary Proposal, the Secondary Proposal would avoid loss duplication by eliminating any Section 245A benefit from offset tested income. However, because of the lack of a shift in basis, the Secondary Proposal creates results that are less similar than the Primary Proposal to the results that would arise if CFC1 and CFC2 were divisions of a single corporation.

For example, under the Primary Proposal, the basis shift would mean that CFC1 could make tax-free distributions under Section 301(c)(2) to the extent of the preexisting basis of both CFC1 and CFC2. This is the same result that would arise if CFC1 and CFC2 were divisions of a single corporation. Under the Secondary Proposal, CFC1 could make tax-free distributions under Section 301(c)(2) only to the extent of the preexisting basis of CFC1, a worse result than if CFC1 and CFC2 were divisions of a single corporation.

On the other hand, as a general matter, a basis shift can either help or hurt taxpayers. If the U.S. shareholder had sufficient basis in CFC1 to permit any desired distribution by CFC1 even without a basis shift from CFC2, the shareholder might prefer the Secondary Proposal to the Primary Proposal. The basis shift under the Primary Proposal would provide no benefit to the shareholder, and could even provide a detriment because of increased gain (or reduced loss) on the sale of the stock of CFC2.

By contrast, under the Secondary Proposal, the tested loss in CFC2 reduces the GILTI inclusion of the U.S. shareholder from the tested income of CFC1, without causing any basis reduction in the stock of CFC2. As a result, if the tested loss reduces the value of CFC2, the tested loss is both reducing a GILTI inclusion and allowing a reduction in gain (or increase in loss) on the sale of the stock of CFC2.

To be sure, under this approach, there is no "double tax benefit" from the tested loss because the offset tested income in CFC1 cannot be distributed tax-free under

Section 245A. Nevertheless, there could be a significant timing benefit if the U.S. shareholder had sufficient basis in CFC1 to cover desired distributions from CFC1, and desired to sell the stock in CFC2. This approach could therefore give rise to significant tax benefits and significant tax planning, particularly since the unreduced tax basis in CFC2 might prevent the creation of gain on a stock sale that could otherwise be taxable at a 21% rate or might create loss that could shelter other gain otherwise taxable at a 21% rate.

The Secondary Proposal would also increase further the incentives of taxpayers to engage in the transactions involving the cap as described in connection with the Primary Proposal. Those techniques relied on the fact that under the Primary Proposal there is no basis reduction in CFC2 in excess of the preexisting basis in CFC2. Under the Secondary Proposal, there is no basis reduction in CFC2 at all. As a result, there is even more incentive under this proposal for M to buy a CFC with a built-in tested loss in order to have the CFC sell those assets to shelter tested income of CFC1, followed by a sale of the CFC stock.

If the Secondary Proposal is adopted, there should not be any consolidated return basis adjustments under -32. If M sells CFC1 at an amount that reflects the untaxed tested income, M would have a taxable gain. The reason is that the tested income does not give rise to e&p, and so Section 1248(j) does not convert the gain into a tax-free dividend under Section 245A. In order to match this result upon the sale of the stock of M, there should not be any basis increase in the stock of M (as there is under Rule 3) when M sells the stock in CFC1. Likewise, when CFC2 has a used tested loss, M's basis in CFC2 does not change either at that time or upon the sale of CFC2. There would be no reason to create a basis disconformity by reducing P's basis in M (as in Rule 1) at either such time.

The authority issues concerning a shift in e&p under the Secondary Proposal would be the same as those issues under the Primary Proposal.