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Report No. 1441
September 29, 2020

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Re: *Report No. 1441 – Report on Proposed and Final Regulations Addressing GILTI and Subpart F High-Tax Exceptions*

Dear Messrs. Kautter, Rettig, and Desmond:

I am pleased to submit our Report No. 1441 commenting on the proposed regulations and certain aspects of the final regulations issued in July of this year addressing the high-tax exemptions under GILTI and Subpart F.

Issues addressed in our report include the application of the GILTI high-tax regime rules to the Subpart F exception, treatment of tested units with negative or undefined tax rates, allocation and apportionment of dedcutions for purposes of determining the effective foreign tax rate, and the CFC group consistency rules.

We appreciate your consideration of our report. If you have any questions or comments, please feel free to contact us and we will be glad to

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Report No. 1441

New York State Bar Association Tax Section

Report on Proposed and Final Regulations Addressing GILTI and Subpart F High-Taxed Income Exception

September 29, 2020

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I. Introduction

This report (the "**Report**")[1] discusses and makes recommendations regarding the proposed regulations (the "**Proposed Regulations**")[2] and selected aspects of the final regulations (the "**Final Regulations**")[3] published in the Federal Register on July 23, 2020, relating to the application of the high-tax exclusion under section 954(b)(4) of the Internal Revenue Code[4] to the global intangible low-taxed income ("**GILTI**") and Subpart F income rules. The Final Regulations adopted, with certain modifications, regulations proposed on June 21, 2019 (the "**2019 Proposed Regulations**")[5] that would allow taxpayers to elect to exclude items of high-taxed income of controlled foreign corporations (as defined in section 957(a)) ("**CFCs**") from tested income for purposes of determining the inclusion of a U.S. shareholder (as defined in section 951(b)) ("**U.S. Shareholder**") under section 951A (the exclusion from tested income, the "**GILTI HT Exception**," and the election to apply the GILTI HT Exception, the "**GILTI HT Election**"). Among other proposed revisions, the Proposed Regulations would largely extend the rules related to the GILTI HT Exception, including the requirement of consistent elections for groups of CFCs (the "**Consistency Requirement**"), to the high-tax exclusion applicable to Subpart F (the exclusion from Subpart F income, the "**Subpart F HT Exception**," and the election to apply the Subpart F HT Exception, the "**Subpart F HT Election**") and would require a single election that would apply for both the GILTI HT Exception and the Subpart F HT Exception (the single (combined) high-tax exception, the "**HT Exception**," and the election to apply the HT Exception, the "**HT Election**").

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[1] The authors of this Report are Peter Connors, Gary Scanlon and David Stauber. Substantial assistance in the preparation of this Report was provided by Andrew Braiterman, Yaron Reich, Michael Schler, Shun Tosaka, Philip Wagman, and Gordon Warnke. Helpful comments were provided by Kimberly Blanchard, Robert Cassanos, Marina Vishnepolskaya, and Richard Reinhold. This Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of the Executive Committee or the House of Delegates of the New York State Bar Association.

[2] REG–127732–19.

[3] T.D. 9902.

[4] Except as otherwise specified, all "section" or "§" references are to the Internal Revenue Code of 1986, as amended (the "**Code**").

[5] REG-104390-18.

Part II of this Report contains an executive summary. Part III discusses the background of the Proposed Regulations and the Final Regulations. Part IV provides a detailed discussion of the issues and our recommendations.

II. Executive Summary

A. Conformity of the Subpart F Regime to the GILTI Regime. The Proposed Regulations generally extend the GILTI HT Exception rules of the Final Regulations to the Subpart F regime and provide for a single election applicable to both regimes ("**Conformity**"). We do not express a view regarding whether Treasury has the authority to require Conformity. Some of us support Conformity from a policy point of view, while others of us believe that there are policy considerations that may cut against requiring Conformity. Therefore, we do not have a formal recommendation in favor of or against whether Conformity should be retained in final regulations.

B. Negative or Undefined Tax Rates. The Proposed Regulations provide that if the effective tax rate with respect to the income of a Tested Unit (as defined below) is undefined or negative, as would occur if the Tested Unit had a loss under U.S. tax principles but nevertheless paid or incurred a foreign tax, the Tested Unit is considered to be subject to a high rate of foreign tax. This rule could cause a loss of the Tested Unit to not be taken into account in calculating a U.S. Shareholder's GILTI inclusion, and could also result in the inability of a U.S. Shareholder to take into account the foreign taxes paid or accrued by the Tested Unit or the Tested Unit's QBAI (as defined below).

We believe that there are circumstances (including situations where the only tax imposed is a gross basis withholding tax and situations involving timing differences or differences in taxable years) in which the treatment of the Tested Unit as high-taxed because of a negative or undefined foreign tax rate is arguably incongruous. We do not, however, make a recommendation to change the rule in the Proposed Regulations because we have not identified a solution that is consistent with the general rules that treat withholding taxes in the same manner as other taxes and the general year-by-year approach of the GILTI regime.

C. Allocating Expenses and Deductions. In determining the foreign effective tax rate to which income of a Tested Unit is subject, it is necessary to allocate expenses, such as interest, to the income. The Proposed Regulations would allocate expenses to income of a Tested Unit based on whether the expenses are "booked" on the Applicable Financial Statement (as defined below) of the Tested Unit. We agree with that approach. Additionally, we propose a method for preventing double counting of expenses.

D. Transition Rule. The revisions to the Subpart F HT Exception that would be adopted by the Proposed Regulations are significant. While the Proposed Regulations would not become effective until taxable years of CFCs beginning after their adoption as final regulations, we believe that a relatively short transition rule or delayed effective date should be considered to allow taxpayers to restructure their operations in advance of becoming subject to the new rules.

E. Special Rules for Adjustments of Foreign Taxes and Later Elections. Under the Proposed Regulations, a HT Election must be made or revoked within 24 months of the unextended due date of the tax return in which the income is required to be reported. We believe that a later adoption or revocation should be allowed in situations where there is a foreign tax redetermination (within the meaning of section 905(c)) after the 24-month period and all taxable years that are, or would be, affected by the HT Election remain open.

F. Combination of Tested Units. The Proposed Regulations would require that high-taxed income be determined separately with respect to each Tested Unit, rather than with respect to each QBU. For this purpose, the Final Regulations combine "same-country" Tested Units of a single CFC for purposes of the determination of high-taxed income. The Proposed Regulations would expand the circumstances under which Tested Units of a CFC would be combined by adding a rule for combining de minimis Tested Units. While we agree with the Tested Unit approach, we propose two modifications to the combination standards to address concerns relating to dual-resident corporations and the Proposed Regulations' de minimis test.

G. The Consistency Requirement. The Proposed Regulations, like the Final Regulations, require HT Elections to be made consistently with respect to each CFC that satisfies a modified standard of affiliation. We refer to this as the "**CFC Affiliation Approach**." Because the CFC Affiliation Approach is applied without regard to the persons that are authorized to make, or are affected by, the HT Elections, the approach would require consistency in certain inappropriate situations, particularly in the context of unrelated taxpayers. In other situations, the CFC Affiliation Approach would not require consistency even where it appears from a policy perspective that consistency should be required. We therefore recommend that, instead of the CFC Affiliation Approach, final regulations adopt a standard for consistency that is similar to that of the 2019 Proposed Regulations, with some modifications. We refer to this as the "**Modified 2019 Proposed Approach**." This approach would require a controlling domestic shareholder (as defined below) (or a group of controlling domestic shareholders) to make consistent HT Elections with respect to each entity for which the controlling domestic shareholder (or controlling domestic shareholders) has the authority to make the election.

Alternatively, if Treasury and the IRS prefer to retain the CFC Affiliation Approach, we propose changes to that approach that would narrow its scope and eliminate some of the more inappropriate applications of the approach. We refer to the CFC Affiliation Approach, as modified, as the "**CFC-CDS Affiliation Approach**." This approach would condition the requirement of consistency on affiliation not only among the CFCs, but also among the CFCs and their CDSs.

III. Background

A. TCJA Provisions

The 2017 legislation commonly known as the Tax Cuts and Jobs Act (the "**TCJA**," or the "**Act**")[6] included a provision requiring current inclusion by U.S. Shareholders of a portion of a CFC's current income referred to as global intangible low-taxed income, or GILTI.[7] Although the TCJA established a modified territorial system under which earnings of foreign subsidiaries are largely exempt from U.S. taxation, the GILTI provisions generally are intended to tax on a current basis CFC earnings (not including earnings already subject to current U.S. tax such as Subpart F income) that are not subject to foreign tax at a minimum rate. As a result of a 50% GILTI deduction for taxable years that begin before January 1, 2026, a corporate U.S. Shareholder's effective U.S. federal income tax rate on GILTI is currently 10.5%.[8] Additionally, corporate U.S. Shareholders are eligible for a foreign tax credit equal to 80% of the foreign taxes imposed on income giving rise to GILTI (subject to application of the section 904 foreign tax credit limitation rules).[9] A non-corporate U.S. Shareholder is not eligible for either the 50% GILTI deduction or the 80% foreign tax credit unless the shareholder elects under section 962 to be taxed on its GILTI and Subpart F income in substantially the same manner as a U.S. corporation, with a second level of U.S. tax being imposed on distributions from the CFC in excess of the U.S. taxes imposed on a current basis.

An important feature of the GILTI regime is its interaction with the foreign tax credit limitation rules. In general, the foreign tax credit is limited to the amount of pre-credit U.S. tax imposed on foreign-source income. This limitation ensures that the credit mitigates

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[6] 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.

[7] Section 951A.

[8] Section 250(a)(1)(B).

[9] Section 960(d).

double taxation of foreign-source income without offsetting U.S. tax on U.S. source income. The foreign tax credit limitation is calculated separately for certain categories (or "baskets") of income. Under pre-TCJA law, there were two baskets: income was either "passive category" income or "general category" income (defined as income other than passive category income). The amount of foreign taxes paid or accrued that exceeded the foreign tax credit limitation for a tax year could be carried forward ten years or carried back one year. The TCJA added two additional foreign tax credit limitation baskets, including the "GILTI basket," which includes any amount includible in gross income as GILTI (other than passive category income).[10] Thus, foreign taxes in excess of the GILTI basket limitation for the year are not eligible to offset U.S. tax on other foreign-source income. In addition, excess foreign taxes in the GILTI basket may not be carried back or carried forward.[11]

The legislative history of the TCJA suggests that a corporate U.S. Shareholder would not incur a GILTI tax liability if the effective foreign tax rate exceeds 13.125% (10.5% effective tax rate divided by 80%) of the GILTI income.[12] However, because of the application of the foreign tax credit limitation under section 904, certain expenses incurred at the level of the U.S. Shareholder (as opposed to expenses incurred by the CFC), such as interest expense incurred by the U.S. parent of a multinational group, must be allocated and apportioned to GILTI notwithstanding that the expenses are not deductible for foreign tax purposes. As a result of (i) the allocation and apportionment rules, (ii) the potential timing mismatch between when an item of income is taken into account for GILTI purposes and when the foreign taxes related to the item of income are deemed paid by the U.S. Shareholder under section 960, and (iii) the inability to carry excess foreign taxes in the GILTI basket back or forward to other years, a corporate U.S. Shareholder may find that including GILTI in its taxable income increases its U.S. tax liability even if GILTI is taxed at a foreign rate greater than 13.125%. As noted in the Joint Committee explanation of the TCJA, a foreign effective tax rate of 13.125% is possible

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[10] Section 904(d)(1)(A).

[11] Section 904(c) and (d)(1)(A).

[12] Conference report to accompany the Tax Cuts and Jobs Act (H. Rept. 115-466), at p. 626 (December 15, 2017).

only if it is assumed, "among other things, . . . that the domestic corporation has no expenses."[13]

Prior to the TCJA, Subpart F generally provided for the current taxation to a U.S. Shareholder of certain types of passive income of a CFC. The Subpart F rules were generally not changed by the TCJA. Under Subpart F, foreign base company ("**FBC**") income and insurance income is taxable to corporate U.S. Shareholders at a current maximum rate of 21%. Foreign tax on income that is subject to inclusion under Subpart F is eligible for a deemed foreign tax credit under section 960. Excess tax credits on such income may be carried forward and carried back, as was the case under prior law.[14] Under the Subpart F HT Exception of section 954(b)(4) and the regulations thereunder in effect prior to the TCJA,[15] income that is otherwise taxable under Subpart F can be excluded if the taxpayer is able to demonstrate that the income is subject to foreign tax at a rate greater than 90% of the maximum U.S. corporate tax rate. Treasury regulations promulgated under section 954(b)(4) further provide that the exception applies only if, in addition to "establishing" that foreign income taxes on the item exceed the 90% threshold, U.S. Shareholders make a Subpart F HT Election to exclude the item from FBC income. The Subpart F HT Election is generally made "item-by-item,"[16] but it must be made for all passive foreign personal holding company income (within the meaning of section 954(c)) of a CFC or for none.[17] The Subpart F HT Election is binding on all U.S. Shareholders of a CFC, even if the U.S. Shareholders are unrelated to one another.[18]

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[13] See Staff of Joint Comm. on Tax'n, 115 Cong., 2d Sess., General Explanation of Public Law 115-97, at 381 (Comm. Print 2018). The Joint Committee explanation acknowledges that absent the assumption of there being no expenses "the results . . . may change." Id.

[14] Section 904(c).

[15] Treas. Reg. § 1.954-1(d)(1) and (5).

[16] For this purpose, a single "item" of income generally includes all income of a CFC that fall into a separate category of FBC income. See Treas. Reg. § 1.954-1(c)(1)(iii) and (d)(1). Therefore, for instance, all of a CFC's FBC sales income would constitute a single item of income for this purpose. See Treas. Reg. § 1.954-1(c)(1)(iii)(B)(2)(i).

[17] Treas. Reg. § 1.954-1(d)(4)(i). See Staff of Joint Comm. on Tax'n, 99th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986, at 983 (Comm. Print 1987).

[18] Treas. Reg. § 1.954-1(d)(5).

For GILTI purposes, section 951A(c)(2)(A)(i) provides that the gross tested income of a CFC for a taxable year is all of the gross income of the CFC for the year, determined without regard to certain items.[19] More specifically, section 951A(c)(2)(A)(i)(II) excludes from gross tested income any Subpart F income of a CFC, and section 951A(c)(2)(A)(i)(III) excludes any gross income excluded from FBC income or insurance income of a CFC by reason of the Subpart F HT Exception.

B. The 2019 Proposed Regulations

On June 21, 2019, Treasury and the IRS published the 2019 Proposed Regulations[20] that would allow taxpayers to elect the GILTI HT Exception to exclude from tested income of a CFC any item of gross income and allocable deductions if the resulting net income is subject to foreign tax at a rate greater than 90% of the U.S. corporate tax rate (*i.e.*, currently 18.9%).[21] The preamble to the 2019 Proposed Regulations justified the extension of the Subpart F HT Exception to GILTI with a broad reading of both section 954(b)(4) and the legislative history to the TCJA, as follows:

> The legislative history evidences an intent to exclude high-taxed income from gross tested income. See Senate Explanation at 371 ("The Committee believes that certain items of income earned by CFCs should be excluded from the GILTI, either because they should be exempt from U.S. tax — as they are generally not the type of income that is the source of base erosion concerns — or are already taxed currently by the United States. Items of income excluded from GILTI because they are exempt from U.S. tax under the bill include foreign oil and gas extraction income (which is generally immobile) and income subject to high levels of foreign tax."). The proposed regulations, which permit taxpayers to electively exclude a CFC's high-taxed income from gross tested income, are consistent, therefore, with this legislative

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[19] See also Treas. Reg. § 1.951A-2(c)(1).

[20] For our prior comments on the Proposed Regulations, see NYSBA Tax Section Report No. 1423, *Report on June 2019 GILTI and Subpart F Regulations* (Sept. 18, 2019) (hereinafter the "**2019 Report**").

[21] Prop. Treas. Reg. § 1.951A-2(c)(7).

> history. Furthermore, an election to exclude a CFC's high-taxed income from gross tested income allows a U.S. shareholder to ensure that its high-taxed non-Subpart F income is eligible for the same treatment as its high-taxed FBCI and insurance income, and thus eliminates an incentive for taxpayers to restructure their CFC operations in order to convert gross tested income into FBCI for the sole purpose of availing themselves of section 954(b)(4) and, thus, the GILTI high-tax exclusion.[22]

Under the 2019 Proposed Regulations, the election for the GILTI HT Exception would be made by the CFC's controlling domestic shareholders for a CFC inclusion year.[23] The "**controlling domestic shareholders**" (or "**CDSs**") of a CFC are those U.S. Shareholders who, in the aggregate, own (within the meaning of section 958(a)) more than 50% of the total combined voting power of all classes of stock of the CFC entitled to vote and who undertake to act on its behalf. In the event that U.S. Shareholders do not, in the aggregate, own (within the meaning of section 958(a)) more than 50% of the total combined voting power of all classes of stock entitled to vote, the CDSs of the CFC are all the U.S. Shareholders who own (within the meaning of section 958(a)) any stock of the CFC.[24]

A GILTI HT Election with respect to a CFC by the CFC's CDSs would bind all the CFC's U.S. Shareholders, not just the electing CDSs.[25] The election would be effective for the CFC inclusion year for which it was made and all subsequent CFC inclusion years of the CFC unless revoked by the CDSs of the CFC (who could revoke the election for any CFC inclusion year).[26] The election could be revoked by the CDSs in the same manner in which it is made.[27] However, if an election were revoked, a new election generally could not be made for any CFC inclusion year of the CFC that began within

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22 REG-101828-19.

23 2019 Prop. Treas. Reg. § 1.951A-2(c)(6)(v)(A)(1).

24 Treas. Reg. § 1.964-1(c)(5).

25 2019 Prop. Treas. Reg. § 1.951A-2(c)(6)(v)(B).

26 2019 Prop. Treas. Reg. § 1.951A-2(c)(6)(v)(C).

27 2019 Prop. Treas. Reg. § 1.951A-2(c)(6)(v)(D)(1).

60 months after the close of the CFC inclusion year for which the election was revoked, and that subsequent election could not be revoked for a CFC inclusion year that began within 60 months after the close of the CFC inclusion year for which the subsequent election was made.[28] Finally, if a CFC was a member of a controlling domestic shareholder group, the election would apply with respect to each member of the CDS group.[29]

A "**controlling domestic shareholder group**" (or "**CDS Group**") was defined under the 2019 Proposed Regulations as two or more CFCs if (a) more than 50% of the stock (by voting power) of each CFC is owned (within the meaning of section 958(a)) by the same CDS (or persons related to the CDS) or (b) if no single CDS owns (within the meaning of section 958(a)) more than 50% of the total combined voting power of all classes of each corporation, more than 50% of the total combined voting power of all classes of the stock of each corporation is owned in the aggregate by the same CDSs and each CDS owns (within the meaning of section 958(a)) the same percentage of stock in each CFC.[30]

Under the 2019 Proposed Regulations, for purposes of the GILTI HT Exception, the effective foreign tax rate was determined separately for each qualified business unit (as defined in section 989) ("**QBU**") of the CFC. As a result, when the GILTI HT Election was in effect for a CFC, the tested income of a particular QBU would be either entirely included in tested income (*i.e.*, if the QBU did not have a sufficiently-high effective foreign tax rate) or entirely excluded from tested income (*i.e.*, if the QBU did have a high effective foreign tax rate).

The 2019 Proposed Regulations provided that the gross income attributable to a QBU was to be determined by reference to the items of gross income reflected on the books and records of the QBU, determined under Federal income tax principles, except that income attributable to a QBU would be adjusted to account for certain disregarded payments.[31] The adjustments for disregarded payments were to be made under the principles of Treasury Regulation section 1.904-4(f)(2)(vi) (rules attributing gross income

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[28] 2019 Prop. Treas. Reg. § 1.951A-2(c)(6)(v)(D)(2)(i).

[29] 2019 Prop. Treas. Reg. § 1.951A-2(c)(6)(ii)(A)(2).

[30] 2019 Prop. Treas. Reg. § 1.951A-2(c)(6)(v)(E)(2).

[31] 2019 Prop. Treas. Reg. § 1.951A-2(c)(6)(ii)(A)(2).

to a foreign branch) without regard to the exclusion for interest described in Treasury Regulation section 1.904-4(f)(2)(vi)(C)(1).[32]

The 2019 Proposed Regulations also introduced a significant change to the methodology for determining the effective tax rate to which CFC income is subject.[33] Specifically, the 2019 Proposed Regulations provided that, for purposes of both the Subpart F HT Exception and the GILTI HT Exception, the effective rate of foreign tax imposed on an item of income is determined, for each QBU, solely at the CFC level by allocating and apportioning the foreign income taxes paid or accrued by the CFC in the current year to the CFC's gross income in that year based on the rules described in the regulations under section 960 for determining foreign income taxes "properly attributable" to income.[34] Foreign income taxes allocated and apportioned to items of income that are excluded from gross tested income because of the GILTI HT Exception (and by implication, the Subpart F HT Exception) would not be attributable to tested income and thus would not be allowed as a deemed paid credit under section 960.[35]

C. The Final Regulations

The Final Regulations largely follow the 2019 Proposed Regulations. The Final Regulations apply for taxable years of CFCs beginning after July 23, 2020. Taxpayers may elect to apply the Final Regulations to tax years beginning after December 31, 2017, if they apply the Final Regulations consistently to each year for which the election is made.

In finalizing the regulations, a number of changes were made from the 2019 Proposed Regulations. Significant changes include the following:

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32 Id.

33 The preamble to the 2019 Proposed Regulations stated that the Act's change to section 960(a) from a pooling based approach to an annual attribution of taxes to income required revising Treasury Regulation section 1.954-1(d)(3).

34 2019 Prop. Treas. Reg. § 1.954-1(d)(3)(i); 2019 Prop. Treas. Reg. § 1.951A-2(c)(6)(iv).

35 Similarly, making the election would eliminate a U.S. Shareholder's "net deemed tangible income return" attributable to qualified business asset investment ("**QBAI**") in high-taxed jurisdictions, which would otherwise reduce GILTI tax liability on low-taxed foreign income, because the tangible property that comprises the QBAI would no longer be used in the production of gross tested income.

First, the GILTI HT Election may now be made annually with no restriction on making the election following a revocation of the election.[36]

Second, the Final Regulations replace the QBU-by-QBU approach to determining the effective foreign tax rate with an approach based on tested units. A "**Tested Unit**" generally is (i) a CFC, (ii) an interest held by a CFC in a pass-through entity (including a disregarded entity) that is either a tax resident of a foreign country or not treated as fiscally transparent by the CFC's country of tax residence or (iii) a branch of a CFC that either gives rise to a taxable presence in the country in which it is located or the income of which is excluded from tax or subjected to a preferential rate of tax in the CFC's country of tax residence.[37]

Third, the Final Regulations provide additional rules addressing disregarded payments, including providing additional detail on how the principles of Treasury Regulation section 1.904-4(f)(2)(vi) should be applied. The Final Regulations also provide special ordering rules for reallocations with respect to multiple disregarded payments.[38]

Fourth, the Final Regulations revise the definition of a group of CFCs for which a consistent GILTI HT election is required. As discussed above, under the 2019 Proposed Regulations, consistency was required for a CDS Group, which was defined as a group of CFCs controlled by a single CDS or, in some cases, multiple controlling CDSs. In contrast, consistency under the Final Regulations is determined by reference to a group of CFCs that are members of an affiliated group within the meaning of section 1504(a), with certain modifications described in Part IV.G below that are intended to broaden its scope ("**CFC Group**").[39] A CFC Group, in contrast to a CDS Group, is determined without regard to whether each CFC has the same CDS (or CDSs).

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[36] Treas. Reg. § 1.951A-2(c)(7)(viii).

[37] Treas. Reg. § 1.951A-2(c)(7)(iv). Specific rules are provided for interests in pass-through entities that are held indirectly by a CFC through a pass-through entity and branches the activities of which are conducted by other Tested Units of a CFC.

[38] Treas. Reg. § 1.951A-2(c)(7)(ii)(B)(2)(iv).

[39] Treas. Reg. § 1.951A-2(c)(7)(viii)(E)(2)(i).

D. The Proposed Regulations

The Proposed Regulations follow the basic paradigm of the 2019 Proposed Regulations and the Final Regulations, but make a number of significant changes.[40]

First, the Proposed Regulations would generally conform computations under the Subpart F HT Exception with the new GILTI HT Exception. The Proposed Regulations would further provide that a taxpayer cannot make the Subpart F HT Election with respect to each CFC in a CFC Group without also making a GILTI HT Election with respect to each CFC in the CFC Group, and vice versa.[41]

Second, the Proposed Regulations would replace the Final Regulations' use of books and records for purposes of determining the effective foreign tax rate of a Tested Unit with a more precise term, "**Applicable Financial Statements**."[42] An applicable financial statement refers to a "separate-entity" (or separate-branch) financial statement that is readily available and is the highest priority item within a list of different types of financial statements.[43]

Third, grouping rules would be applied to determine the effective foreign tax rate with respect to different types of income earned by a Tested Unit. Generally, these are the general gross income items,[44] the passive gross income items[45] and equity gross

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[40] The Proposed Regulations would become effective for taxable years of a CFC beginning after the date final regulations are filed with the Federal Register, and for the taxable year of a U.S. Shareholder in which or with which the taxable year of a CFC ends. Prop. Treas. Reg. § 1.954-1(h)(3).

[41] Cf. Prop. Treas. Reg. § 1.951A-2(c)(1)(iii), cross-referencing Prop. Treas. Reg. §1. 954-1(d)(1) and (6).

[42] Prop. Treas. Reg. § 1.954-1(d)(3).

[43] Prop. Treas. Reg. § 1.954-1(d)(3)(i). These financial statements include, for example, financial statements that are audited or unaudited, and that are prepared in accordance with U.S. generally accepted accounting principles ("U.S. GAAP"), international financial reporting standards ("**IFRS**"), or the generally accepted accounting principles of the jurisdiction in which the entity is organized or the activities are located ("**local-country GAAP**").

[44] This does not include passive income and can be further subdivided in limited circumstances (for example, in the case of income that is re-sourced under an income tax treaty).

[45] Passive items are further subdivided into income items described in Treasury Regulation section 1.954-1(c)(1)(iii)(B).

income items.[46] Both gross tested income and FBC income in each of the categories would be tested together for purposes of the effective rate calculation. Thus, it would be possible to have "blended" income in the same group. For example, the gross general income item group might include gross tested income that is subject to a foreign tax at a 30% rate and FBC income that is subject to a 0% foreign tax rate, resulting in disqualification of all the income in the group from, or inclusion of all the income within, the HT Exception, depending on the mix of income. The calculation is described in more detail in Part III.E below.

Fourth, the Proposed Regulations provide that the effective foreign tax rate is deemed to exceed 90% of the U.S. corporate rate if the amount of the tentative net item, increased by the foreign taxes paid or accrued with respect to the tentative net item, is zero or negative, but the paid or accrued foreign tax amount is positive (*e.g.*, because there is positive net income for foreign tax purposes due to the allocation of expenses, timing differences or differences in taxable years). The heading in the Proposed Regulations refers to this as an "undefined value" or "negative" effective foreign tax rate.[47]

Fifth, in determining tentative tested income and allocating expenses for purposes of determining whether the HT Exception is applicable, the Proposed Regulations would depart from the general approach to allocation and apportionment under section 861 and instead require that allocations of expenses be determined by reference to the Tested Unit's Applicable Financial Statement.[48]

Sixth, the Proposed Regulations would add a combination rule that would apply in cases in which a Tested Unit is a tax resident of or located in the same foreign country as another Tested Unit or in which the Tested Unit's income meets a de minimis threshold.[49] The de minimis rule would apply where the gross income attributable to the Tested Unit is less than the lesser of (a) one percent of the gross income of the CFC or (b) $250,000.

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[46] Prop. Treas. Reg. § 1.954-1(d)(1)(ii).

[47] Prop. Treas. Reg. § 1.954-1(d)(4)(ii).

[48] Prop. Treas. Reg. § 1.954-1(d)(1)(iv)(B).

[49] Prop. Treas. Reg. § 1.954-1(d)(2)(iii).

Finally, the Proposed Regulations include three anti-abuse rules. One of these would apply in connection with the de minimis rule.[50] Another would apply in connection with the use of Applicable Financial Statements.[51] A third would address transactions or structures involving certain instruments ("applicable instruments") or reverse hybrid entities that are undertaken with a significant purpose of manipulating whether an item of income qualifies for the HT Exception.[52] An example in the Proposed Regulations illustrates the application of this rule.[53]

E. Calculation of the Foreign Effective Tax Rate

Under the Proposed Regulations, upon identifying the Tested Units, a CFC's gross income items are attributed to each of the Tested Units. The gross income in each separate category—general gross item, equity gross item and passive gross item—attributable to a Tested Unit is called an "item of gross income." An equity gross item is income or gain from stock or an interest in a pass-through entity that is exempt or subject to similar relief, *e.g.*, a preferential rate under the tax laws of the Tested Unit. A passive gross item is income that would constitute passive foreign personal holding company income.[54] A general gross item is generally residual gross income—more specifically, income in a single separate category of income as defined in Treasury Regulation section 1.904-5(a)(4)(iv) of a type that would be treated as gross tested income, gross FBC income, or gross insurance income and would not be passive foreign personal holding company income or an equity gross item.[55]

An item of gross income is attributable to a Tested Unit to the extent that the item is properly reflected on an Applicable Financial Statement, including audited or unaudited financials, prepared in accordance with U.S. GAAP, IFRS, or local-country GAAP of the

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[50] Prop. Treas. Reg. § 1.954-1(d)(2)(iii)(A)(2).

[51] Prop. Treas. Reg. § 1.954-1(d)(3)(v).

[52] Prop. Treas. Reg. § 1.954-1(d)(7).

[53] Prop. Treas. Reg. § 1.954-1(d)(9)(iii)(F).

[54] Passive items are further subdivided into income items described in Treas. Reg. section 1.954-1(c)(1)(iii)(B).

[55] Prop. Treas. Reg. § 1.954-1(d)(1)(ii)(A)-(C).

Tested Unit.[56] For this purpose, in the case of payments that are generally disregarded for U.S. tax purposes because they are made to, from, or between branches or disregarded entities of the CFC, income is reattributed to account for the payments for purposes of determining the gross income attributable to a Tested Unit. After the tentative gross tested income item of each Tested Unit is determined, the CFC's deductions and foreign taxes are allocated and apportioned to each Tested Unit (or to a residual category) in order to determine the "tentative net item."[57] The allocation and apportionment process generally follows the rules promulgated for calculating the foreign tax credit limitation under section 904 and deemed paid foreign taxes under section 960.[58]

Finally, the effective foreign income tax rate on each tentative net item is calculated by dividing (x) the U.S. dollar amount of foreign income taxes paid or accrued that have been allocated and apportioned to the tentative net item by (y) the U.S. dollar amount of the tentative net item, which is grossed-up by the amount of the foreign income taxes.[59] If the foreign tax rate on the tentative net item is in excess of 90% of the maximum U.S. corporate rate, and an election is made, the gross item to which the tentative net item relates is excluded from the CFC's Subpart F income or tested income, as applicable, and thus from the U.S. Shareholder's computation of its Subpart F and GILTI inclusion.[60]

F. Interaction of GILTI HT Exception with Other Code Provisions

U.S.-parented multinational groups frequently are liable for tax on GILTI despite having CFCs with an overall effective foreign tax rate in excess of 13.125%, even after taking the foreign tax credit into account. This most commonly results from the apportionment of expenses incurred in the United States to the GILTI foreign tax credit basket and timing mismatches between when an item of income is taken into account for GILTI purposes and when the foreign taxes related to the item of income are deemed paid by the U.S. Shareholder under section 960. Furthermore, as noted above, the GILTI

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56 Prop. Treas. Reg. § 1.954-1(d)(1)(iii)(A) and (d)(3)(i). The preamble to the Proposed Regulations notes that book and records were replaced with the applicable financial statements concept to promote certainty and administrability. REG-127732-19, Federal Register Vol. 85, No. 142, July 23, 2020, at 44652.

57 Prop. Treas. Reg. § 1.954-1(d)(1)(iv).

58 Prop. Treas. Reg. § 1.954-1(d)(1)(iv)(A).

59 Prop. Treas. Reg. § 1.954-1(d)(4)(i).

60 Prop. Treas. Reg. § 1.954-1(d)(1)(i)(B).

foreign tax credit may not be carried forward to future taxable years (or back to prior tax years). The GILTI HT Exception permits U.S.-parented groups to avoid potential residual GILTI tax liability resulting from expense apportionment provided that the effective foreign tax rate of the group's CFCs exceeds 18.9%. While it may be that U.S.-parented groups eligible for the exception will elect to apply it in certain cases, negative side effects could outweigh the benefits in a number of other cases.

Because there are many ways in which reporting GILTI income on a tax return may affect the taxpayer's U.S. tax liability, taxpayers will generally consider all the consequences of making (or revoking) the GILTI HT Election. For example, a U.S. Shareholder of CFCs with both high-taxed and low-taxed foreign operations could find it disadvantageous to remove high-taxed tested income from its GILTI computation because doing so eliminates the U.S. Shareholder's ability to cross-credit foreign taxes paid or accrued on the high-taxed income against its residual GILTI tax liability on the low-taxed tested income. Similarly, making the election would eliminate a U.S. Shareholder's "net deemed tangible income return" attributable to QBAI in high-taxed jurisdictions that would otherwise reduce GILTI tax liability on low-taxed foreign income from other jurisdictions. Taxpayers must also consider the effects of the election on the allocation and apportionment of expenses, the calculation of the section 163(j) limitation on deduction of interest expense, the effect on the calculation of specified interest expense, the potential deferral of the deduction for accrued but unpaid amounts under section 267(a)(3)(B), and the eligibility for payments on hybrid instruments or involving hybrid entities for exclusion from the anti-hybrid rules of section 267A.[61] A tested loss in one CFC may also offset the high-taxed tested income of another CFC, which could make the GILTI HT Exception unnecessary.

In addition, as a result of the application of the GILTI HT Exception, CFC earnings attributable to income excluded from tested income will not be treated as previously taxed earnings and profits ("**PTEP**"). This has two major consequences that U.S.-parented groups will likely consider. First, dividend distributions of the earnings and profits ("**E&P**") will need to satisfy the requirements of section 245A rather than the requirements of the PTEP rules in order to be received tax-free by the U.S. parent. Unlike the PTEP rules,

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[61] The Proposed Regulations provide rules that, in general, ensure that a specified payment is not a disqualified hybrid amount to the extent it is included in the income of a tax resident of the United States or a U.S. taxable branch, or is taken into account by a U.S. Shareholder under the Subpart F or GILTI rules. See Prop. Treas. Reg. § 1.267A-3(b). To the extent that income qualifies for the HT Exception, the application of the anti-hybrid rules needs to be considered.

section 245A has certain holding period requirements, anti-hybrid rules, and other rules that must be satisfied for distributions from CFCs to the U.S. parent to be tax-free. Second, distributions of PTEP can generate GILTI foreign tax credits where withholding and other foreign taxes are imposed on distributions of PTEP from a CFC to its U.S. parent or from a lower tier CFC to an upper tier CFC.[62] By contrast, foreign taxes (including withholding tax) on dividends of E&P that satisfy the requirements of section 245A are not eligible for foreign tax credits.[63] As a result, U.S.-parented groups will need to consider foreign repatriation tax costs when deciding whether or not to make the GILTI HT Election. In addition, tax basis considerations may be relevant, since a GILTI inclusion, but not income excluded under the GILTI HT Exception, increases the U.S. Shareholder's basis in the CFC, and a PTEP distribution, but generally not a section 245A distribution, reduces basis.[64]

IV. Discussion and Recommendations

A. Conformity of the Subpart F Regime to the GILTI Regime

a. Background

As discussed above, the Proposed Regulations generally conform the Subpart F HT Exception under section 954(b)(4) to the GILTI HT Exception under the Final Regulations. Under current Treasury Regulations, the Subpart F HT Election is made CFC-by-CFC[65] and "item-by-item," other than with respect to passive foreign personal holding company income.[66] By contrast, the GILTI HT Election is made on an all-or-nothing basis with respect to all eligible income of CFCs within a CFC Group.

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62 Section 960(b)(2).

63 Section 245A(d)(1).

64 Basis is reduced under section 961(d) on a section 245A distribution, but only for purposes of calculating loss on the disposition of the stock. Basis is also reduced under section 1059(a), but only if the section 245A distribution constitutes an "extraordinary dividend."

65 Although on its face section 954(b)(4) appears susceptible to allowing different U.S. Shareholders of a CFC to make different elections, Treasury Regulation section 1.954-1(d)(5) provides that an election made by CDSs of a CFC is binding on all the U.S. Shareholders of the CFC.

66 Treasury Regulation section 1.954-1(d)(4)(i) requires consistency in the case of all items of passive foreign personal holding company income of a single CFC.

A number of comments on the 2019 Proposed Regulations suggested that the GILTI HT Exception and the Subpart F HT Exception should be conformed by making certain existing rules under the Subpart F HT Exception applicable to the GILTI HT Exception. The Proposed Regulations instead take the approach of changing the rules under the Subpart F HT Exception to conform to the rules applicable to the GILTI HT Exception under the Final Regulations. Among other things, the Proposed Regulations require that high-taxed income for purposes of the Subpart F Exception be determined at the level of the Tested Unit. In addition, and perhaps most significantly, under the Proposed Regulations, the Subpart F HT Election can be made only if the GILTI HT Election is also made, and vice versa, and if made must be made for all CFCs within a CFC Group.

The preamble to the Final Regulations gives the following explanation:

> Comments on the 2019 proposed regulations recommended that various aspects of the GILTI high-tax exclusion be conformed with the Subpart F high-tax exception to ensure that the goals of the Treasury Department and the IRS in promulgating the GILTI high-tax exclusion are not undermined. For example, comments noted that the election for the Subpart F high-tax exception (other than with respect to passive foreign personal holding company income) is made on an item-by-item basis with respect to each individual CFC. In contrast, the election for the GILTI high-tax exclusion is subject to a "consistency requirement," pursuant to which an election must be made with respect to all of the CFCs that are members of a CFC group (as discussed in part III of this Explanation of Provisions). Comments asserted that the consistency requirement would make the GILTI high-tax exclusion less beneficial to taxpayers, causing them in certain cases to engage in uneconomic tax planning to convert tested income into Subpart F income to avail themselves of the Subpart F high-tax exception, contrary to one of the stated purposes of the GILTI high-tax exclusion (to eliminate incentives to convert tested income into Subpart F income).
>
> As discussed in the preamble to the final regulations, numerous comments recommended that the application of the GILTI high-tax exclusion be conformed with the Subpart F high-tax exception. The Treasury Department and the IRS

> agree that the GILTI high-tax exclusion and the Subpart F high-tax exception should be conformed but have determined that the rules applicable to the GILTI high-tax exclusion are appropriate and better reflect the changes made as part of the Act than the existing Subpart F high-tax exception. Accordingly, to prevent inappropriate tax planning and reduce complexity, these proposed regulations revise and conform the provisions of the Subpart F high-tax exception with the provisions of the GILTI high-tax exclusion in the final regulations, as modified by these proposed regulations.
>
> Another comment on the 2019 proposed regulations suggested that section 954(b)(4) should apply consistently to all of a CFC's items of gross income. In response to this comment, these proposed regulations provide for a single election under section 954(b)(4) for purposes of both Subpart F income and tested income (the "high-tax exception"). This unified rule, modeled on the GILTI high-tax exclusion in the final regulations, provides for further simplification.[67]

b. Discussion

We do not comment on whether Conformity is within the regulatory authority of Treasury and the IRS.[68]

From a policy perspective, we generally agree that the framework of the GILTI HT Exception, including the Tested Unit approach, is a more straightforward and effective method of identifying whether income is subject to a high rate of foreign tax and minimizing opportunities for inappropriate manipulation by taxpayers. With respect to Conformity, some of our members support this approach as a policy matter for the reasons stated in the preamble to the Proposed Regulations. They believe Conformity is necessary to prevent artificial shifting of income between the Subpart F and tested income categories (for example, by way of a check-the-box election) in order to maximize the benefit of making the election for some but not all of the income. This view maintains that

[67] REG-127732-19, Federal Register Vol. 85, No. 142, July 23, 2020, at 44651 (internal citations omitted).

[68] Similarly, in the 2019 Report, we did not comment on whether the GILTI HT Exception itself is within the scope of regulatory authority. 2019 Report, p. 76.

even if Congress intended that high-taxed income not be subject to GILTI, Congress did not intend to allow the foreign tax credit rules to be taken advantage of in this manner.

On the other hand, others of us do not believe that it is appropriate to require that a GILTI HT Election be made as a condition of making a Subpart F HT Election. As noted in Part III.F above, depending on a taxpayer's particular situation, the GILTI HT Election can be materially detrimental. The Subpart F HT Exception is clearly contemplated by the Code, and it is arguably inappropriate to require that a taxpayer be subject to unfavorable results under the GILTI HT Exception, which is an administrative construct, in order to be permitted to avail itself of the benefits of the statutorily-designated Subpart F HT Exception. In addition, there are substantial differences between the two regimes, including the section 250 deduction for GILTI and the fact that, absent the exclusion rules, GILTI calculations are made on a group-wide rather than a CFC-by-CFC basis. At the same time, these members are sympathetic to the concern expressed in the preamble regarding the potential for taxpayers to engage in planning to convert what would otherwise be tested income into Subpart F income, although they note that this is primarily an issue with respect to potential FBC sales or services income as opposed to foreign personal holding company income. In addition, these members do not have the same level of concern with requiring a Subpart F HT Election as a condition to making a GILTI HT Election.

B. Negative or Undefined Tax Rates

a. Background

The Proposed Regulations provide that where the effective rate of foreign tax with respect to a tentative net item is an undefined value or negative effective foreign tax rate, the tentative net item will be deemed to be high-taxed.[69] An undefined (or negative) effective foreign tax rate may result if, for example, foreign taxes are allocated and apportioned to the corresponding item of gross income, and the tentative net item (plus the foreign taxes) is zero (or negative) because the amount of deductions allocated and apportioned to the gross income is equal to (or exceeds) the amount of gross income plus the foreign taxes.

If a GILTI HT Election is in effect with respect to a CFC, all of the gross income attributable to the CFC's tentative net items that qualify as high-taxed, and all the deductions allocated and apportioned to the gross income under section 861, would be

[69] Prop. Treas. Reg. § 1.954–1(d)(4)(ii).

assigned to the residual grouping, and thus the income (including the deductions allocated and apportioned to the income) would not be taken into account in determining a CFC's tested income (or tested loss). Further, no credit would be allowed for the foreign taxes allocated and apportioned to the gross income to offset a taxpayer's remaining GILTI liability, and any QBAI used to produce the income would not give rise to net deemed tangible income return that can reduce the taxpayer's GILTI inclusion. Treasury and the IRS have requested comments regarding whether this result is appropriate in all cases.

b. Discussion

We believe that the HT Exception generally should apply in situations involving a negative or undefined tax rate. For example, assume $100 of taxes are payable with respect to certain income under foreign law, but the expenses associated with the income cause there to be negative taxable income from a U.S. federal income tax perspective. In this situation, we believe that the HT Exception should apply. Such an approach is consistent with the overall approach of the Final Regulations and eliminates the cliff effect that might otherwise occur in situations where it would be a close case as to whether taxable income plus taxes was positive or negative. In addition, taxpayers might otherwise be encouraged to take aggressive positions with respect to the allocation of expenses.

We recognize that there are circumstances in which treating tentative net items subject to undefined foreign tax rates as high-taxed may be viewed as unduly harsh, in particular where the relevant jurisdiction does not generally impose a high rate of tax. For example, if a Tested Unit[70] has a loss and the only relevant foreign tax is a gross basis withholding tax, the Tested Unit could be treated as subject to a high effective rate of foreign tax even if the foreign country in which the Tested Unit is resident does not have an income tax. However, providing an exception would be inconsistent with the treatment that would apply to the withholding tax if the Tested Unit has a small amount of net income, as well as the general rules treating withholding taxes in the same manner as other foreign oncome taxes for purposes of the HT Exception.

Similarly, a negative or undefined tax rate may result from a mismatch between timing of income and deductions for U.S. and foreign tax purposes or differences between taxable years for U.S. and foreign tax purposes. Suppose, for example, that a Tested

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[70] Although testing is done on the basis of tentative net items within Tested Units, we sometimes refer to income and losses of Tested Units for the sake of simplicity.

Unit is on a calendar year for U.S. tax purposes but a January 31 year-end for foreign tax purposes. Assume that the Tested Unit is highly profitable for both U.S. and foreign tax purposes in calendar year 1 and has a substantial loss in calendar year 2. Most if not all of the foreign tax attributable to the calendar year 1 income would likely accrue in calendar year 2, and the Tested Unit would be treated as high-taxed in calendar year 2 even if the statutory tax rate in the foreign country is substantially less than the U.S. rate.

Consideration could be given to a rule that would potentially avoid the adverse results of this timing mismatch by basing the foreign tax rate determination on a multi-year period. This would be inconsistent, however, with the general scheme of the GILTI regime, which makes determinations of inclusions and foreign tax credits on a year-by-year basis, without adjustment for differences in timing rules or accounting periods. We note that the provision in the Final Regulations that allows the GILTI HT Election to be made or revoked on a year-by-year basis does give taxpayers some flexibility to avoid an unfavorable application of the negative or undefined tax rate rule by not making the election in years where it is unduly burdensome.

C. Allocating Expenses and Deductions

a. Background

The Final Regulations generally use items properly reflected on the separate set of books and records of a Tested Unit as the starting point for determining gross income attributable to the Tested Unit.[71] In contrast, the Final Regulations do not allocate deductions based on the books and records of the Tested Unit. Instead, the Final Regulations provide that deductions are generally allocated and apportioned to a tentative gross tested income item under the indirect credit principles of Treasury Regulation section 1.960-1(d)(3) by treating each tentative gross tested income item as assigned to a "separate tested income group" (as that term is described in Treasury Regulation section 1.960-1(d)(2)(ii)(C)).[72]

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[71] Treas. Reg. § 1.951A-2(c)(7)(ii)(B)(1).

[72] Treas. Reg. § 1.951A-2(c)(7)(iii). As background, section 960(a) and (d) provide that a U.S. Shareholder that is a corporation is deemed to have paid the foreign taxes paid by the CFC that are attributable to items included by the U.S. Shareholder as Subpart F inclusions or as GILTI. Treasury Regulations under section 904 provide rules for associating foreign taxes paid by a CFC with the Subpart F inclusion or GILTI inclusion and for associating the foreign taxes with the various categories and groupings of income that must be tracked for purposes of the tax credit limitation rules of section

Under those rules, certain deductions (including interest expense) are allocated and apportioned based on a specific factor (such as assets or gross income) among the separate items of gross income of a CFC,[73] such that deductions reflected on the books and records of a single Tested Unit, and generally taken into account for foreign tax purposes in computing foreign taxable income, may not be fully taken into account for purposes of determining a tentative tested income item.

The Proposed Regulations, by contrast, allocate and apportion deductions to the extent properly reflected on the Applicable Financial Statements, but only for purposes of determining whether the Tested Unit is high-taxed for purposes of section 954(b)(4), and not for any other purpose such as for determining income of the CFC for purposes of Subpart F and GILTI inclusions under sections 954(b)(5) and 951A(c)(2)(A)(ii) and the associated foreign tax credits under section 960. In contrast to section 954(b)(4), under which the rules in the Proposed Regulations are intended to approximate the foreign tax base, taxable income and items of income for purposes of sections 954(b)(5), 951A(c)(2)(A)(ii), and 960 continue to be determined using the allocation and apportionment rules set forth in the regulations under section 861.

In the preamble to the Proposed Regulations, Treasury and the IRS have expressed concern over whether this results in the double counting of expenses reflected on a Tested Unit's Applicable Financial Statement if the same expenses would both cause the Tested Unit to fall within the HT Exception, by increasing the effective foreign tax rate on the reduced U.S. tested income of the Tested Unit to above 18.9%, and also reduce tested income of other Tested Units within the CFC that do not qualify for the HT Exception applying the general apportionment rules. One approach under consideration by Treasury and the IRS is to provide that deductions allocated and apportioned to an item of gross income based on an Applicable Financial Statement for purposes of calculating a tentative net item under the HT Exception cannot be allocated and

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904, foreign currency rules, and other foreign tax credit rules and restrictions. A CFC must assign gross income to section 904 categories and then assign income within those categories among the Subpart F income, tested income, and residual income groups, and in the case of the Subpart F income group, the income must be further assigned to subgroups within the group. Treas. Reg. § 1.960-1(d)(2). Deductions are generally allocated among the income groups under the rules of sections 861 through 865 and 904(d). The regulations under section 960 cross reference Treasury Regulation section 1.904-6 for rules on allocating foreign income taxes to section 904 categories.

[73] Treas. Reg. § 1.960-1(d)(3).

apportioned to a different item of gross income that does not qualify for the HT Exception for purposes of calculating the inclusion under section 951(a) or section 951A.

b. Discussion

The allocation of deductions can obviously have a significant impact on a Tested Unit's effective foreign tax rate for the purposes of the HT Exception. For example, and as noted in the preamble to the Proposed Regulations,[74] suppose that a CFC has an expense that is fully deductible in determining the taxable income of a Tested Unit in the foreign jurisdiction in which the Tested Unit operates and is not deductible in any other jurisdiction in which the CFC operates. Under the Final Regulations, this deduction may nevertheless be allocated and apportioned for U.S. tax purposes against the gross income of other Tested Units of a CFC, some of which may not be tax resident in the same jurisdiction in which the deduction is allowed for foreign tax purposes. This difference between U.S. federal and foreign tax treatment may result in some income qualifying (or not qualifying) for the HT Exception even when the statutory rate of foreign tax is low (or high).

We support the change that is contained in the Proposed Regulations of using a booking rule so that income and expense are more properly aligned for purposes of determining whether a Tested Unit is treated as subject to a high rate of tax. If a rationale for the HT Exception is that the United States should not tax income that does not pose a risk of base erosion because the local tax rate is high, then reference to the Applicable Financial Statements seems to provide a more sensible rule.

We also share the concern expressed in the preamble to the Proposed Regulations that using different principles for expense allocation for different purposes may potentially lead to distortions, *e.g.*, double counting. One counterargument to this is that the allocation of deductions for purposes of the HT Exception is, as a conceptual matter, a completely separate step in the HT Exception calculation, and it should not have an impact on the taxpayer's tested income and Subpart F income calculations. As a practical matter, the value to a taxpayer of the double benefit (if any) will depend on the rate at which the income that the expense is deductible against is subject to tax (21% in the case of Subpart F income and 10.5% in the case of tested income). Because the effect of any double counting can vary significantly across taxpayers, it is challenging to ascertain the degree to which double counting presents a problem at a practical level. We would also note that distortions from different allocation methods can work against a

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[74] See REG-127732-19, Federal Register Vol. 85, No. 142, July 23, 2020, at 44658.

taxpayer if an expense that is not reflected on the Applicable Financial Statement of a high-taxed Tested Unit is allocated and apportioned against income of that unit under the general allocation and apportionment rules and therefore does not reduce the U.S. Shareholder's GILTI inclusion.

On balance, we believe that a limited modification to the Proposed Regulations is appropriate. We recommend that a portion of the expenses on the Applicable Financial Statement of a high-taxed Tested Unit that would otherwise be apportioned to reduce tested income of other Tested Units should not be so apportioned, but only to the extent of that portion of the expenses that is necessary to treat the high-taxed unit as subject to a high rate of tax. Alternatively, the regulations could be revised to provide that expenses shown on Applicable Financial Statements of high-taxed Tested Units (or, more precisely, expenses allocated to high-taxed tentative net items) would be disregarded in their entirety for purposes of determining tested income of other Tested Units, but no portion of expenses reflected on Applicable Financial Statements of other Tested Units would be apportioned to the high-taxed Tested Unit (or, more precisely, to high-taxed tentative net items of a Tested Unit), with the result that the expenses of the other units would fully reduce tested income.

D. Transition Rules

a. Background

The Proposed Regulations would generally apply to taxable years of CFCs beginning after the date of their filing with the Federal Register as final regulations. There are no transition rules applicable to pre-existing CFCs or otherwise.

b. Discussion

The Proposed Regulations make radical changes to the long-standing rules governing the Subpart F HT Exception that were not expressly or implicitly contemplated by the TCJA. Accordingly, given their unexpected impact on taxpayers' prior planning, we believe that consideration should be given to allowing taxpayers to delay for a relatively short period of time (*e.g.*, one or two years) the application of the rules with respect to CFCs with respect to which the taxpayer was a U.S. Shareholder prior to the publication of the Proposed Regulations. Alternatively, the effective date of the final regulations could simply be deferred. We note that transition relief or a delayed effective date is particularly important if the Proposed Regulations are finalized prior to the end of this year and would thus otherwise apply to calendar-year CFCs in 2021.

E. Special Rules for Adjustments of Foreign Taxes and Later Elections

The CDSs of a CFC may make an HT Election on their original tax return for the taxable year in which ends the relevant taxable year of the CFC. The Proposed Regulations provide that the HT Election can be made or revoked on an amended return only if all U.S. Shareholders of the CFC file amended returns within a single six-month period within 24 months (the "**24-month period**") of the unextended due date of the original return of the CDS's inclusion year.[75] The preamble to the Proposed Regulations notes that Treasury and the IRS are aware that changes in circumstances occurring after the 24-month period may cause a taxpayer to benefit from making or revoking the HT Election, including a foreign tax redetermination ("**FTR**") with respect to one or more of the taxpayer's CFCs. An FTR is defined as a change in the liability for a foreign income tax as defined in Treasury Regulation section 1.960-1(b)(5), or certain other changes that may affect a taxpayer's foreign tax credit.[76]

The preamble requests comments on rules that would permit a taxpayer to make (or revoke) an election after the 24-month period in cases where the taxpayer can establish that the election (or revocation) will not result in time-barred tax deficiencies.[77] Under the Proposed Regulations, calculations relating to the HT Exception are revised to take into account FTRs,[78] but do not provide for extension of election or revocation deadlines as a result of an FTR.[79]

Section 905(c) requires a U.S. taxpayer claiming a foreign tax credit to notify the IRS in the case of a refund of or other changes (including as a result of audits) in foreign tax amounts or the lapse of two years after foreign taxes are accrued before they are paid. The IRS is authorized to determine the resulting adjustment to the taxpayer's U.S. tax liability. Section 905(c)(2)(B) provides that if accrued foreign taxes are not paid within two years after the end of the taxable year to which the taxes relate, or are refunded after

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75 Prop. Treas. Reg. §1.954-1(d)(6)(i)(B)(2).

76 Treas. Reg. §1.905-3(a).

77 REG-127732-19, Federal Register Vol. 85, No. 142, July 23, 2020, at 44655.

78 Prop. Treas. Reg. §1.954-1(d)(1)(iv)(D).

79 *See* Prop. Treas. Reg. §1.954-1(d)(6)(i)(B)(2).

being paid, then they are taken into account in the taxable year to which they relate.[80] Thus, section 905(c)(2) contemplates situations where a section 905(c) FTR is made and relevant foreign tax amounts, E&P, and tested income of a CFC in its taxable year change and its U.S. Shareholders are required to file amended returns more than 24 months after the unextended due date of their original returns.[81] The statute of limitations is explicitly extended under section 905(c) and section 6501(c)(5) with respect to changes resulting from FTRs. Proposed regulations under section 905 treat a change in foreign income tax liability that results in a change in the application of the Subpart F HT Exception as resulting in a foreign tax redetermination.[82]

We believe that final regulations should allow the taxpayer to make or revoke the HT Election on its amended return(s) even after the 24-month period has passed if a change in the foreign tax liability occurs. We believe that abuse is not likely to arise if taxpayers are permitted to make or revoke an HT Election after the 24-month period given the HT Exception's formulaic approach as long as the statute of limitations is not closed with respect to any taxable year of any taxpayer affected by the change in election.[83] Because the taxpayer is required to file a U.S. amended tax return,[84] the IRS's ability to evaluate claims or make additional assessments related to the application of the HT

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[80] Prior to the TCJA, the indirect foreign credits allowed by sections 902 and 960 were based on multi-year pools. Accordingly, section 905(c) generally contemplated a prospective adjustment to the pool in the year when the foreign tax adjustment was made. After TCJA, a taxpayer is generally only permitted an indirect foreign tax credit under section 960 for taxes that are "properly attributable" to Subpart F income or tested income accrued in the current taxable year. Thus, corresponding adjustments to reflect the elimination of the pre-TCJA pooling regime were made to section 905(c), and foreign tax redeterminations now result in changes in U.S. tax liability in the taxable year to which the foreign taxes relate, rather than in the subsequent taxable year in which the foreign taxes are paid or refunded. See generally the preamble to REG-105495-19, Federal Register Vol. 84, No. 242, December 17, 2019, at 69142.

[81] The proposed foreign tax credit regulations clarify the amended return is not required if U.S. tax liabilities do not change. *See* Prop. Treas. Reg. §1.905-4(b)(1)(v).

[82] Prop. Treas. Reg. § 1.905-3(a).

[83] The preamble to the proposed foreign tax credit regulations also acknowledges that applying section 905(c) for purposes of both foreign tax credits and the GILTI HT Exception and Subpart F HT Exception should be instrumental in avoiding abuse. REG-105495-19, Federal Register Vol. 84, No. 242, December 17, 2019, at 69142.

[84] See Treas. Reg. § 1.905-4T. See also Prop. Treas. Reg. § 1.904-4(b)(1)(v).

Exception should not be adversely affected. To protect the sound administration of the tax system, we recommend that any taxpayer making (or revoking) the HT Election and all other U.S. taxpayers with a taxable year affected by the change in election should be obligated to waive the statute of limitations.[85] The requirement of waiver of the statute of limitations has been adopted as a mechanism in similar circumstances.[86]

F. Combination of Tested Units

a. Background

Under the Proposed Regulations, Tested Units include (1) CFCs, (2) interests in certain pass-through entities, and (3) certain branches.[87] An interest in a pass-through entity is not a Tested Unit unless the pass-through entity is (a) a tax resident of any foreign country or (b) a certain type of hybrid entity that is not treated as fiscally transparent for purposes of the tax law of the foreign country of which the CFC is a tax resident or, in the case of an interest in a pass-through entity held by a CFC indirectly through one or more other Tested Units, for purposes of the tax law of the foreign country of which the Tested Unit that directly (or indirectly through the fewest number of transparent interests) owns the interest is a tax resident. A branch of a CFC is a Tested Unit if either the branch gives rise to a taxable presence under the tax law of the foreign country where the branch is located or the income attributable to the branch is exempt or subject to similar relief (*e.g.*, a preferential tax rate) under the law of the country where the CFC is a tax resident.

Under a combination rule (the "**Combination Rule**"), a CFC's Tested Units that are residents of, or have a taxable presence in, the same country are combined for purposes of determining the effective rate of foreign tax. The Combination Rule applies without regard to whether the separate Tested Units are subject to the same foreign tax rate or have the same functional currency. Application of the Combination Rule is mandatory.

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85. We note that affected taxpayers may include taxpayers not otherwise affected by the FTR. For example, if CFC1 has an FTR and its sole U.S. Shareholder, US1, decides to make the HT Election, and the Consistency Requirement mandates a HT Election for CFC2, the election will affect all U.S. Shareholders of CFC2, including any that are unrelated to US1.

86 Treas. Reg. § 1.367-8(a) (requiring a taxpayer to agree to extend the statute of limitations in gain recognition agreements).

87 Prop. Treas. Reg. § 1.954-1(d)(2)(i)(A)-(C).

b. Dual Resident Corporations

Applying the Combination Rule requires determination of the tax residency of a Tested Unit. Tested Units of a CFC that are resident in or located in (in the case of a branch subject to tax in a foreign country) the same foreign country are treated as a single Tested Unit in applying the HT Exception under the Combination Rule.[88] As such, the Proposed Regulations require that the tax residence of each Tested Unit be identified. However, the Combination Rule does not provide a tie-breaker rule to identify the jurisdiction of an entity that is a resident in two or more jurisdictions.[89]

Revenue Ruling 2004-76 addressed the question of which tax treaty to apply to a non-U.S. corporation that is a resident of two countries, both of which have a tax treaty with the United States, and which is treated as a resident of only one country for purposes of the tax treaty between the two countries. The ruling applied the tax treaty between the two countries to determine residency for purposes of determining which U.S. tax treaty to apply to the foreign corporation.[90]

We believe it is similarly reasonable to determine a Tested Unit's jurisdiction for purposes of the HT Exception on the basis of a tax treaty between the relevant foreign countries because the treaty rule would likely accurately reflect the economic reality of foreign taxable income and foreign tax imposed thereon. In contrast, a single definitive rule—for example, relying on country of incorporation or effective management—may be inconsistent with the practical applications of relevant foreign tax law. In the absence of a treaty tie-breaker rule, we believe that a taxpayer should be allowed to use any reasonable method (consistently applied) to determine the residency of a dual-resident Tested Unit.

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[88] Prop. Treas. Reg. § 1.954-1(d)(2)(iii)(A)(1). The Final Regulations include a similar same country rule. Treas. Reg. § 1.951A-2(c)(7)(iv)(C).

[89] The entity classification regulations address a similar issue: dual residency between the United States and a foreign jurisdiction, rather than between foreign countries. Under the check-the-box regulations, a dual-chartered entity is defined as a corporation created or organized under the laws of more than one jurisdiction. Treas. Reg. § 301.7701(b)-2(b)(9). The regulations treat a dual-chartered entity as a domestic entity if it is incorporated under U.S. law.

[90] Rev. Rul. 2004-76, 2004-2 C.B. 111, Situations 1 and 2 (applying US-Country Y tax treaty to a corporation that is a tax resident of both Country X and Country Y and is treated as Country Y's resident after the application of the Country X-Country Y tax treaty).

c. De Minimis Rule.

The Proposed Regulations include a de minimis rule requiring combination where the gross income attributable to each Tested Unit is less than the lesser of one percent of gross income of the CFC or $250,000.

We believe that this benchmark is too low to be of much practical use. We propose that the de minimis rule be set at the lesser of five percent of gross income of the CFC or $500,000.

G. The Consistency Requirement

a. Background

Under the Consistency Requirement an HT Election is made or revoked with respect to each member of a CFC Group.[91] The regulations do not explicitly describe the consequences of making an HT election with respect to one member of a CFC Group but not another; however, it is presumed that such an inconsistent election would be invalid.[92] The Final Regulations apply the Consistency Requirement solely with respect to GILTI HT Elections. The Proposed Regulations would extend the scope of the Consistency Requirement to require that a single HT Election be made with respect to each CFC in a CFC Group with respect to all of its high-taxed tentative net items, which includes amounts that would be, but for the HT Exception, tested income or Subpart F income.[93]

The 2019 Proposed Regulations also had a Consistency Requirement, but the requirement was applied by reference to members of a CDS Group. Under the 2019 Proposed Regulations, a CDS Group was defined as two or more CFCs if either (i) more than 50% of the voting stock of each CFC is owned[94] by the same CDS, or (ii) if no single

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91 Treas. Reg. § 1.951A-2(c)(7)(viii)(E)(1); Prop. Treas. Reg. § 1.954-1(d)(6)(v).

92 See Treas. Reg. § 1.951A-2(c)(7)(viii)(D) ("A high-tax election is valid only if all of the requirements [for making the election] are satisfied.").

93 Prop. Treas. Reg. § 1.954-1(d)(6)(ii).

94 For purposes of this section, unless otherwise indicated (*e.g.*, in the context of ownership under section 318), "owned," "owns," "ownership," or any other variation of the term refers to direct or indirect ownership within the meaning of section 958(a). Stock owned, directly or indirectly, by or for a foreign corporation, foreign partnership, or foreign trust or foreign estate is treated as owned proportionately by a shareholder, partner, or beneficiary under section 958(a)(2).

CDS owns more than 50% of the voting stock of each corporation, more than 50% of the voting stock of each CFC is owned in the aggregate by the same CDSs and each CDS owns the same percentage of stock in each CFC.[95] As discussed above, CDSs of a CFC are defined under Treasury Regulation section 1.964-1(c)(5) as those U.S. Shareholders who, in the aggregate, own more than 50% of the total combined voting power of all classes of the stock entitled to vote and who undertake to act on its behalf. In the event that U.S. Shareholders do not, in the aggregate, own more than 50% of the total combined voting power of all classes of stock entitled to vote, the CDSs of the CFC are those U.S. Shareholders who own any stock of the corporation.

In the 2019 Report, we made a number of comments with respect to the CDS Group concept, including (i) the possible circularity of the related party rule, (ii) clarification of as to whether ownership is limited to ownership by U.S. persons and (iii) issues arising on a change in control with respect to the CDS Group concept. In response to these comments, Treasury and the IRS adopted the CFC Affiliation Approach, which requires consistency among members of a CFC Group, rather than a CDS Group. Importantly, under the 2019 Proposed Regulations, the composition of a CDS Group was generally determined based on common ownership by one or more CDSs; in contrast the composition of a CFC Group under the CFC Affiliation Approach is determined based entirely on the relatedness of the CFCs themselves without regard to the identity of their CDSs. Under the CFC Affiliation Approach, a CFC Group can exist solely by reason of the common ownership of a person that is indifferent to U.S. tax, such as a publicly-traded foreign corporation or a partnership without U.S. partners.

A CFC Group is an affiliated group, as defined in section 1504(a), with certain modifications that broaden the scope of affiliation.[96] First, the includible corporations of a CFC Group are determined without regard to section 1504(b)(1) through (6) (which exclude certain corporations, such as foreign corporations, tax-exempt organizations, insurance companies, section 936 corporations, and RICs and REITs).[97] Second, a CFC Group is determined by applying a greater-than-50% threshold instead of an 80% threshold, and a "vote **or** value" test instead of a "vote **and** value" test.[98] Third, stock

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95 2019 Prop. Treas. Reg. § 1.951A-2(c)(6)(v)(E)(2).

96 Treas. Reg. § 1.951A-2(c)(7)(viii)(E)(2)(i); Prop. Treas. Reg. § 1.954-1(d)(6)(v)(B)(1).

97 Id.

98 Id.

owned by each member of a CFC Group is determined by applying section 318(a), except (*a*) without regard to the "partner to partnership" and "beneficiary to trust" attribution rules under section 318(a)(3)(A) and (B); (*b*) treating options as exercised only to the extent that the option is reasonably certain to be exercised as described in Treasury Regulation section 1.1504-4(g); and (*c*) applying section 318(a)(2)(C) to attribute stock owned by a corporation to any shareholder of the corporation that owns 5% or more (rather than 50% or more) of the stock of the corporation in proportion to the value of the stock that the shareholder owns.[99]

The determination of whether a CFC is included in a CFC Group is made as of the close of the CFC inclusion year of the CFC that ends with or within the taxable years of the CDSs.[100] One or more CFCs are members of a CFC Group if the requirements for CFC Affiliation (the "**CFC Affiliation Requirements**") are satisfied as of the end of the CFC inclusion year of at least one of the CFCs, even if the requirements are not satisfied as of the end of the CFC inclusion year of all of the CFCs. If the CDSs do not have the same taxable year, the determination of whether a CFC is a member of a CFC Group is made with respect to the CFC inclusion year that ends with or within the taxable year of the majority of the CDSs (determined based on voting power) or, if no majority taxable year exists, the calendar year.[101]

A CFC may not be a member of more than one CFC Group.[102] If a CFC would satisfy the CFC Affiliation Requirements with respect to more than one CFC Group, then the 50% ownership threshold is determined solely by reference to voting power, or, if applicable, by reference to the ownership existing as of the end of the first CFC inclusion year of a CFC that would cause a CFC Group to exist (the "**Tie-Breaker Rule**").[103]

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[99] Id. Significantly, notwithstanding the term "CFC Group" a CFC Group can include not only CFCs, but also non-CFC foreign corporations or even domestic corporations, including the CDSs of one or more CFC members of the CFC Group. For instance, a CFC Group may consist of one CFC and its CDS. However, the Consistency Requirement requires an election only with respect to members of the CFC Group that are CFCs.

[100] Treas. Reg. § 1.951A-2(c)(7)(viii)(E)(2)(ii); Prop. Treas. Reg. § 1.954-1(d)(6)(v)(B)(2).

[101] Id.

[102] Treas. Reg. § 1.951A-2(c)(7)(viii)(E)(2)(iii); Prop. Treas. Reg. § 1.954-1(d)(6)(v)(B)(3).

[103] Id.

A domestic partnership can be a U.S. Shareholder for purposes of GILTI and Subpart F.[104] However, in general, a domestic partnership is not treated as owning stock in a CFC for purposes of determining the GILTI inclusion of a partnership and its partners.[105] This rule does not apply, however, for purposes of determining "whether any United States shareholder is a controlling domestic shareholder (as defined in §1.964-1(c)(5))."[106] The 2019 Proposed Regulations would extend these rules (relating to the treatment of domestic partnerships) applicable to the GILTI regime to the Subpart F regime.[107] The preamble to the 2019 Proposed Regulations requested comments on whether, and for which purposes, the aggregate treatment for domestic partnerships should be extended to the determination of the CDSs of a CFC. The preamble to the Final Regulations states that Treasury and the IRS intend to address comments received in response to this issue in connection with finalizing the proposed regulations under sections 951, 956, 958 and 1502.

In the 2019 Report, we recommended that, for a domestic partnership that owns CFCs, aggregate rather than entity principles should apply in determining the CDSs that are eligible to make or revoke the GILTI HT Election with respect to the CFCs. This recommendation was intended to ensure that the persons authorized to make a GILTI HT Election were the persons directly affected by the election (*i.e.*, the U.S. Shareholder partners). Similarly, we recommended that aggregate rather than entity principles should apply to a domestic partnership in determining the existence of a CDS Group. This recommendation was made because treating domestic partnerships as entities for this purpose could lead to different results for similarly-situated taxpayers. In particular, CFCs owned by a domestic partnership would be members of a CDS Group without regard to the percentage of interests indirectly owned by U.S. Shareholder partners, whereas CFCs directly owned by the partners would be members of a CDS Group only if more than 50% of the voting stock of the CFCs was owned by U.S. Shareholders. For the same reasons, we continue to believe that aggregate treatment is appropriate for purposes of determining the persons that should be authorized to make a HT Election and, except as noted below, the composition of a CFC Group. The treatment of partnerships is discussed in more detail below in Examples 8, 9 and 10.

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[104] Sections 951(b) and 7701(a)(30)(B); cf. Treas. Reg. § 1.951A-1(e)(2).

[105] Treas. Reg. § 1.951A-1(e)(1).

[106] Treas. Reg. § 1.951A-1(e)(2).

[107] See Prop. Treas. Reg. § 1.958-1(d).

b. Policy Considerations

According to the preamble to the Final Regulations, the Consistency Requirement is intended to prevent taxpayers from artificially increasing their section 904 limitation by excluding some high-taxed income (thereby eliminating the expenses that would be allocated and apportioned to the income) but including other high-taxed income (thereby taking into account the related taxes). Under section 904(b)(4), foreign source income is generally determined without regard to deductions properly allocable or apportionable to dividends from CFCs that are potentially eligible for the deduction under section 245A or to CFC stock to the extent income with respect to the stock is dividend income.[108] Income of a CFC excluded from gross tested income under the GILTI HT Exception will ultimately give rise to dividends potentially subject to section 245A upon repatriation. Accordingly, deductions that are properly allocated and apportioned to income excluded under the exception are disregarded for purposes of determining a taxpayer's foreign tax credit limitation under section 904.[109]

The preamble to the Final Regulations explains the rationale for the Consistency Requirement as follows:

> Without a consistency requirement, taxpayers may be able to include high-taxed income in GILTI to claim foreign tax credits up to the amount of their section 904 limitation, while electing to exclude the remainder of such income under the GILTI high-tax exclusion. Consequently, the taxpayer's section 904 limitation would not take into account all the deductions attributable to investments generating high-taxed income, resulting in a distortive application of the foreign tax credit limitation under section 904. A consistency requirement prevents this result by ensuring that a taxpayer that seeks to cross-credit the foreign tax imposed on high-taxed tentative tested income against low-taxed tentative tested income must take all of its high-taxed tentative tested income into account along with all of the deductions allocated and apportioned to that category of income. This concern does not arise with respect to other types of income

[108] See also Treas. Reg. § 1.904(b)-3(b) and (c).

[109] See also Treas. Reg. § 1.904(b)-3(e) for an example illustrating the effect upon the calculation of a foreign tax credit limitation of disregarding a deduction.

> that are excluded from tested income (for example, foreign oil and gas extraction income) because such items are always excluded (that is, there is no electivity as to whether they are included in tested income), and the foreign taxes attributable to that income can never be claimed as a credit against the U.S. tax imposed on section 951A inclusions.[110]

As discussed above, the Proposed Regulations would extend the Consistency Requirement so that it requires consistent elections across all members of a CFC Group with respect to both high-taxed tested income and high-taxed Subpart F income. Under current regulations, a CDS can make a selective and separate Subpart F HT Election with respect to each of its CFCs. Treasury and the IRS determined that requiring consistency with respect to both GILTI HT Elections and Subpart F HT Elections was needed to address the same section 904 distortion concern identified in the preamble to the Final Regulations.

The preamble to the Proposed Regulations illustrates this as follows:

> Under the current regulations, by structuring in a way that some of its high-taxed foreign income is treated as foreign base company sales income (a category of foreign base company income) and electing the Subpart F high-tax exception for only certain CFCs, a taxpayer may selectively exclude only a portion of its high-taxed CFC income from U.S. taxation under sections 951 and 951A. The taxpayer can then use foreign tax credits from the high-taxed income that is not excluded against its low-taxed foreign income. However, the taxpayer's foreign tax credit limitation will not fully take into account the expenses attributable to investments giving rise to high-taxed income, since expenses allocable to excluded high-taxed income will be disregarded under section 904(b)(4). Consequently, the foreign tax limitation may be higher on a relative basis than it would have been if all high-taxed foreign income and all expenses attributable to such income were taken into account, and tax credits from non-

[110] T.D. 9902, Federal Register Vol. 85, No. 142, July 23, 2020, at 44627.

> excluded high-taxed income may more generously reduce U.S. tax liability on the taxpayer's low-taxed income.
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> In contrast, under the single high-tax exception provided by these proposed regulations, the election into the high-tax exception must be made for all CFCs that are members of a CFC group. A taxpayer that wishes to use high-taxed income to cross-credit against low-taxed income would need to include all its foreign income and allocable expenses in the foreign tax credit limitation calculation. Thus, the foreign tax credit limitation will take into account all expenses attributable to foreign income and the tax credits from high-taxed foreign income will be appropriately limited.[111]

As indicated in the preambles to both the Final Regulations and the Proposed Regulations, the ability to make selective HT Elections can be beneficial to a U.S. Shareholder in an "excess credit" position. In particular, consider a U.S. Shareholder that has excess credits in its GILTI basket and has three CFCs – CFC1 has income subject to a very high effective tax rate, CFC2 has income subject to an effective tax rate that is slightly greater than 18.9%, and CFC3 has income subject to no tax. In this case, the U.S. Shareholder might prefer to make a HT Election with respect to CFC2, thereby eliminating its tested income at the "cost" of surrendering CFC2's foreign tax credits, while still including the income of CFC1 so that the higher foreign taxes paid by CFC1 can be used to offset its U.S. tax liability with respect to its GILTI inclusion with respect to CFC3. In contrast, if the U.S. Shareholder is required to be consistent with respect to all its CFCs, an HT Election could dramatically reduce the U.S. Shareholder's benefit relative to a selective election with respect to CFC2, or even result in greater total U.S. tax relative to no election at all, because the U.S. Shareholder would have no foreign tax credits to offset against its U.S. tax liability with respect to its GILTI inclusion with respect to CFC3.

Treasury and the IRS in both preambles advance the section 904 concern to support the Consistency Requirement. However, selective HT Elections could lower a U.S. Shareholder's total U.S. tax liability relative to consistent HT Elections in other ways. For instance, because QBAI is defined to include tangible assets used in the production of tested income, assets of a Tested Unit of a CFC that produce income excluded from gross tested income by reason of the HT Election for a taxable year are not included in

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[111] REG-127732-19, Federal Register Vol. 85, No. 142, July 23, 2020, at 44656-44657.

QBAI that produces net deemed tangible income return for the year.[112] Therefore, a U.S. Shareholder may prefer to make an HT Election with respect to its high-taxed CFCs that have immaterial QBAI but not with respect its high-taxed CFCs with significant QBAI.

Benefits of selective HT Elections could also arise even outside of GILTI and Subpart F. For instance, under section 267(a)(3)(B), an accrual of a payment to a CFC is generally not permitted as a deduction until paid, except that a deduction is permitted to the extent the corresponding income increases a U.S. Shareholder's pro rata share of the recipient CFC's tested income.[113] Because an accrual of income by a high-taxed CFC would not be gross tested income if an HT Election is made, a U.S. Shareholder might prefer not to make an election with respect to a high-taxed CFC that accrues an unpaid amount from a related party in order to avoid deferral of the deduction until the time of payment.[114] In addition, the U.S. Shareholder might prefer not to make an election with respect to a high-taxed CFC that makes an actual deductible payment to a related high-taxed CFC, while making an election with respect to the payee CFC, in order to obtain a deduction for the payor without the related income ever being included in income.

c. Discussion

The policy-based considerations for the Consistency Requirement are centered around a U.S. Shareholder's ability to reduce its U.S. tax liability through selective HT Elections, including by eliminating some, but not all, of its Subpart F and GILTI inclusions, and the expenses allocable to the inclusions for purposes of the foreign tax credit limitation of section 904. Moreover, under both the Final Regulations and the Proposed Regulations, CDSs are the only persons authorized to make the HT Election, and the CDSs of a CFC are, in general, the U.S. Shareholders with the most significant interests in the CFC. It would therefore seem to follow that the Consistency Requirement should be applied at the U.S. Shareholder level, *i.e.*, applied separately to each U.S. Shareholder with respect to all the CFCs of which the shareholder is a U.S. Shareholder. Taken to its logical extreme, this would mean that unrelated U.S. Shareholders could make different

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[112] See section 951A(d)(2)(A) and Treas. Reg. § 1.951A-3(c)(1).

[113] Treas. Reg. § 1.951A-5(c).

[114] Although the detriment of deferring the deduction may be outweighed by the benefit of the high-taxed CFC never having a tested income inclusion if the HT Election is made, section 267(a)(3) considerations could affect the decision as to how to make selective elections if such elections were permitted and would minimize a taxpayer's overall tax liability.

elections with respect to a single CFC, but that each U.S. Shareholder would be required to make consistent elections with respect to each CFC with respect to which it is a U.S. Shareholder. We recognize, however, that this result would be contrary to the long-standing current regulations under Subpart F which require that all U.S. Shareholders of a CFC are bound by a single election.[115] It also requires, at least arguably, a strained reading of section 954(b)(4).

In contrast, the policies articulated above would not appear to be best served by the CFC Affiliation Approach, which requires consistency among a group of CFCs without regard to the overlap in ownership (if any) by the CFCs' CDSs. By retaining the requirement that CDSs (a shareholder-level paradigm) make the GILTI HT Election with respect to their CFCs, but then subjecting the CDSs to a requirement of consistency with respect to any CFC that satisfies the CFC Affiliation Requirements (a CFC-level paradigm), the CFC Affiliation Approach creates a tension in the Consistency Requirement that results in practical difficulties and anomalies in its application. As a result, the CFC Affiliation Approach will, in many circumstances, have too broad a reach (*i.e.*, apply to fact patterns where the section 904 distortion and other concerns that motivate the Consistency Requirement are not implicated) and, conversely, will have too narrow a reach in other circumstances (*i.e.*, fail to apply to facts patterns where these concerns are implicated). Indeed, the tensions inherent in the CFC Affiliation Approach between the CFC-level group determination and the shareholder-level election may result in the HT Exception being effectively unavailable to many taxpayers at a practical level.

Of particular concern is that the CFC Affiliation Approach can impose a requirement of consistency between unrelated persons. The potential for such a scenario is increased as a result of the repeal of section 958(b)(4). Prior to its repeal by the Act, section 958(b)(4) prevented a foreign corporation from qualifying as a CFC solely by reason of the "downward attribution" of its stock that is owned by a foreign person (*e.g.*, a publicly-traded foreign parent) to a U.S. person (*e.g.*, a U.S. subsidiary of the foreign parent) under section 318(a)(3)(C). After its repeal, a foreign corporation can qualify as a CFC even if substantially less than 50% (or even none) of its stock is actually owned by U.S. Shareholders. For purposes of this Report, a foreign corporation that is a CFC solely by reason of the repeal of section 958(b)(4) is referred to as a "**Non-Controlled CFC**."

In the case of a Non-Controlled CFC, any U.S. Shareholder that owns stock in the CFC may be a CDS under Treasury Regulation section 1.964-1(c)(5). It is not uncommon

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[115] Treas. Reg. § 1.954-1(d)(5).

for the CDS of a Non-Controlled CFC to be unrelated to the non-U.S. owners of the Non-Controlled CFC. For instance, assume a publicly-traded foreign parent (FP) and an unrelated U.S. corporation (USP) own 90% and 10%, respectively, of a Non-Controlled CFC (CFC1), and that FP owns 100% of USS, which owns 100% of another CFC (CFC2).[116] USP is the CDS of CFC1, but CFC1 is a member of a CFC Group that includes CFC2. Under these facts, the CFC Affiliation Approach to the Consistency Requirement would appear to require USP to make a HT Election for CFC1 in order for USS to make a valid election for CFC2, and vice versa. Imposing a duty of cooperation between unrelated parties – USP and USS – is inappropriate in this scenario where there is no danger of whipsaw to the government, particularly because the person authorized to make the election with respect to each CFC bears the entire impact of the election. Indeed, not only does it appear that the CFC Affiliation Approach requires consistency between CFC1 and CFC2, it would appear to require consistency even with respect to CFCs of FP for which there are no CDSs (*e.g.*, a foreign subsidiary wholly-owned by FP would be a Non-Controlled CFC without a CDS but would be included in the CFC Group).[117]

We recognize that a rule requiring consistency solely at the CDS level presents some challenges. However, we believe that such an approach fundamentally aligns better with the stated purpose of the Consistency Requirement in the preambles to the Proposed Regulations and Final Regulations and avoids the untoward results of the CFC Affiliation Approach. Therefore, we recommend that the Treasury and the IRS adopt the Modified 2019 Proposed Approach, which is based on the CDS-level identity of CFCs, similar to the approach of the 2019 Proposed Regulations, but with the modifications discussed below, which would both expand and narrow its scope.

Under the Modified 2019 Proposed Approach, consistent HT Elections must be made with respect to each CFC that has identical CDSs, as described in more detail below (the "**Identical CDS Requirement**"). Unlike the approach in the 2019 Proposed Regulations, the Modified 2019 Proposed Approach would apply the Consistency Requirement with respect to each CFC of which a U.S. Shareholder is the sole CDS, regardless of whether or not the U.S. Shareholder owns more than 50% of the voting power of each CFC. Therefore, for instance, a U.S. Shareholder would have to make consistent HT Elections for each of its wholly-owned CFCs and each of the Non-Controlled CFCs for which it is the sole CDS. Also unlike the 2019 Proposed Regulations,

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[116] See Example 2B below for a diagram illustrating a similar fact pattern.

[117] See Example 1 below for a diagram illustrating a similar fact pattern.

the Modified 2019 Proposed Approach would apply to CFCs that are commonly-owned by identical CDSs, regardless of whether the CDSs own more than 50% of the voting power of each CFC or whether each CDS owns the same percentage of stock in each CFC. For cases in which the Identical CDS Requirement is satisfied with respect to a CFC, we have identified no policy rationale for excluding the CFC from the CFC Group (and thereby from the Consistency Requirement) on the basis that the ownership percentages of the CDSs authorized to make the election with respect to the CFC are not identical to the ownership percentages of the CDSs with respect to the other CFCs in the CFC Group, nor on the basis that the CDSs do not own more than 50% of the voting power of the CFC.

The application of the Modified 2019 Proposed Approach to the Consistency Requirement would depend entirely on whether one or more CFCs satisfy the Identical CDS Requirement. Under Treasury Regulation section 1.964-1(c)(5), the CDS of a Non-Controlled CFC is every U.S. Shareholder that owns stock in the CFC. Therefore, the identity of the CDSs of a Non-Controlled CFC will be static from year to year, absent an actual change in the ownership of the CFC. However, under Treasury Regulation section 1.964-1(c)(5), in the case of a CFC with U.S. Shareholders that own more than 50% of the voting power of the CFC (a "**Controlled CFC**"), whether a U.S. Shareholder is a CDS may depend entirely on whether the shareholder undertakes to act on the CFC's behalf (*e.g.*, attaches a statement with its tax return making a HT Election). Therefore, the U.S. Shareholders of a Controlled CFC may have a significant amount of latitude to opt in or opt out as CDSs in any particular year. This definition of a CDS could cause the identity of the CDSs of a Controlled CFC to change from year to year, and thus render the application of the Consistency Requirement to the CFC uncertain or effectively elective.

To address this concern, we propose that, solely for the purpose of determining whether the Identical CDS Requirement is satisfied, a CDS is, with respect to a CFC, either (1) each U.S. Shareholder that owns more than 50% of the voting power of the CFC, or (2) if there is no U.S. Shareholder that owns more than 50% of the voting power of the CFC, each U.S. Shareholder that owns stock of the CFC. This special definition for a CDS is intended to ensure that the Identical CDS Requirement is determined only by reference to the U.S. Shareholders that could, alone or in conjunction with other U.S. Shareholders, make an election, while minimizing the ability of a group of U.S. Shareholders of Controlled CFCs to avoid the Consistency Requirement through opting in or opting out of CDS status.

We recognize that requiring identical CDSs in cases where there is no single U.S. Shareholder with a majority voting interest may permit inconsistent HT Elections with respect to CFCs that have substantial overlap in ownership. Treasury and the IRS could

consider a lower level of required overlap. However, if the threshold was lower, there could be a "daisy chain" effect that could result in the Consistency Requirement applying to CFCs with minimal overlap in ownership. For example, with a 60% common ownership threshold, assume that CFC1 is owned 20% each by U.S. Shareholders A, B, C, D, and E, CFC2 is owned 20% each by C, D, E, F and G, CFC3 is owned 20% each by E, F, G, H and I, and CFC4 is owned 20% each by G, H, I, J, and K. Since the required overlap exists between CFC1 and CFC2, between CFC2 and CFC3, and between CFC3 and CFC4, it appears that consistency would be required with respect to all four CFCs despite there being no overlap in ownership between CFC1 and CFC4, absent some arbitrary rule for creating separate CFC Groups.

Solely for purposes of determining whether the Identical CDS Requirement is satisfied, similar to the 2019 Proposed Regulations, we would propose that related CDSs be treated as a single CDS (the "**Related CDS Aggregation Rule**"). Also similar to the 2019 Proposed Regulations, for this purpose, a CDS could be treated as related to another CDS if they share a relationship described in section 267(b) or section 707(b). If the motivation for adopting the CFC Affiliation Approach was, in part, to prevent inconsistent HT Elections from being made with respect to related CFCs, the Related CDS Aggregation Rule would generally address this concern by requiring consistency for CFCs owned by different, but commonly-controlled CDSs. For instance, assume FP owns 100% of each of US1 and US2, US1 owns 100% of CFC1, US2 owns 100% of CFC2, and US1 and US2 each owns 50% of CFC3.[118] Under the Related CDS Aggregation Rule, US1 and US2, related corporations, would be treated as a single CDS (US1-US2), such that the Identical CDS Requirement would be treated as satisfied with respect to CFC1, CFC2, and CFC3.

Separate domestic corporate groups owned by a partnership (domestic or foreign) would not be treated as related under a standard of relatedness determined under section 267(b) or section 707(b), unless the section 1563(a)(2) brother-sister controlled group affiliation test is met by looking through to the partners of the partnership.[119] If the Treasury and the IRS believe that the Related CDS Aggregation Rule should apply to such domestic groups, the section 267(b) or section 707 standard could be modified for this purpose or another standard could be adopted, for instance, a relatedness standard

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[118] See Example 7 below for a diagram illustrating a similar fact pattern.

[119] See sections 267(b)(3) and (f), and 1563(a)(2) ("brother-sister controlled group" between two corporations if owned by "5 or fewer persons who are individuals, estates, or trusts").

for CDSs that incorporates section 318 (similar to the CFC Affiliation Requirements of the Final Regulations).

Alternatively, consideration could be given to limiting relatedness to members of an affiliated group, with certain modifications to prevent abuse (the "**Affiliated CDS Aggregation Rule**"). Under the Affiliated CDS Aggregation Rule, for purposes of the Identical CDS Requirement only members of a Modified Affiliated Group would be treated as a single CDS. For this purpose, a "**Modified Affiliated Group**" would mean an affiliated group within the meaning of section 1504, except that the principles of section 958(a) would apply to treat stock of a corporation that is owned by an entity that is not a member of the Modified Affiliated Group as owned proportionately by any owners of the entity for purposes of determining whether the corporation is included in the Modified Affiliated Group. A CDS could therefore not be excluded from the Modified Affiliated Group by inserting a partnership or a foreign corporation between other group members and the CDS.

The narrower Affiliated CDS Aggregation Rule would be beneficial to portfolio companies of private equity funds and separate U.S. groups of foreign parents. Brother-sister U.S. groups owned by funds or foreign parents, while under common control, are separate taxpayers from a U.S. perspective, and may be in different businesses, be operationally independent, and plan their tax affairs (including matters related to their CFC subsidiaries) without coordination. Indeed, the existence of separate U.S. groups of foreign-parented multinational groups often is due to the fact that these separate groups are engaged in different businesses under separate management, which is even more commonly the case for portfolio companies of private equity funds. The presence of separate U.S. groups engaged in different businesses under separate management militates strongly against the likelihood of particular CFCs being included in particular groups for tax planning purposes. In addition, absent affirmative planning by a U.S. corporate group and a related U.S. Shareholder (such as a separate U.S. corporate group), the policy justifications for the Consistency Requirement are not as clearly implicated where separate U.S. Shareholders that are not included in an affiliated group make inconsistent elections, even when the shareholders are related.

In order to address concerns about the potential for abuse involving CFCs owned by related taxpayers that are not members of an affiliated group of corporations, consideration could be given to a targeted anti-abuse rule that would, for the purpose of applying the Affiliated CDS Aggregation Rule, disregard any transaction a principal purpose of which is the avoidance of the Consistency Requirement, including through a transaction that causes a U.S. Shareholder to cease to be a member of a Modified Affiliated Group. As further protection against the potential for abuse, consideration could

also be given to providing that, if any member of one Modified Affiliated Group owns, directly or indirectly, any stock of another member of a Modified Affiliated Group or stock in a CFC with respect to which a member of the other Modified Affiliated Group is a CDS, or if there are substantial intercompany transactions between related parties that are not members of the same Modified Affiliated Group, the Related CDS Aggregation Rule, rather than the Affiliated CDS Aggregation Rule, would apply to determine whether CDS members of both Modified Affiliated Groups should be treated as a single CDS.

We believe that the Modified 2019 Proposed Approach strikes the right balance of administrability, consistency, and practicability. The approach would require a CDS (or a group of CDSs) to make consistent HT Elections with respect to each entity for which the CDS (or CDSs) has the authority to make the election. It would not require a U.S. Shareholder to coordinate with unrelated persons to make a valid HT Election with respect to its own CFCs or cause the election to be invalid by reason of there being a related CFC that has no CDS. Finally, the approach makes the Consistency Requirement, to the greatest extent possible, co-terminus with the U.S. Shareholders that make and bear the impact of the HT Election, and is in this regard fundamentally consistent with the policy objectives of the Consistency Requirement.

If the CFC Affiliation Approach is retained in the regulations finalizing the Proposed Regulations, we would propose the CFC-CDS Affiliation Approach, which would narrow the scope of the CFC Affiliation Approach in order to address some of the more problematic applications of the rule. Under the CFC-CDS Affiliation Approach, a CFC that otherwise satisfies the CFC Affiliation Requirements with respect to a CFC Group would not be treated as a member of the CFC Group unless one of two tests is met. The first test would be satisfied if each CDS of the CFC also satisfies the CFC Affiliation Requirements with respect to each of the other CFCs that are members of the CFC Group. The second test would be satisfied if either (i) Section 958(a) 10% U.S. Shareholders that own, in the aggregate, greater than 50% of the voting power of the CFC also satisfy the CFC Affiliation Requirements with respect to the CFC Group or (ii) each Section 958(a) 10% U.S. Shareholder of the CFC satisfies the CFC Affiliation Requirements with respect to the CFC Group. For this purpose, a "**Section 958(a) 10% U.S. Shareholder**" is a U.S. Shareholder that owns 10% or more by vote or value of the CFC.[120] The CFC-CDS Affiliation Approach is intended to ensure that a CFC is a member

[120] Some of us would extend the determination of a Section 958(a) 10% U.S. Shareholder to include indirect ownership through domestic entities (in effect applying section 958(a)(2) to stock owned indirectly through both foreign and domestic entities). Under this approach, a Section 958(a) 10% U.S.

of a CFC Group only if CDSs of the CFC (or U.S. Shareholders of the CFC that could be CDSs if they undertook to act on behalf of the CFC) are themselves members of the CFC Group.[121]

We also considered an approach that would provide that a CFC would not be treated as satisfying the CFC Affiliation Requirements if the CFC would not be classified as a CFC but for the repeal of section 958(b)(4) (the "**Non-Controlled CFC Approach**"). While the Non-Controlled CFC Approach would address some of the most obvious inappropriate applications of the Consistency Requirement, we concluded that it would result in an overly narrow application of the CFC Affiliation Requirement, causing many similarly-situated taxpayers to be subject to different rules. In particular, the approach would prevent any Non-Controlled CFC from being treated as a member of any CFC Group. This would include Non-Controlled CFCs that have CDSs which are themselves wholly-owned by the non-U.S. owner of the Non-Controlled CFCs, and Non-Controlled CFCs that are owned, directly and indirectly, by the same CDSs, including through a chain of Non-Controlled CFCs. For example, assume that FP owns 100% of US, FP and US own 90% and 10%, respectively, of CFC1, CFC1 owns 100% of CFC2, and CFC2 owns 100% of CFC3. In this case, if final regulations were to adopt the Non-Controlled CFC Approach, US would be permitted to make a separate election for each of CFC1, CFC2 and CFC3, even though US is affiliated with each CFC, because each is a Non-Controlled CFC. The Non-Controlled CFC Approach is not discussed further in this Report.

In the next section, we provide Examples intended to illustrate how each of the CFC Affiliation Approach, the Modified 2019 Proposed Approach, and the CFC-CDS Affiliation Approach would apply to a variety of fact patterns. We note that, as illustrated by the Examples, arguably none of the approaches produces ideal results in all situations,

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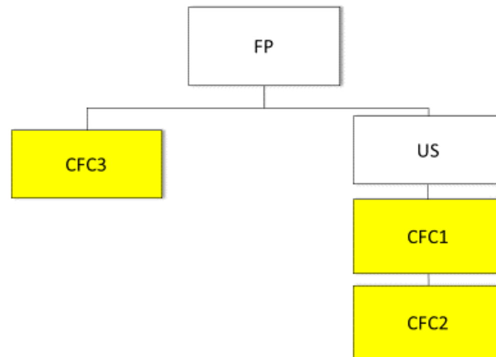
Shareholder would not be limited to those U.S. Shareholders that would be required to include (under section 951(a) or section 951A(a)) their pro rata share of Subpart F or tested income with respect to the CFC for the taxable year.

[121] We also considered a variation of the CDS Affiliation Approach under which a CFC would not be treated as satisfying the CFC Affiliation Requirements with respect to a CFC Group unless there is at least one Section 958(a) 10% U.S. Shareholder with respect to the CFC that also satisfies the CFC Affiliation Requirements with respect to each CFC that is a member of the CFC Group (the "**Section 958(a) 10% U.S. Shareholder Affiliation Approach**"). While we have no strong preference for the CFC-CDS Affiliation Approach over the Section 958(a) 10% U.S. Shareholder Affiliation Approach, the premise of each of the two approaches – that there should be some type of affiliation between the U.S. Shareholders that have the authority to make the election and bear the consequences of the election – are similar enough to justify dispensing with a detailed description of the latter approach in favor of focusing on the former. Therefore, the Section 958(a) 10% U.S. Shareholder Affiliation Approach is not further discussed in this Report.

and we suspect that Treasury and the IRS ultimately will have to adopt what it deems to be the best of a set of imperfect solutions.

d. Examples

Example 1 (CFC Group Member With No CDS)



Assume that a foreign corporation (FP) owns 100% of a foreign corporation (CFC3) and 100% of a domestic corporation (US). US, in turn, owns 100% of CFC1. CFC1 owns 100% of CFC2. As a result of the repeal of section 958(b)(4), CFC3 is a CFC because FP's ownership of CFC3 is attributed to US under section 318(a)(3). US is the CDS of CFC1 and CFC2. CFC3 does not appear to have a CDS.

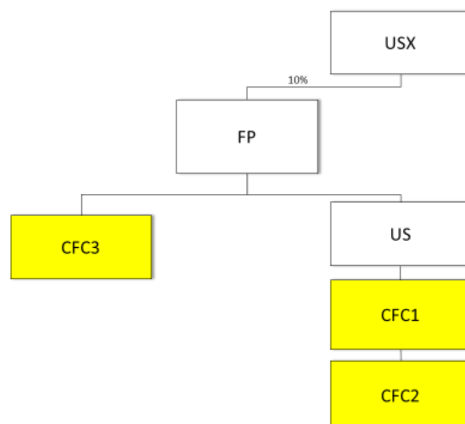
Under the CFC Affiliation Approach, CFC3 is a member of the CFC Group that includes CFC1 and CFC2 because CFC3 satisfies the CFC Affiliation Requirements with respect to CFC1 and CFC2. For an HT Election with respect to CFC1 and CFC2 to be valid, it appears that an election must also be made with respect to CFC3 because CFC3 is a member of the CFC Group that includes CFC1 and CFC2, notwithstanding that CFC3 is a Non-Controlled CFC and does not have a CDS or any U.S. Shareholder that would have any inclusions under section 951 or 951A. As a result, there is a concern that it may not be possible for US to make a valid HT Election with respect to CFC1 and CFC2 because the Consistency Requirement cannot be satisfied with respect to CFC3. We strongly urge Treasury and the IRS to consider taking steps to address this issue in the near term, even if they do not otherwise modify the CFC Affiliation Approach.

Each of the Modified 2019 Proposed Approach and the CFC-CDS Affiliation Approach would exclude CFC3 from the CFC Group that includes CFC1 and CFC2 in Example 1. Under the Modified 2019 Proposed Approach, final regulations would provide that consistency is required for each CFC that satisfies the Identical CDS Requirement. US is the CDS of CFC1 and CFC2, and CFC3 does not have a CDS. Accordingly, a

consistent HT Election would not be required for CFC3, on the one hand, and CFC1 and CFC2, on the other.

Under the CFC-CDS Affiliation Approach, a CFC would not be treated as satisfying the CFC Affiliation Requirements with respect to a CFC Group unless each CDS of the CFC also satisfies the CFC Affiliation Requirements with respect to each CFC member of the CFC Group. Applying the CFC-CDS Affiliation Approach to Example 1, there is no CDS of CFC3, and thus no CDS of CFC3 satisfies the CFC Affiliation Requirements with respect to each of CFC1, CFC2, and CFC3. Accordingly, CFC3 would not be a member of a CFC Group that includes CFC1 and CFC2.

Example 2A (CFC Group Members with differing CDSs #1)



Assume the same facts as Example 1, except that an unrelated US investor (USX) owns 10% of the stock of FP.

Under the CFC Affiliation Approach, CFC3 is a member of the CFC Group that includes CFC1 and CFC2 because CFC3 satisfies the CFC Affiliation Requirements with respect to CFC1 and CFC2. For an HT Election with respect to CFC1 and CFC2 to be valid, USX must make an election with respect to CFC3 because CFC3 is a member of the CFC Group that includes CFC1 and CFC2, notwithstanding that USX, the CDS of CFC3, is not related to US, the CDS of CFC1 and CFC2. Similarly, for an HT Election with respect to CFC to be valid, US must make an election with respect to CFC1 and CFC2.

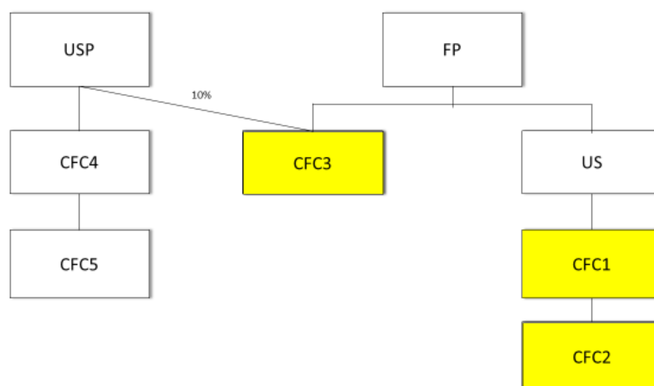
We do not see any policy reason for requiring consistency between unrelated parties on these facts. While FP controls CFC3, and USX is merely an indirect minority investor in CFC3, an HT Election with respect to CFC3 is relevant only to USX as the sole U.S. Shareholder of CFC3. Further, neither USX nor US has the capacity to make the election with respect to each other's CFCs, nor can either otherwise compel the other to make the election. Thus, the Consistency Requirement, on these facts, ensures that neither USX nor US will be able to make a valid HT Election absent an agreement between the two companies to coordinate tax elections with respect to CFCs in which they have no common interest.

Each of the Modified 2019 Proposed Approach and the CFC-CDS Affiliation Approach would appropriately exclude CFC3 from the CFC Group that includes CFC1 and CFC2 in Example 2A. Under the Modified 2019 Proposed Approach, consistency is required for each CFC that satisfies the Identical CDS Requirement. US is the CDS of CFC1 and CFC2, and USX is the CDS of CFC3. Because CFC1 and CFC2, on the one

hand, and CFC3, on the other, do not have identical CDSs, a consistent HT Election with respect to CFC1 and CFC2, on the one hand, and CFC, on the other, would not be required (although consistent elections would have to be made with respect to CFC1 and CFC2).

Under the CFC-CDS Affiliation Approach, a CFC would not be treated as satisfying the CFC Affiliation Requirements with respect to a CFC Group unless each CDS of the CFC also satisfies the CFC Affiliation Requirements with respect to each CFC member of the CFC Group. Applying the CFC Affiliation Requirements to Example 2A, USX does not satisfy the CFC Affiliation Requirements with respect to each of CFC1, CFC2 and CFC3. Accordingly, CFC3 would not be a member of a CFC Group that includes CFC1 and CFC2.

Example 2B (CFC Group Members with differing CDSs #2)



Assume the same facts as in Example 1, except that FP owns only 90% of another foreign corporation (CFC3). The remaining 10% of CFC3 is owned by a domestic corporation (USP). In addition, USP owns 100% of a foreign corporation (CFC4), and CFC4, in turn, owns 100% of another foreign corporation (CFC5). In this Example 2B, USP is the CDS of CFC3, CFC4 and CFC5, and US is the CDS of CFC1 and CFC2.

Under the CFC Affiliation Approach, notwithstanding that USP is not also a CDS of CFC1 or CFC2, CFC3 is a member of a CFC group that includes CFC1 and CFC2. As a result, under the Consistency Requirement, an election made by US with respect to CFC1 and CFC2 would not be valid unless an election was also made by USP with respect to CFC3, and, conversely, an election made by USP with respect to CFC3 would not be valid unless an election was also made by US with respect to CFC1 and CFC2.

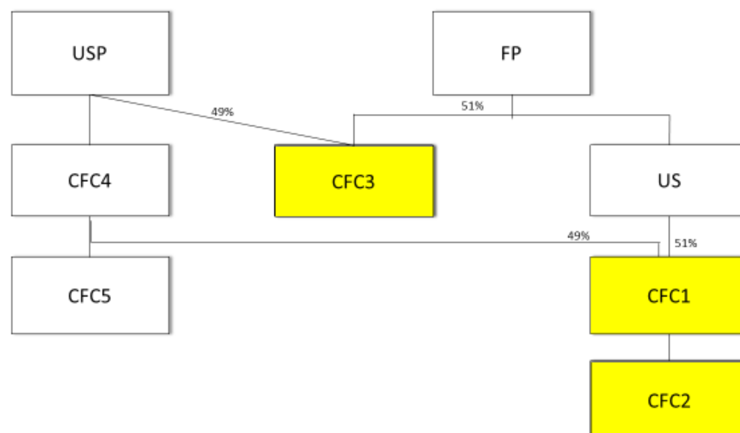
Similar to Example 2A, we fail to see any policy reason for requiring consistency between unrelated parties on the facts of Example 2B. While FP controls CFC3, and USP is merely a minority investor in CFC3, a HT Election with respect to CFC3 is relevant only to USP as the sole U.S. Shareholder of CFC3. Moreover, USP has no economic interest in CFC1 or CFC2, and US has no economic interest in CFC3. Thus, neither USP nor US, as unrelated domestic corporations, has the ability to manipulate the foreign tax credit limitation through selective HT Elections on these facts, and so the policy motivations behind the Consistency Requirement are not implicated. Further, neither USP nor US has the ability to make the election with respect to each other's CFCs or otherwise compel the other to make the election. Thus, the Consistency Requirement, on these facts, ensures that neither USP nor US will be able to make a valid HT Election absent an agreement between the two companies to coordinate tax elections with respect to CFCs for which they do not have common interests. In light of the numerous joint ventures entered into, and strategic investments made by, multinational corporations, this

type of fact pattern may be fairly common, and thus a broad swath of taxpayers could be inappropriately subject to the Consistency Requirement.

Each of the Modified 2019 Proposed Approach and the CFC-CDS Affiliation Approach would appropriately exclude CFC3 from the CFC Group that includes CFC1 and CFC2 in Example 2B. Under the Modified 2019 Proposed Approach, the CDS of CFC3 (USP) is not identical to the CDS of CFC1 and CFC2 (US), and therefore consistent HT Elections would not have to made with respect to CFC3, on the one hand, and CFC1 and CFC2, on the other. However, CFC3, CFC4, and CFC5 do have an identical CDS (USP), and therefore consistent HT Elections must be made with respect to each of CFC3, CFC4, and CFC5. Including CFC3, CFC4 and CFC5 in a CFC Group is, in our view, appropriate from a policy standpoint, since USP is the only taxpayer affected by whether HT Elections are made with respect to those entities. The CFC Affiliation Approach is under-inclusive in this regard, since it does not require CFC3 to be included in a CFC Group with CFC4 and CFC5.

Under the CFC-CDS Affiliation Approach, CFC3 would not be a member of a CFC Group that includes CFC1 and CFC2 because USP, the CDS of CFC3, does not satisfy the CFC Affiliation Requirements with respect to each of CFC1, CFC2, and CFC3. Because the CFC-CDS Affiliation Approach simply narrows the CFC Affiliation Approach, it would not require CFC3 to be included in a CFC Group with CFC4 and CFC5.

Example 2C (CFC Group Members with differing CDSs #3)



Assume the same facts as in Example 2B except that (i) USP owns 49% of CFC3 and (ii) CFC4 owns 49% of CFC1. Notwithstanding that USP is a Section 958(a) 10% U.S. Shareholder of CFC1 and CFC2 (indirectly through CFC4), US is the sole CDS of CFC1 and CFC2 because US alone owns more than 50% of the voting power of CFC1 and CFC2. USP is the sole CDS of CFC3, CFC4, and CFC5.

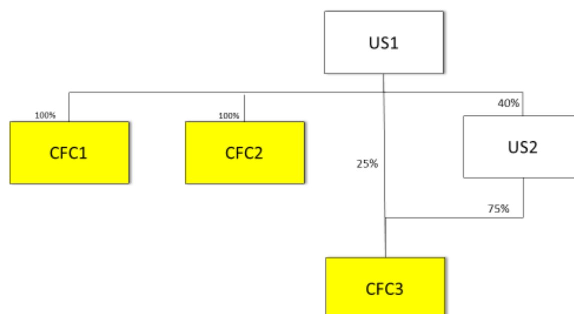
Under the CFC Affiliation Approach, the result in Example 2C would be the same as the result in Example 2B. CFC3 would be a member of a CFC Group that includes CFC1 and CFC2 and thus would be subject to the Consistency Requirement. This is admittedly a closer case than Example 2B, but we nevertheless believe that consistency should not be required with respect to CFC1 and CFC2 on the one hand, and CFC3 on the other hand, because the elections would be made unilaterally by unrelated CDSs. By contrast, it would seem more appropriate, from the perspective of the policy concerns articulated in the preamble, to require consistency with respect to CFC3 on the one hand, and CFC4 and CFC5 on the other hand.

Under the Modified 2019 Proposed Approach, CFC1 and CFC2 have identical CDSs (US), and CFC3, CFC4, and CFC5 have identical CDSs (USP), and thus consistent HT Elections would be required for each of CFC1 and CFC2 and consistent elections would be required for each of CFC3, CFC4, and CFC5. However, the CDSs of CFC1 and CFC2 (US) are not identical to the CDSs of CFC3, CFC4, and CFC5 (USP). Therefore, consistent HT Elections would not have to made with respect to CFC1 and CFC2, on the one hand, and CFC3, CFC4, and CFC5, on the other.

Under the CFC-CDS Affiliation Approach, CFC3 would not be a member of a CFC Group that includes CFC1 and CFC2 because USP, the CDS of CFC3, does not satisfy

the CFC Affiliation Requirements with respect to each of CFC1, CFC2, and CFC3. CFC3 would also not be a member of the CFC Group that includes CFC4 and CFC5 because USP also does not satisfy the CFC Affiliation Requirements with respect to each of CFC3, CFC4, and CFC5.

Example 3 (Indirect Ownership)



Assume that a domestic corporation (US1) owns 100% of the stock of two foreign corporations (CFC1 and CFC2). US1 also owns 40% of another domestic corporation (US2) and 25% of another foreign corporation (CFC3). US2 owns the remaining 75% of CFC3. US1 is the sole CDS of CFC1 and CFC2 because US1 owns more than 50% of the voting power of CFC1 and CFC2, whereas US2 is the sole CDS of CFC3 because US2 owns more than 50% of the voting power of CFC3.[122]

Under the CFC Affiliation Approach, CFC3 would be a member of a CFC Group that includes CFC1 and CFC2 because, for purposes of determining whether the CFC Affiliation Requirements are satisfied with respect to a CFC Group, section 318(a)(2)(C) (attribution from a corporation) is modified to permit a proportionate amount of stock owned by a corporation to be attributed to a shareholder that owns 5% or more (rather than 50% or more) of the stock of the corporation. Thus, US1 is treated as owning 55% of CFC3, which is equal to the 25% of CFC3 that US1 owns directly plus the 30% of CFC3 that US1 owns through attribution from US2 under section 318(a)(2)(C) as modified (40% * 75%).[123]

We believe that, on balance, the result under the CFC Affiliation Approach in Example 3 represents an overbroad application of the Consistency Requirement. US1's election with respect to CFC1 and CFC2 should not be necessary for US2 to make an

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[122] See Treas. Reg. § 1.964-1(c)(5).

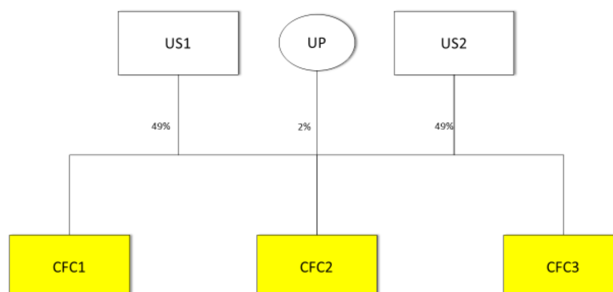
[123] Note that CFC3 appears to also be the sole CFC in a separate CFC Group with US2. However, the Tie-Breaker Rule, discussed above, is inapplicable because CFC3 has only one class of stock outstanding and the ownership has been the same since the end of the first CFC inclusion year. See Treas. Reg. § 1.951A-2(c)(7)(viii)(E)(2)(iii).

election with respect to CFC3 because US1's election with respect to CFC1 and CFC2 would otherwise have no impact on US2, which owns no interest in CFC1 and CFC2. Similarly, US2's election with respect to CFC3 should not be necessary for US1 to make an election with respect to CFC1 and CFC2 because, while US2's election with respect to CFC3 will have an impact on US1, US1 does not have the ability to make an HT Election with respect to CFC3.

Each of the Modified 2019 Proposed Approach and the CFC-CDS Affiliation Approach would exclude CFC3 from the CFC Group that includes CFC1 and CFC2 in Example 3. Under the Modified 2019 Proposed Approach, the CDS of CFC1 and CFC2 (US1) is not identical to the CDS of CFC3 (US2). Further, US1 and US2 would not be related for purposes of either the Related CDS Aggregation Rule or the Affiliated CDS Aggregation Rule, and thus US1 and US2 would not be treated as a single CDS for purposes of applying the Modified 2019 Proposed Approach. Therefore, consistent HT Elections would not have to made with respect to CFC1 and CFC2, on the one hand, and CFC3, on the other.

Similarly, under the CFC-CDS Affiliation Approach, because US2, the sole CDS of CFC3, does not satisfy the CFC Affiliation Requirements with respect to each of CFC1, CFC2, and CFC3, CFC3 would not be a member of a CFC Group that includes CFC1 and CFC2.

Example 4 (49% U.S. Shareholders #1)



Assume that a domestic corporation (US1) and another domestic corporation (US2) each owns 49% of each of three foreign corporations (CFC1, CFC2, and CFC3). The remaining 2% of each CFC is owned by an unrelated individual (UP). Assume further that, for purposes of the Modified 2019 Proposed Approach, the CDSs of each of CFC1, CFC2, and CFC3 are US1 and US2 because they are the U.S. Shareholders that own, in the aggregate, more than 50% of each CFC.

Under the CFC Affiliation Approach, none of CFC1, CFC2, or CFC3 are members of the same CFC Group because they do not satisfy the CFC Affiliation Requirements with respect to each other. Thus, the Consistency Requirement will not apply under the CFC Affiliation Approach with respect to CFC1, CFC2, and CFC3, notwithstanding that their CDSs (US1 and US2) own, in the aggregate, 98% of each CFC and in equal proportions. This example illustrates that, under the CFC Affiliation Approach, the Consistency Requirement may not apply in all cases where, as a matter of policy, it seems like it should. This disconnect results from the fact that the CFC Affiliation Requirements depend on the level of affiliation between CFCs and not the identity of the CDSs of the CFCs.[124]

The CFC-CDS Affiliation Approach would not change the result under the CFC Affiliation Approach, because the CFC-CDS Affiliation Approach can only narrow the scope of the CFC Affiliation Approach. In contrast, under the Modified 2019 Proposed Approach, CFC1, CFC2, and CFC3 have identical CDSs (US1 and US2), and therefore consistent HT Elections would have to be made with respect to each of CFC1, CFC2, and CFC3. This result would obtain even if US1 and US2 owned CFC1, CFC2, and CFC3 in

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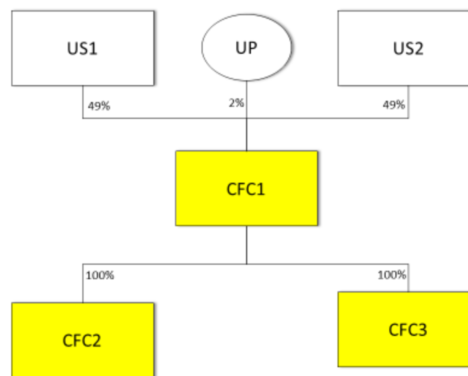
[124] See Treas. Reg. § 1.951A-2(c)(7)(viii)(E)(2)(i).

non-identical proportions, assuming US1 and US2 remained the sole CDSs with respect to each CFC.

Example 5 (49% U.S. Shareholders #2)

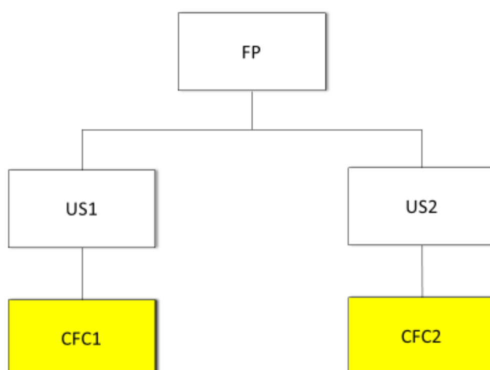


Assume the same facts as in Example 4, except that CFC1 owns 100% of both CFC2, and CFC3. As in Example 4, for purposes of the Modified 2019 Proposed Approach, the CDSs of CFC1, CFC2, and CFC3 are US1 and US2 because US1 and US2, in the aggregate, own more than 50% of the voting power of each of CFC1, CFC2, and CFC3.

In contrast to Example 4, under the CFC Affiliation Approach, CFC1, CFC2, and CFC3 are members of the same CFC Group because the CFC Affiliation Requirements are satisfied with respect to each. Thus, the Consistency Requirement applies in Example 5, but not Example 4, although US1 and US2's economic interest in CFC1, CFC2 and CFC3 is not fundamentally different in Examples 4 and 5; their direct 49% interest in CFC2 and CFC3 has merely become an indirect 49% interest. However, because CFC1 owns CFC2 and CFC3, rather than being brother-sister to CFC2 and CFC3, CFC1 can be the common parent that permits each of CFC1, CFC2, and CFC3 to satisfy the CFC Affiliation Requirements.

Under the Modified 2019 Proposed Approach, similar to the CFC Affiliation Approach and Example 4, because CFC1, CFC2, and CFC3 have identical CDSs (US1 and US2), consistent HT Elections would have to be made with respect to each of CFC1, CFC2, and CFC3. In contrast, but consistent with the result applying the CFC Affiliation Approach in Example 4, the CFC-CDS Affiliation Approach would prevent CFC1, CFC2, and CFC3 from being members of the same CFC Group, because US1 and US2 (the sole CDSs of CFC1, CFC2 and CFC3) do not satisfy the CFC Affiliation Requirements with respect to any of CFC1, CFC2, or CFC3.

Example 6 (Foreign-Parented Groups #1)



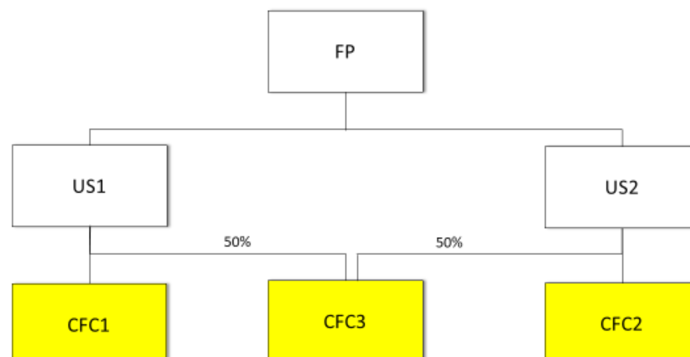
Assume that a foreign corporation (FP) owns 100% of two domestic corporations (US1 and US2), US1 owns 100% of a foreign corporation (CFC1), and US2 owns 100% of another foreign corporation (CFC2). US1 is the CDS of CFC1, and US2 is the CDS of CFC2.

Under the CFC Affiliation Approach, CFC1 and CFC2 are members of the same CFC Group because the CFC Affiliation Requirements are satisfied with respect to each CFC. Whether this result seems appropriate from a policy perspective depends on whether US1 and US2 could, in some manner, inappropriately manipulate their Subpart F and GILTI inclusions and foreign tax credits by making selective HT Elections. If US1 and US2 constitute separate businesses that operate independently, and have not engaged in transactions with a principal purpose of avoiding the Consistency Requirement, requiring consistency here, where there are separate U.S. taxpayers, would not appear to be appropriate from a policy perspective.

Under the Modified 2019 Proposed Approach, whether CFC1 and CFC2 have identical CDSs depends on whether final regulations adopt the Related CDS Aggregation Rule or the Affiliated CDS Aggregation Rule. Under the Related CDS Aggregation Rule, for purposes of determining whether CFC1 and CFC2 have identical CDSs, US1 and US2 would be treated as a single CDS because they are related parties under section 267(b), with the result that each of CFC1 and CFC2 would be treated as having an identical CDS (US1-US2). Therefore, consistent HT elections would have to be made with respect to CFC1 and CFC2. Under the Affiliated CDS Aggregation Rule, absent the application of an anti-abuse rule or some other exception, CFC1 and CFC2 would have different CDSs because US1 and US2 would not be members of the same Modified Affiliated Group. Therefore, consistent HT elections would not have to made with respect to CFC1 and CFC2.

Under the CFC-CDS Affiliation Approach, CFC1 and CFC2 would be members of the same CFC Group because each of US1 and US2, the CDSs with respect to CFC1 and CFC2, respectively, satisfy the CFC Affiliation Requirements with respect to CFC1 and CFC2.

Example 7 (Foreign-Parented Groups #2)



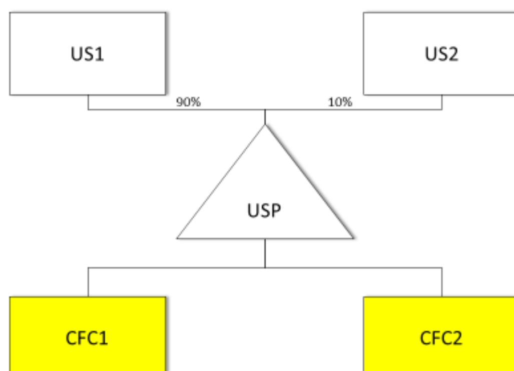
Assume the same facts as Example 6, except that, in addition, US1 and US2 each owns 50% of another foreign corporation (CFC3).

Under the CFC Affiliation Approach, CFC1, CFC2, and CFC3 are members of the same CFC Group because the CFC Affiliation Requirements are satisfied with respect to each CFC.

Under the Modified 2019 Proposed Approach, whether CFC1, CFC2, and CFC3 have identical CDSs may depend on whether the Related CDS Aggregation Rule or the Affiliated CDS Aggregation Rule is adopted. Under the Related CDS Aggregation Rule, for purposes of determining whether CFC1, CFC2, and CFC3 have identical CDSs, US1 and US2 would be treated as a single CDS because they are related under section 267(b) and thus members of the same Modified Affiliated Group, with the result that each of CFC1, CFC2, and CFC3 would be treated as having an identical CDS (US1-US2). Therefore, consistent HT Elections would have to be made with respect to each of CFC1, CFC2, and CFC3. Under the Affiliated CDS Aggregation Rule, by contrast, absent the application of an anti-abuse rule or some other exception, CFC1 and CFC2 would have different CDSs (US1 and US2); as discussed above, a possible exception could be made to the Affiliated CDS Aggregation Rule in the case of a CFC that is jointly owned by related members of different Modified Affiliated Groups

Under the CFC-CDS Affiliation Approach, CFC3 would be a member of the CFC Group that includes CFC1 and CFC2 because each of US1 and US2, the sole CDSs with respect to CFC3, satisfies the CFC Affiliation Requirements with respect to CFC1, CFC2, and CFC3.

Example 8 (Partnership Aggregate/Entity Considerations #1)



Assume that a domestic partnership (USP) owns 100% of the stock of each of two foreign corporations (CFC1 and CFC2). Assume that a domestic corporation (US1) and another domestic corporation (US2) own 90% and 10%, respectively, of USP. Under current Treasury Regulation section 1.964-1(c)(4), which treats a domestic partnership as an entity purposes of determining the CDSs of a CFC, USP (and not US1 and US2) is the CDS with respect to CFC1 and CFC2. However, as discussed above, we have recommended that, for purposes of the HT Election and for purposes of applying the Consistency Requirement, domestic partnerships should be treated as aggregates, similar to the treatment of foreign partnerships and foreign corporations.

Under the CFC Affiliation Approach, CFC1 and CFC2 would be members of the same CFC Group, because, under section 318(a)(3)(C), USP's interest in CFC1 is attributed to CFC2. That CFC1 and CFC2 are members of the same CFC Group seems appropriate, regardless of whether USP is treated as the CDS or its partners are the CDSs. In either case, the same U.S. Shareholders (US1 and US2) will have the same indirect interest in each of CFC1 and CFC2 and, even if USP makes the election, it would be making the election solely on behalf of its partners that are the U.S. Shareholders.

Similarly, under the Modified 2019 Proposed Approach, CFC1 would be treated as having identical CDSs regardless of whether USP is treated as an entity or an aggregate. If USP were treated as an entity, the CDS of each of CFC1 and CFC2 would be USP. If USP were treated as an aggregate, US1 would be a CDS with a greater than 50% voting interest; if the facts were changed so that US1 and US2 each own 50% of USP, the CDSs with respect to both CFCs would be US1 and US2. Under either an entity or an aggregate

approach to partnerships, the Consistency Requirement would apply to each of CFC1 and CFC2 under the Modified 2019 Proposed Approach.[125]

Under the CFC-CDS Affiliation Approach, in contrast, it would appear that whether CFC1 and CFC2 are members of the same CFC Group may depend on whether USP is treated as an entity or an aggregate. Under an aggregate approach, US1 would satisfy the CFC Affiliation Requirements with respect to each of CFC1 and CFC2, and therefore CFC1 and CFC2 would be members of the same CFC Group. Under a strict entity approach, because a partnership cannot satisfy the CFC Affiliation Requirements even if the partnership is otherwise affiliated, it would appear that the CFC Affiliation Requirements would not be met. If an entity approach was retained, the CFC Affiliation Requirements could be modified to provide that a partnership that is a CDS is treated as an includible corporation for purposes of determining whether the CDS satisfies the CFC Affiliation Requirements with respect to each member of the CFC Group. This may, however, be overly broad insofar as it could result in CFC1 and CFC2 being members of the same CFC Group even if ownership of USP is widely dispersed.

To summarize, the treatment of domestic partnerships as entities or aggregates is not determinative on the facts of this Example 8 if the Modified 2019 Proposed Approach is applied. If, by contrast, Treasury and the IRS adopt the CFC-CDS Affiliation Approach, the treatment of domestic partnerships as entities or aggregates could be determinative in some cases. Applying the CFC-CDS Affiliation Approach and entity treatment of partnerships to Example 8, for example, would result in CFC1 and CFC2 being included in a CFC Group.

Applying the CFC-CDS Affiliation Approach and treating partnerships on an aggregate basis would in some cases produce the anomalous result that a chain of parent-subsidiary CFCs under a domestic partnership would clearly satisfy the CFC Affiliation Requirements under the CFC-CDS Affiliation Approach, but in some cases the result would be different if the CFCs were owned as brother-sister subsidiaries of the partnership. If the same CFCs were owned by the domestic partnership as brother-sister subsidiaries, the aggregate approach would require looking through to the partners to

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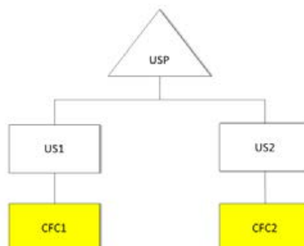
[125] The treatment of domestic partnerships as entities or aggregates would, however, produce different results under the Modified 2019 Proposed Approach if, for instance, US1 also owned one or more CFCs directly. In that case, entity treatment of USP would result in non-identical CDSs for CFC1 and CFC2, on the one hand, and CFC3, on the other, whereas aggregate treatment would result in identical CDSs for all the CFCs. See Example 10 for an illustration of this fact pattern.

determine whether the Consistency Requirement is applicable.[126] Because there is no principled distinction between the two cases, the adoption of an entity approach is arguably more appropriate if the CFC-CDS Affiliation Approach is adopted.

[126] Where, as in the facts of this Example, there is a U.S. person with a greater than 50% interest in the partnership, the Consistency Requirement would apply under the CFC Affiliation Approach with an aggregate approach to partnerships, regardless of whether the CFCs are owned in a single chain or as brother-sister subsidiaries of the partnership.

Example 9 (Partnership Aggregate/Entity Considerations #2)



Assume that a domestic partnership (USP) owns 100% of the stock of each of two domestic corporations (US1 and US2). Assume that US1 owns 100% of a foreign corporation (CFC1) and US2 owns 100% of another foreign corporation (CFC2). US1 is the CDS of CFC1 and US2 is the CDS of CFC2.

Under the CFC Affiliation Approach, CFC1 and CFC2 satisfy the CFC Affiliation Requirements with respect to each other and therefore would be members of the same CFC Group. This fact pattern closely resembles a (somewhat simplified) typical private equity fund structure. Assuming that each of US1 and US2 is a portfolio company that operates independently and with respect to which the fund does not invest, manage, or report on a combined basis, we can think of no policy reason to require the application of the Consistency Requirement to CFC1 and CFC2. We nevertheless do not make a specific recommendation with respect to this particular fact pattern; instead, we offer certain alternative approaches that Treasury and the IRS could adopt.

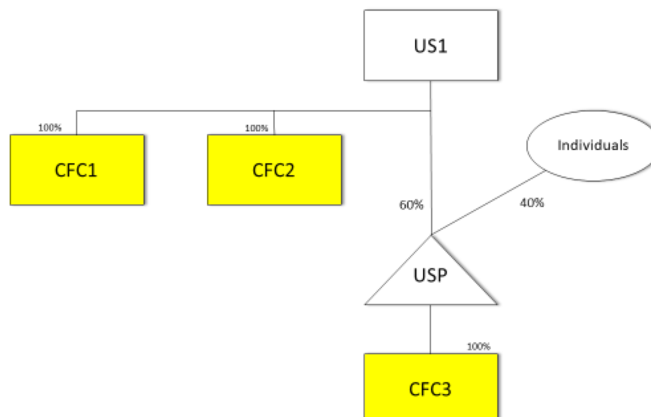
Under the Modified 2019 Proposed Approach, whether CFC1 and CFC2 have identical CDSs may depend on whether the Related CDS Aggregation Rule or the Affiliated CDS Aggregation Rule is adopted. Under the Related CDS Aggregation Rule, absent modifications to the relatedness standard in section 267(b) or 707(b) or some other standard, US1 and US2 would not be related, and therefore US1 and US2 would not be treated as a single CDS. However, if, for instance, the relatedness standard for the Related CDS Aggregation Rule were determined by modifying section 1563(a)(2) to permit partnerships to parent "brother-sister" controlled groups,[127] CFC1 and CFC2 would be members of the same Modified Affiliated Group, with the result that each of CFC1 and CFC2 would be treated as having identical CDSs (US1-US2). Therefore, consistent HT

[127] A member of a brother-sister controlled group under section 1563(e)(2) is a "related party" under section 267(b)(3) and (f). Under section 1563(e)(2), a brother-sister controlled group of corporations can only be created through the common ownership of "5 or fewer persons who are individuals, estates, or trusts."

Elections would have to made with respect to CFC1 and CFC2. In contrast, under the Affiliated CDS Aggregation Rule, absent the application of an anti-abuse rule or some other exception, CFC1 and CFC2 would have different CDSs (US1 and US2), and therefore consistent HT Elections would not be required with respect to CFC1 and CFC2.

Under the CFC-CDS Affiliation Approach, CFC1 and CFC2 would be members of the same CFC Group because the stock of US1 owned by USP would be attributed to US2 under section 318(a)(3)(C). Therefore, consistent HT Elections would have to be made for CFC1 and CFC2.

Example 10 (Partnership Aggregate/Entity Considerations #3)



Assume that a domestic corporation (US1) owns 100% of the stock of two foreign corporations (CFC1 and CFC2). US1 also owns 60% of a domestic partnership (USP), and a number of unrelated foreign individuals own the remaining 40% of USP. USP owns 100% of a foreign corporation (CFC3). US1 is the CDS with respect to CFC1 and CFC2. Under current Treasury Regulation section 1.964-1(c)(4), which treats a domestic partnership as an entity purposes of determining the CDSs of a CFC, USP is the CDS of CFC3.

Under the CFC Affiliation Approach, CFC3 would be treated as a member of a CFC Group that includes CFC1 and CFC2 because CFC3 satisfies the CFC Affiliation Requirements with respect to each of CFC1 and CFC2. This seems appropriate, because, under these facts, the only person that will have an inclusion with respect to each of CFC1, CFC2, and CFC3 is US1, and US1, either directly with respect to CFC1 and CFC2 or indirectly (through USP) with respect to CFC3, presumably would have the ability to unilaterally make a HT Election with respect to each CFC.

Under the Modified 2019 Proposed Approach, if USP was treated as an entity for purposes of determining the identity of a CDS, CFC1 and CFC2, on the one hand, and CFC3, on the other, would appear to have different CDSs (US1 and USP, respectively). In that case, whether CFC1, CFC2, and CFC3 have identical CDSs may depend on whether the final regulations adopt the Related CDS Aggregation Rule or the Affiliated CDS Aggregation Rule. Under the Related CDS Aggregation Rule, for purposes of determining whether CFC1, CFC2, and CFC3 have identical CDSs, US1 and USP would be treated as a single CDS because they are related under section 267, with the result that each of CFC1, CFC2, and CFC3 would be treated as having identical CDSs (US1-USP). Therefore, consistent HT Elections would have to made with respect to CFC1,

CFC2, and CFC3. In contrast, under the Affiliated CDS Aggregation Rule, if partnerships are treated on an entity basis, absent the application of an anti-abuse rule or some other exception, CFC1, CFC2, and CFC3 would have different CDSs, because USP, a partnership, cannot be a member of a Modified Affiliated Group.

However, if final regulations provided that a domestic partnership is treated as an aggregate for purposes of determining the application of the Consistency Requirement, US1 would be the sole CDS with respect to each of CFC1, CFC2, and CFC3. Note that, even if Treasury and the IRS determined it was appropriate to retain the rule permitting domestic partnerships to be CDSs, the final regulations could still treat domestic partnerships as an aggregate for the limited purpose of the Consistency Requirement. In this instance at least, the aggregate treatment of partnerships seems to clearly produce the right result from a policy perspective.

Under the CFC-CDS Affiliation Approach, aggregate treatment or entity treatment of USP would not be determinative, assuming that the CFC Affiliation Requirements are modified to provide that partnerships that are CDSs are treated as includible corporations for purposes of determining whether the CDS satisfies the CFC Affiliation Requirements with respect to each member of the CFC Group. In that case, under an entity treatment of domestic partnerships, CFC1, CFC2, and CFC3 would all be members of the same CFC Group, because the CDS of CFC1 and CFC2 (US1) and the CDS of CFC3 (USP) would satisfy the CFC Affiliation Requirements with respect to each other member of the CFC Group. Similarly, under an aggregate treatment of domestic partnerships, CFC3 would be a member of a CFC Group that includes CFC1 and CFC2 because the CDS of CFC1, CFC2, and CFC3 (US1) would satisfy the CFC Affiliation Requirements with respect to each other member of the CFC Group.