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

Report No. 1457
January 18, 2022

The Honorable Lily Batchelder
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Thomas C. West, Jr.
Deputy Assistant Secretary
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Mr. Krishna Vallabhaneni
Tax Legislative Counsel
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Re: Report No. 1457 – Report on the Application of Section 382 to Foreign Corporations

Dear Mme. Batchelder and Messrs. West and Vallabhaneni:

I am pleased to submit Report No. 1457 of the Tax Section of the New York State Bar Association discussing the application of Section 382 to foreign corporations that undergo an ownership change. The Report discusses whether and how Section 382 should apply to a controlled foreign corporation not engaged in a US trade or business. The Report ultimately recommends that there should be some form of limitation on the use of foreign corporation attributes in the case of an acquisition, and while the application of Section 382 has material flaws, it is likely the best currently available option. In addition, the Report suggests possible revisions to the Section 382 regulations should Treasury wish to issue guidance on the application of Section 382 to controlled foreign corporations.

We appreciate your consideration of our recommendations and comments. If you have any questions on this report, please feel free to contact us and we would be happy to assist in any way we can.

Respectfully Submitted,

Gordon Warnke

Gordon E. Warnke
Chair

Enclosure

Cc:

Peter Blessing
Associate Chief Counsel (International)
Internal Revenue Service

Colin Campbell
Chief Attorney-Advisor
Department of the Treasury (Office of Tax Policy)

Jose Murillo
Deputy Assistant Secretary
Department of the Treasury

Kevin Nichols
International Tax Counsel
Department of the Treasury (Office of Tax Policy)

The Honorable William M. Paul
Acting Chief Counsel
Internal Revenue Service

James Wang
Attorney-Advisor
Department of the Treasury (Office of Tax Policy)

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

Brett York
Deputy Tax Legislative Counsel
Department of the Treasury

Brenda Zent
Special Advisor
Department of the Treasury (Office of Tax Policy)

Report No. 1457

New York State Bar Association

Tax Section

Report on the Application of Section 382 to Foreign Corporations

January 18, 2022

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I. Introduction

This report ("**Report**")[1] of the Tax Section of the New York State Bar Association discusses the application of Section 382 to foreign corporations that undergo an ownership change as defined in Section 382(g) and the Regulations thereunder.[2] In particular, this Report discusses issues relating to the application of Section 382 to controlled foreign corporations ("**CFCs**") that are not engaged in a US trade or business.[3] As discussed below, ultimately, our recommendation to the Internal Revenue Service ("**IRS**" or "**Service**") and the Department of Treasury (together with the IRS, "**Treasury**") is that there should be some form of limitation on the use of CFC attributes when a CFC is acquired, and while the application of Section 382 to CFCs has material flaws, unless and until a new regime is enacted by Congress, the Section 382 regime (with certain modifications) is likely the best available option. We would be happy to consider further options to limit the use of CFC attributes in the case of statutory amendments allowing for such options.

This Report generally starts by (i) assuming Section 382 applies to CFCs (or will, pursuant to Regulations, apply) and discussing *how* it should apply, and then (ii) discussing *whether* Section 382 should apply to CFCs.[4] This Report does not take a position on whether, under current law, Section 382 applies to a CFC not engaged in a US trade or business, or on other ancillary issues under current law, such as whether a CFC's Section 382 limitation would be determined based upon a zero stock value pursuant to Section 382(e)(3) if the CFC is not engaged in a US trade or business. Any reference to current law regarding such issues is solely for ease of discussion.

[1] The principal authors of this Report are James Coss, Andrew Herman, and Brian Krause, with substantial contributions from Joshua Goldstein, Valentine Lysikatos Carey, and Christina Tacoronti. Helpful comments were received from William Alexander, Peter Benesch, Kim Blanchard, Robert Cassanos, Peter Connors, Kevin Glenn, Marty Hamilton, Kevin Jacobs, Michael Schler, Joseph Toce, Shun Tosaka, Phillip Wagman, Gordon Warnke, and Lee Zimet. This report reflects solely the views of the New York State Bar Association Tax Section and not those of the New York State Bar Association's Executive Committee or its House of Delegates.

[2] Unless otherwise indicated, all "**Section**" references are to the Internal Revenue Code of 1986, as amended as of the date hereof (the "**Code**"), and all "**Reg. §**" and "**Regulations**" references are to the Treasury Regulations promulgated thereunder.

[3] This Report follows our prior report No. 1394, dated May 4, 2018, which discusses the "GILTI" provisions of the Code enacted as part of the legislation informally known as the Tax Cuts and Jobs Act (the "**Act**"), including issues arising under Section 382 if carryover of tested losses of a CFC were to be allowed. 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). *See* New York State Bar Association Tax Section Report No. 1394, *Report on the GILTI Provisions of the Code* (May 4, 2018) (hereinafter, the "**GILTI Report**"). For additional discussion of the application of Section 382 to CFCs, *see* Wagman, "(How) Should Section 382 Apply to Foreign Corporations?" Tax Forum No. 713 (Mar. 2021) (available from the author upon request).

[4] The introductory material of this Report, including Part II.C., sets out a framework for limiting CFC attributes – whether and how it should be done. Then, as noted above, *how* Section 382 should apply is discussed before circling back to analyze *whether* it should apply.

II. Summary of Recommendations

The Report's recommendations are the following:[5]

1. Consistent with our prior recommendations and the approach adopted in Reg. §1.382-3(j), any rules concerning the application of Section 382 should be informed by the Purposive Approach. These rules should be (i) tailored to address circumstances where abuses are most likely to occur, (ii) provide clear and administrable mechanical standards that do not rely on subjective intent, and (iii) adequately protect the policy interests underlying Section 382 without causing undue burden or complexity on taxpayers. Accordingly, only owner shifts involving an Inclusion Shareholder should be taken into account. In particular, owner shifts of a CFC should only be taken into account in determining whether an ownership change has occurred to the extent that an Inclusion Shareholder (in the case of an Inclusion Shareholder that is an individual), or a public group that indirectly owns the CFC stock through ownership of an Inclusion Shareholder (in the case of an Inclusion Shareholder that is a domestic entity), increases its ownership percentage of CFC stock. This rule would be consistent with the Purposive Approach adopted by Reg. §1.382-3, and would further Anti-Trafficking Policy and Averaging Policy. Further, in the case of acquisitions of CFC stock by multiple related acquirors, the percentage increase by an Inclusion Shareholder, directly or indirectly, should include the percentage increase of the related acquirors (whether or not such related acquirors are Inclusion Shareholders) during the three-year testing period.

2. Similar to Section 382 in the domestic context, an owner shift of a CFC should include an indirect acquisition. In particular, an owner shift should include the direct or indirect acquisition by any 5% shareholder (including a public group) of an equity interest in a corporate (or partnership) Inclusion Shareholder to the same extent such acquisition would be an ownership change if the CFC were a domestic corporation. Thus, there should be no special rule preventing such acquisitions from being an owner shift, even if the Inclusion Shareholder owns 100% of the CFC before and after the acquisition. Although the justification for this rule would be most persuasive in the case where a consolidated group acquires a domestic target corporation that owns CFCs with US tax attributes, such as Example 2b below, this rule should apply to any acquisition of an interest in an Inclusion Shareholder even outside of the consolidated group context, such as Example 2a, because even in such a context, trafficking is plausible.

3. The ownership percentage point threshold for an ownership change should not be different for a CFC than it is for a domestic corporation (i.e., such threshold should remain at 50 percentage points).

4. Owner shifts involving Inclusion Shareholders that are individuals should be taken into account in the same manner as owner shifts involving Inclusion Shareholders that are

[5] Certain capitalized terms used in the Summary of Recommendations are defined further below.

corporations, and an individual's pro rata share of CFC items should be affected by a Section 382 ownership change the same way as a corporation's pro rata share would be affected.

5. To the extent an ownership increase is excepted from contributing to an owner shift for purposes of Section 382 because the acquiror is a non-Inclusion Shareholder, a subsequent direct or indirect transfer within five years of the original acquisition by the non-Inclusion Shareholder to an Inclusion Shareholder should be taken into account as an owner shift (even if such subsequent transfer, by itself, would not be an owner shift under normal Section 382 rules). In such a case, while there are several different potential methodologies for the timing of the ownership change, the NUBIG/NUBIL determination, and the RBIG/RBIL recognition period, a sensible approach would measure NUBIG/NUBIL and begin the recognition period for RBIG/RBIL at the time of the original acquisition and would treat the owner shift (and ownership change) as occurring at the time of the subsequent transfer. Alternatively, measurement of NUBIG/NUBIL and the beginning of the RBIG/RBIL recognition period could also be at the time of the subsequent transfer. In any case, because of the problems associated with a retroactive ownership change, the owner shift should take place as of the subsequent transfer.

6. Owner shifts during the testing period of a non-CFC foreign loss corporation that subsequently becomes a CFC should be taken into account for purposes of determining whether there has been an ownership change of a CFC.

7. Treasury should exercise the grant of regulatory authority under Section 382(m) to clarify that CFCs are permitted to carryforward all disallowed RBIL, regardless of whether associated with a US trade or business. This clarification should not require Congressional legislation because Section 382(h)(4) says that RBIL is carried forward under rules "similar" to the rules for NOLs. It does not require that the rules be identical.

8. Treasury should resolve any uncertainty in the area of determining the equity value of a CFC for purposes of the Section 382 limitation, and should exercise its authority to issue Regulations under Section 382(e)(3) permitting a CFC to include the value of non-ECI items. The approach we would recommend is to segregate a foreign corporation's US branch from its remaining operations. Separate equity values would be computed for each as if they were held by separate and distinct corporations and the CFC would have separate Section 382 limitations with respect to its US trade or business activities and its other activities.

9. The majority of members of the Executive Committee of the Tax Section have significant concern that using the Segregated Approach, under which a separate Section 382 limitation would be determined for GILTI and Subpar F assets, would be very difficult and perhaps impracticable. They believe that using the Aggregate Approach, under which a single Section 382 limitation would be determined and then allocated between GILTI and Subpart F income using current allocation and apportionment rules, would be far less difficult to administer. Accordingly, we recommend Treasury issues guidance adopting the Aggregate Approach. However, if instead Treasury was to determine that the Segregated Approach or a similar approach should be adopted, then we recommend that Treasury issues clear and pragmatic guidance on categorizing assets as GILTI or Subpart F assets.

10. Other than the Interest Carryforwards, built-in losses, and the pre-change portion of current year losses (in the case of a mid-year acquisition of a corporate Inclusion Shareholder), Section 382 should not apply to other CFC attributes.[6]

11. The current regulatory framework for treatment of non-consolidated controlled groups of corporations should continue to apply and, if there is an ownership change of a corporate Inclusion Shareholder which owns a CFC, Regulations should retain the taxpayer electivity in Reg. §1.382-8 as to which Section 382 limitation (the corporate Inclusion Shareholder's or the CFC's) benefits from the value of CFC stock.

12. Section 382 should apply directly to the CFC, as opposed to the CFC's attributes being considered attributes of a corporate Inclusion Shareholder.

13. When 100% of the stock of multiple CFCs is acquired from a single seller (or single consolidated group) in an ownership change, the Section 382 limitation should be calculated on an aggregate basis. Further, assuming the Section 382 limitation is calculated on an aggregate basis when 100% of the stock of multiple CFCs is acquired from a single seller (or single consolidated group) in an ownership change, NUBIG/NUBIL should similarly be calculated on an aggregate basis.

14. If the Section 382 limitation and NUBIG/NUBIL are determined on an aggregate basis, then the aggregate basis should apply by reference to a CFC group. A CFC group should be comprised of the CFCs acquired from a single seller (or single consolidated group) in a single transaction (or series of related transactions), where an amount of stock satisfying Section 1504(a)(2) (i.e., 80% vote and 80% value) of each CFC is owned by the acquiror (or by a related person) after the acquisition.

15. There should be some form of limitation on the use of CFC attributes when a CFC is acquired, and while the application of Section 382 to CFCs has material flaws, unless and until a new regime is enacted by Congress, the Section 382 regime (with certain modifications) is likely the best available option. Despite its imperfections, Section 382 is an existing system which appears to literally apply, is intended to police the type of loss trafficking that can occur in the acquisition of a CFC, and there is significant statutory authority to alter the domestic rules to more narrowly tailor Section 382 to the CFC context and address loss trafficking transactions

[6] On November 19, 2021, the US House of Representatives passed a reconciliation bill commonly referred to as the Build Back Better Act (the "**House Bill**"). *See* H.R. 5376, 117th Cong. (2021). The House Bill provides for a jurisdiction-by-jurisdiction approach to tested losses and allows the carryforward of unused tested losses. On December 11, 2021, the Senate Finance Committee Chair Ron Wyden released text of the Finance Committee's updated draft of the Build Back Better Act (the "**Wyden Bill**"). The Wyden Bill also provides for a jurisdiction-by-jurisdiction approach to tested losses and allows the carryforward of unused tested losses.

In addition, both the House Bill and the Wyden Bill provide that the definition of a pre-change loss under Section 382(d) includes the carryforward net tested loss by adding at the end of Section 382(d) the following new paragraph: "(4) the term 'pre-change loss' shall include any excess carried over under section 951A(c)(3) under rules similar to the rules of paragraph (1)." *See* House Bill §138126; Wyden Bill §128126.

If this legislation or substantially similar legislation is passed, the application of Section 382 to such attributes should be revisited. The House Bill, the Wyden Bill, any other legislative proposals currently being discussed, and their implications for Section 382, are beyond the scope of this Report.

in which abuse is most likely to occur. Moreover, the potential alternative loss limitation regimes that have been identified have equal or greater flaws. We would be happy to consider further options to limit the use of CFC attributes in the case of statutory amendments allowing for such options.

16. SRLY would not sufficiently police loss trafficking in the CFC context and should not be used in place of Section 382.

17. Section 384 could potentially police loss trafficking in the CFC context, but its application would be limited to at-least 80% acquisitions or Section 381 transactions. Further, there is limited statutory authority to alter Section 384 in order to narrowly tailor it to transactions involving CFCs. If Treasury wants to adopt a "halfway" approach, Section 384 is a possibility, because it would capture the most basic transaction where loss trafficking motivates an acquisition (e.g., USP owns CFCs with built-in gains, and so acquires CFCs with built-in losses to offset the built-in gains). However, there would be significant obstacles, given its limited application and its narrow focus.

III. Background

A. <u>Section 382</u>

Section 382 Generally

Section 382 places an annual limitation on the amount of taxable income a loss corporation that has undergone an ownership change may offset using its pre-ownership change net operating losses ("**NOLs**") and certain other tax attributes (the "**Section 382 limitation**"). For these purposes, a "**loss corporation**" includes any corporation entitled to use a NOL, a net unrealized built-in loss in its assets ("**NUBIL**"), a capital loss carryover, a carryover of excess foreign tax credits under 904(c), a carryover of general business credits or minimum tax credits under Sections 39 or 53, or any corporation entitled to use a business interest expense carryforward under Section 163(j).[7]

Whether an ownership change has occurred is determined based on changes in ownership of the loss corporation by individuals that own 5% or more of the loss corporation. A transaction that causes a change in such 5% shareholder's ownership is called an "**owner shift**."[8] Specifically, under Section 382(g)(1), an ownership change occurs if, immediately after any owner shift or any

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[7] Sections 382(k)(1), (h)(3)(B); Reg. §1.382-2(a). NUBIL is defined as the amount by which the aggregate adjusted basis of the loss corporation's assets immediately before the ownership change exceeds the fair market value of its assets at the time. Section 382(h)(3)(A)(i). If the NUBIL is less than a threshold de minimis amount, the loss corporation has a NUBIL of zero. Section 382(h)(3)(B). Generally, for purposes of this Report, the same definition of "loss corporation" applies to CFCs; however, a CFC does not have, and is not entitled to use in a meaningful way, all of the attributes that a domestic corporation is entitled to use. Which attributes should be subject to limitation is discussed below in Part IV.C. The definition of "loss corporation" naturally should derive from which attributes are subject to limitation, meaning that a CFC is a loss corporation if it is entitled to use one or more of such attributes.

[8] Reg. § 1.382-2T(e)(1).

equity structure shift, the percentage of stock of the loss corporation owned by one or more 5% shareholders has increased by more than 50 percentage points over the lowest percentage of stock of the loss corporation owned by such shareholders over the three-year period ending on the day of any owner shift (the "**testing period**").

The Regulations generally provide that individuals who directly or indirectly own 5% or more of a loss corporation's stock are considered 5% shareholders.[9] Accordingly, corporations, partnerships, or other legal entities that own shares of the loss corporation are not considered 5% shareholders themselves. Instead, the owners of such entities are considered as owning their proportionate share of the loss corporation stock held indirectly through such entities.[10] In addition, groups of individuals, entities, or other persons each of whom owns less than 5% of the loss corporation are generally aggregated together and treated as a 5% shareholder (a "**public group**").[11] Finally, if an entity directly or indirectly owns 5% or more of the loss corporation, but no shareholder owns 5% or more of the loss corporation indirectly through such entity, the owners of the entity are grouped together into a separate public group.[12] Transfers of the loss corporation stock within a public group are not taken into account for purposes of determining whether there has been an ownership change.[13]

The Section 382 limitation for a given taxable year is generally equal to the product of (a) the fair market value of the corporation's stock at the time of the ownership change and (b) the long-term tax-exempt rate in effect at the time of the ownership change.[14] If the Section 382 limitation for a given year is greater than the loss corporation's taxable income, the excess limitation is carried forward to the following years.[15]

In the case of a foreign corporation, Congress added Section 382(e)(3) as part of the Technical and Miscellaneous Revenue Act of 1988. Section 382(e)(3) provides that:

> Except as otherwise provided in regulations, in determining the value of any old loss corporation which is a foreign corporation, there shall be taken into account only items treated as connected with the conduct of a trade or business in the United States.

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[9] Each 5% shareholder's percentage ownership is determined by reference to the value of the shares of the loss corporation's stock owned directly and indirectly by such shareholder, relative to the value of all of the loss corporation's outstanding stock. Section 382(j)(6)(C).

[10] Section 382(l)(3)(A)(ii); Reg. §1.382-2T(h)(2). Other attribution rules, for example, with respect to options or members of the same family, also apply. Reg. §1.382-2T(h).

[11] Reg. §1.382-2T(g)(1). In addition, certain transactions, such as issuance of loss corporation stock, generally create additional segregated public groups. Reg. §1.382-2T(j)(2)(iii).

[12] Reg. §§1.382-2T(j)(1)(iv), -2T(g)(1)(ii).

[13] Reg. §1.382-2T(e)(1)(ii).

[14] Section 382(b)(1).

[15] Section 382(b)(2).

This rule appears designed to ensure that the Section 382 limitation is calculated with reference to only the assets and liabilities of the foreign corporation's US branch. The legislative history refers to Section 382(e)(3) as one of a number of technical corrections to Section 382, including refining the methodology for computing the value of a loss corporation's stock for purposes of determining the Section 382 limitation. Specifically, the House and Senate reports state:

> The bill also clarifies that if the old loss corporation is a foreign corporation, except as provided in the regulations its value shall be determined taking into account only assets and liabilities treated as connected with the conduct of a trade or business in the United States.

There is no other explanation of the provision in the legislative history. In addition, Treasury has not issued any proposed or final Regulations under Section 382(e)(3) and there is little other guidance relating to its application.

Finally, Section 382(h) provides special rules addressing the treatment of gains and losses that are built-in at the time of the ownership change if such built-in gains and losses are recognized during the five-year period after the ownership change (the "**recognition period**", and such gains and losses, "**RBIG**" and "**RBIL**," respectively).[16] If a loss corporation has a NUBIG, the Section 382 limitation for any taxable year in which such NUBIG becomes an RBIG (i.e., is recognized), is increased by the amount of RBIG for that year.[17] The aggregate increase is limited to the NUBIG.

If a loss corporation has a NUBIL, the aggregate RBIL is subject to limitation as if it were a pre-change loss to the extent it does not exceed the NUBIL.[18] Section 382(h)(2)(B) specifies that any amount allowable as depreciation, amortization, or depletion is treated as RBIL to the extent it is attributable to a built-in loss in the applicable property as of the time of an ownership change.[19]

On September 9, 2019, Treasury issued proposed Regulations under Section 382(h) addressing the treatment of built-in gain or loss. Under these proposed Regulations, dividends and inclusions of global intangible low-taxed income ("**GILTI**") under Section 951A that are recognized by a loss corporation with respect to a CFC during the five-year recognition period are not treated as RBIG. A loss corporation's Subpart F inclusions under Section 951 and gains taxable as dividends under Section 1248 are similarly excluded from being treated as RBIG.[20]

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[16] A loss corporation cannot have both a NUBIL and a net unrealized built-in gain ("**NUBIG**"). NUBIG is defined as the amount by which the aggregate fair market value of the loss corporation's assets immediately before the ownership change exceeds the aggregate adjusted basis of its assets at that time. Section 382(h)(3)(A)(i). Like with NUBIL, if a loss corporation's NUBIG is less than a threshold de minimis amount, then the NUBIG is zero. Section 382(h)(3)(B). NUBIL and NUBIG are calculated on a separate-company basis, except in the consolidated group context.

[17] Section 382(h)(1)(A)(i).

[18] Section 382(h)(1)(B)(i) and (ii).

[19] Section 382(h)(1)(B).

[20] Prop. Reg. §1.382-7(d)(2)(ii). For a detailed discussion of the proposed Regulations, see New York State Bar Association Tax Section Report No. 1426, *Report on Proposed Regulations under Section 382(h) Related to Built-in Gain and Loss* (Nov. 11, 2019).

Legislative History

Section 382 was originally enacted in 1954 to address what were perceived as abusive transfers of loss corporation stock. Prior to 1954, the Service's primary weapon to address loss trafficking was the predecessor to Section 269. Section 269 generally disallows an NOL deduction or other tax benefit if control of a corporation is acquired and "the principal purpose" of such acquisition is evasion or avoidance of federal income tax by "securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy."[21] Prior to enactment of Section 382, the Service was consistently unsuccessful in establishing the requisite subjective "the principal purpose" standard in litigation.[22] Accordingly, Section 382 gives the Service a set of mechanical rules to supplement the subjective standards of Section 269.[23] Section 382 was substantially changed by the Tax Reform Act of 1986.[24]

The legislative history to the Tax Reform Act of 1986 makes clear that the purpose of the Section 382 limitation is to restrict the function of NOL carryforwards as a device for transferring tax benefits (the "**Anti-Trafficking Policy**")[25] and to preserve the integrity of the carryover provisions as an averaging system (the "**Averaging Policy**").[26] Inherent in the loss limitation rules of Section

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[21] Section 269(a).

[22] *See, e.g., Commodores Point Terminal Corp.*, 11 T.C. 411 (1948); *Alcorn Wholesale Co.*, 16 T.C. 75 (1951), *Berland's Inc.*, 16 T.C. 182 (1951); *Chelsea Prods. Inc.*, 16 T.C. 840 (1951); *WAGE, Inc.*, 19 T.C. 249 (1952). Often, when the court found the acquisition to be motivated by a business purpose, the principal purpose test could not be met.

[23] H.R. Rep. No. 1337 83rd Cong., 2d Sess. 41 (1954), *reprinted* in 1954 U.S. CODE CONG. & ADMIN. 4017, 4057 notes that the previous loss trafficking rules had been "ineffectual" because of the "necessity of providing that tax avoidance was the primary purpose of the transaction." The report goes on to note that:

> The committee added a provision designed to limit undue tax benefits of this character by restricting the amount of net operating loss carryover which may be deducted where 50 percent or more of the participating interest in a corporation was acquired by new owners. . . . This special limitation on net operating loss carryovers provides *an objective standard* governing the availability of a major tax benefit which has been abused through trafficking in corporations with operating loss carryovers.

(Emphasis added).

[24] P.L. 99-514, 100 Stat. 85 (1986). Prior to the Tax Reform Act of 1984, Section 382 applied different rules to taxable acquisitions and tax-free reorganizations.

[25] H.R. Rep. No. 426, 99th Cong., 1st Sess. 256 (1985) provides:

> The primary purpose of the special limitations on the use of NOL carryforwards is to restrict the function of carryforwards to that of an averaging device. This purpose is not well served by present law rules that present opportunities for tax benefit transfers. The committee concluded that the special limitations on the use of NOL carryforwards should be revised to reduce the number of circumstances in which NOL carryforwards can be used as a device for transferring tax benefits.

[26] S. Rep. No. 313, 99th Cong., 2d Sess. 230-31 (1986) provides:

> The primary purpose of the special limitations is the preservation of the integrity of the carryover provisions. The carryover provisions perform a needed averaging function when they smooth out the distortions caused by the annual accounting system. If, on the other hand, carryovers can be

382 is the goal of preventing the loss corporation from obtaining a greater benefit from its losses attributable to the period of time before the ownership change (the "**pre-change period**") than it would have obtained had the change not occurred. This is referred to as the "**neutrality principle**."[27]

Although the applicability Section 382 depends on the extent to which 5% shareholder's ownership interests in the corporation change within the testing period, the identity of the shareholder is generally not relevant because Anti-Trafficking Policy and Averaging Policy are typically implicated regardless of who the parties to the owner shift are. In Notice 2010-49,[28] however, the Service requested comments regarding potential modifications to the treatment of less than 5% shareholders ("**Small Shareholders**") under Section 382, and in so doing the Service identified cases where the policies are not implicated in the same way depending on the parties to the owner shift. Notice 2010-49 states that the proper treatment of Small Shareholders depends upon the policy considerations underlying Section 382, and it sets forth two general approaches for modifying the Regulations. While both approaches are informed by the same policy concern—preventing an acquisition of loss corporation stock followed by the contribution of income-producing assets or the diversion of income-producing opportunities to the corporation—the approaches differ "in the extent they seek to identify and limit their effect to circumstances in which that abuse is most likely to occur."[29]

Under the "**Ownership Tracking Approach**," all changes in ownership are generally tracked without regard to whether the shareholders who increase their ownership are Small Shareholders or 5% shareholders. This approach "ensures that abusive transactions are addressed by tracking all changes in ownership without regard to their particular circumstances."[30] As a result, a transaction that results in an increase in ownership interests by Small Shareholders would generally result in the segregation of these Small Shareholders into a new public group, except where public trading among Small Shareholders causes such tracking to be unduly burdensome. Thus, for example, while public trading between Small Shareholders is not taken into account under the Ownership Tracking Approach as a matter of administrative convenience, the sale of stock by a 5% shareholder to Small Shareholders would cause these Small Shareholders to be segregated into a new public group under the Ownership Tracking Approach, as it "is not unduly burdensome for

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> transferred in a way that permits a loss to offset unrelated income, no legitimate averaging function is performed. With completely free transferability of tax losses, the carryover provisions become a mechanism for partial recoupment of losses through the tax system. Under such a system, the Federal Government would effectively be required to reimburse a portion of all corporate tax losses. Regardless of the merits of such a reimbursement program, the carryover rules appear to be an inappropriate and inefficient mechanism for delivery of the reimbursement.

[27] *Id.* at 232.

[28] 2010-27 I.R.B. 10 (June 11, 2010).

[29] *Id*.

[30] *Id*.

the corporation to know that a 5-percent shareholder has reduced its ownership and that ownership interest has been acquired by Small Shareholders."[31]

By contrast, the "**Purposive Approach**," consistent with the purposes of Section 382, "seeks to identify more specifically the circumstances in which abuses are likely to arise."[32] As described in Notice 2010-49, the Purposive Approach reflects the view that "it is unnecessary to take into account all readily-identifiable acquisitions of stock by Small Shareholders, because Small Shareholders are generally not in a position to acquire loss corporation stock in order to contribute income-producing assets or divert income-producing opportunities." Consequently, rules under the Purposive Approach would disregard certain acquisitions by Small Shareholders (even if not involving public trading) that would be cognizable shifts under the Ownership Tracking Approach for purposes of Section 382. Notice 2010-49 further describes how the Purposive Approach can be applied on a limited basis only to certain transactions (e.g., stock issuances and redemptions) (the "**Limited Purposive Approach**") or can be adopted on a more complete basis (the "**Expansive Purposive Approach**").[33]

Importantly, both the Ownership Tracking Approach and the Purposive Approach implement mechanical rules and do not rely on a determination of subjective intent. The key difference is that the mechanical rules under the Ownership Tracking Approach capture all transactions that are not unduly burdensome to track, while rules under the Purposive Approach are more narrowly tailored to those situations in which the abuses Section 382 was intended to prevent are most likely to occur.

In a prior report,[34] we recommended modifications consistent with the Limited Purposive Approach, noting that this approach "is fully consistent with section 382's framework," the policy underlying the small issuance and cash issuance exceptions which disregard certain acquisitions of loss corporation stock,[35] and consistent with two additional policies underlying Section 382: (i) tax considerations should not influence corporate acquisitions and (ii) an administrable standard is

[31] *Id*.

[32] *Id*.

[33] Generally, the Expansive Purposive Approach would disregard more transactions involving Small Shareholders for purposes of Section 382 than the Limited Purposive Approach. The Expansive Purposive Approach "would be justified on the grounds that where Small Shareholders owned the shares at the beginning of the testing period and on the last testing date, no shareholder has increased its ownership interest in such a way that would allow it to engage in any abuse that § 382 was enacted to prevent." Notice 2010-49, 2010-27 I.R.B. 10 (June 11, 2010). A detailed discussion of the differences between the Limited Purposive Approach and the Expansive Purposive Approach is beyond the scope of this Report. For a more detailed discussion, *see* New York State Bar Tax Section Report No. 1238, *Report on Notice 2010-49* (March 18, 2011) (the "**2010-49 Report**"). *See also* Dimon, Limit My Practice Instead! Thoughts on Reforming Section 382, 88 Taxes 65 (Mar. 2010).

[34] The 2010-49 Report.

[35] *See* Reg. §1.382-3(j)(2), (3).

necessary to determine whether Section 382 applies.[36] In rejecting the Ownership Tracking Approach, we noted that "[w]e generally do not believe it is necessary to apply the segregation rules to identifiable transactions that do not reasonably implicate the abuses that section 382 intends to prevent."[37]

Ultimately, the government issued proposed Regulations[38] which modified the existing regulatory framework pursuant to the Purposive Approach, and these Regulations were finalized in 2013.[39] These Regulations (i) turn off the rule that previously created a separate public group when Small Shareholders acquired stock from a 5% shareholder or an entity that owned 5% of the loss corporation; (ii) add a new exception for small redemptions; and (iii) generally exempt from the segregation rules transactions involving stock in an entity that itself owns 10% or less of the loss corporation's stock.[40]

The preamble to the proposed Regulations explained that:

> these proposed regulations are intended to lessen the administrative burden and section 382 implications associated with transactions that are unlikely to implicate section 382 policy concerns. In general, these proposed regulations employ objective criteria to implement the Purposive Approach. The IRS and the Treasury Department believe that, where practicable, objective rules best serve the interests of loss corporations that desire certainty with respect to their section 382 positions, and best serve the interests of the government in fairly and consistently administering a complex statutory scheme.[41]

The preamble further explains that:

> The IRS and the Treasury Department believe that the proposal strikes an appropriate balance between reducing complexity and safeguarding section 382 policies. The proposal will enable loss corporations to disregard indirect changes in its ownership that may, under the current regulations, require burdensome

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[36] The 2010-49 Report, at 12. For a discussion of these additional policies underlying Section 382, *see* New York State Bar Tax Section Report, *Report on the Treatment of Fluctuations in Value Under Section 382(l)(3)(C)*, at 13-15 (Dec. 22, 2009).

Section 382(l)(3)(C), at 13-15 (Dec. 22, 2009).

[37] The 2010-49 Report, at 13. As discussed in the 2010-49 Report, the Expansive Purposive Approach was rejected as it would require significant changes to the framework of Section 382, presented problems of administrability, and raised questions as to whether the government had authority to adopt this approach. *Id.* at 14-15 ("On balance, the Limited Purposive Approach is simpler and more administrable than the Expansive Purposive Approach and will sufficiently protect taxpayers in many cases from experiencing an ownership change as a result of non-abusive transactions.").

[38] Notice of Proposed Rulemaking, 76 Fed. Reg. 72362 (Dec. 16, 2011).

[39] T.D. 9638 (Oct. 21, 2013).

[40] *See* Reg. §1.382-3(j). Reg. §1.382-3(j) also excludes owner shifts involving small issuances and cash issuances.

[41] Notice of Proposed Rulemaking, 76 Fed. Reg. 72362, at 72363 (Dec. 16, 2011).

information gathering and may unnecessarily impede the loss corporation's ability to reorganize its affairs. At the same time, however, the proposal imposes criteria that protect the government's interests.[42]

[42] *Id* at 72364.

B. Taxation of Foreign Corporations

In the US tax system, a CFC with no US trade or business is generally not subject to US federal income tax. Instead, each person who is a 10% United States shareholder, as defined in Section 951(b), that directly or indirectly,[43] within the meaning of Section 958(a), owns CFC stock (an "**Inclusion Shareholder**") must include in income (i) its pro rata share of the CFC's Subpart F income for the year,[44] and (ii) its "net CFC tested income" over its "net deemed tangible income return" (the "**GILTI inclusion**"), if such Inclusion Shareholder owns stock of the CFC on the last day of the CFC's tax year on which it is a CFC.[45]

An Inclusion Shareholder's net CFC tested income is its aggregate pro rata shares of CFC tested income minus its aggregate pro rata shares of CFC tested loss.[46] The net deemed tangible income return is 10% of such shareholder's aggregate pro rata shares of CFC tangible depreciable asset basis ("**QBAI**"), less certain interest expense.[47] Under Section 250, a domestic corporation is entitled to a deduction equal to 50% of its GILTI inclusion, subject to certain limitations. Accordingly, as a general matter, the effective tax rate on the GILTI inclusion is currently 10.5% (ignoring any foreign taxes on the underlying income).[48]

Unlike a US corporation, a foreign corporation does not have NOLs, except to the extent the NOLs arise in its conduct of a U.S. trade or business.[49] Furthermore, an Inclusion Shareholder is not entitled to carryover its CFC's tested loss to offset the CFC's tested income in future tax years. Thus, under the existing GILTI regime, other than the Section 163(j) business interest expense carryforward (discussed below) and the recognition of built-in losses, an Inclusion Shareholder's ability to utilize the CFC's tested loss is limited to the current taxable year. Similarly, if a consistently loss-making CFC with no US trade or business merges or liquidates into a US

[43] Section 958(b) provides that, for purposes of, *inter alia*, Section 951(b), the constructive ownership rules of Section 318 apply with certain modifications. The House Bill and the Wyden Bill further modify the application of Section 318 by limiting downward attribution to corporations from shareholders, such that a US subsidiary would be prevented from being treated as owning stock in a foreign-owned brother-sister subsidiary under a foreign parent. This change, and others proposed in the House Bill and the Wyden Bill, are beyond the scope of this Report.

[44] Section 951(a)(1).

[45] Section 951A(b)(1). For the avoidance of doubt, for purposes of the discussion of Section 382, the term "Inclusion Shareholder" includes a shareholder that would have had a Subpart F or GILTI inclusion but for the fact that the Inclusion Shareholder disposed of its CFC stock prior to the last day of the CFC's tax year. For example, if US individual A sells 100% of the stock of CFC to US Individual B during the year, then US Individual A is an Inclusion Shareholder because it would have had a Section 951 or Section 951A inclusion had it retained the CFC stock until the end of the year.

[46] Section 951(b)(1); Reg. §1.951A-1(c)(2).

[47] Section 951A(b)(2); Reg. §1.951A-1(c)(3). The House Bill and the Wyden Bill reduce the percentage to 5% for CFCs (unless located in a US territory).

[48] This deduction will be reduced to 27.5% for tax years beginning after December 31, 2025. Section 250(a)(3)(B).

[49] Reg. §1.367(b)-3(e); Rev. Rul. 72-421, 1972 C.B. 166.

corporation, the US corporation does not inherit any NOLs (other than those effectively connected to a US trade or business).[50]

Arguably, a CFC that generates a tested loss that is not used to offset another CFC's tested income in the year, or an Inclusion Shareholder that takes into account its pro rata share of tested loss but cannot use it to offset tested income of another CFC, should be entitled to a carryforward of the unused tested loss.[51] However, the Regulations specifically provide a CFC is not entitled to a Section 172 deduction for an NOL carryforward.[52]

As part of the Act, Congress enacted Section 163(j), which limits the amount of business interest expense that may be deducted in a given taxable year. Any business interest expense ("**BIE**") not allowed as a deduction as a result of Section 163(j) is carried forward as business interest paid or accrued in the succeeding taxable years and treated as BIE in such succeeding taxable year (an "**Interest Carryforward**"). Regulations provide that a foreign corporation's ability to deduct BIE is subject to limitation under Section 163(j), generally in the same manner as that of a domestic corporation for purposes of determining the foreign corporation's taxable income.[53] In addition, Regulations generally allow an election to be made for a group of CFCs under common control, such that the CFC group is subject to a combined Section 163(j) limitation. The combined limitation is generally based on the sum of each CFC group member's separate company BIE, Interest Carryforward, business interest income and adjusted taxable income.[54] If a CFC joins a "CFC group," the Regulations impose a separate return limitation year ("SRLY") concept and allow the Interest Carryforward of the joining CFC to be used by the group to the extent the joining CFC contributes to the Section 163(j) limitation of the group.[55]

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[50] *Id.*

[51] For a more detailed discussion of the potential application of CFC NOL carryover rules, see the GILTI Report. Certain current legislative proposals have contemplated country-by-country GILTI calculations. In particular, on May 28, 2021, Treasury released the "General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals," which included, among other items, a proposal that would require GILTI to be determined on a country-by-country basis. In addition, both the House Bill and the Wyden Bill, as noted above, provide for a jurisdiction-by-jurisdiction GILTI calculation using a "taxable unit" concept, which includes separate CFCs, interests in pass-through entities, and activities of branches. The jurisdiction-by-jurisdiction method would apply to net CFC tested income, net deemed tangible income return, QBAI, and interest expense.

If legislation limits the use of tested loss such that it can only offset tested income generated by a CFC organized in the same jurisdiction, then the case for some form of loss carryover appears to be even more compelling. Indeed, both the House Bill and the Wyden Bill provide that tested losses not used to offset tested income are carried forward to the succeeding year. Further, both the House Bill and the Wyden Bill propose additional changes that could have implications for the issues discussed in this Report. Such legislative proposals and their implications on Section 382 are beyond the scope of this Report.

[52] *See* Reg. §§1.951A-2(c)(1), 1.952-2(c)(5). A CFC is also not entitled to a Section 1212 deduction for capital loss carryforwards.

[53] Reg. §1.163(j)-7(b).

[54] Reg. §1.163(j)-7(c)-(e).

[55] Reg. §1.163(j)-7(c).

C. Framework for Limiting CFC Attributes – Whether it Should be Done at All, and if so, Whether Section 382 is the Best Way to Do it

Whether Section 382 should apply to CFCs is a two-fold inquiry. First, should a loss limitation regime apply to CFCs? If so, is Section 382 the right regime? With respect to the first question, as an initial matter, there is a legitimate government interest in policing certain types of loss trafficking transactions, suggesting that some type of loss limitation regime should apply to CFCs. As a simple example, a taxpayer should not be able to acquire a foreign loss corporation with a substantial built-in loss in its assets solely for the purpose of utilizing that built-in loss to reduce the taxpayer's GILTI or Subpart F inclusions. The benefit of preventing this type of transaction must be weighed against the effectiveness of the system designed to prevent it and the complexity and any ancillary problems associated with such a system. In other words, it must be considered whether there is sufficient justification to support the application of complicated loss limitation rules to CFCs or whether existing rules sufficiently mitigate the likelihood of abuse.

The effective tax rate benefit of a particular type of attribute (and by extension, the effective tax rate on the associated income) can inform the relative importance of a provision limiting such an attribute. An Inclusion Shareholder's Subpart F income is taxed at ordinary income rates. However, the Subpart F regime is, relatively, a limited regime intended to cover only certain types of mobile or passive income, and historically has operated as a type of anti-abuse regime. This does not suggest that a loss limitation regime should not apply to the Subpart F regime, but rather is a factor in weighing policy benefits of applying a loss limitation regime against the complexity of doing so. The GILTI regime is much broader, applying to most income generated by a CFC, but is currently taxed at a lower effective rate in the case of a corporate Inclusion Shareholder because of the Section 250 deduction.[56] Furthermore, because CFCs cannot carryforward NOLs under current law,[57] the ability to traffic in CFC attributes is significantly more limited than in the case of domestic corporations. In addition, US acquirors of foreign target corporations will often make a Section 338(g) election in order to achieve basis step-up that can be used to increase QBAI and reduce tested income, as well as to cleanse any unfavorable tax attributes or history of the target. A US corporate seller might prefer a Section 338(g) election to convert unrealized gain inside the CFC from being reflected as stock gain taxed at highest marginal rates into GILTI tested income included at the lower effective rate. Because it results in the elimination of the attributes of the foreign target and the creation of a "new target" corporation, a Section 338(g) election would make any loss limitation regime inapplicable to the foreign target. Finally, if an Inclusion Shareholder's CFCs pay a high rate of foreign tax on their income and the Inclusion Shareholder

[56] On May 28, 2021, Treasury released the "General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals," which included, among other items, a proposal to increase the minimum GILTI rate. Discussion of these proposals is beyond the scope of this Report. In addition, on October 8, 2021, members of the Organisation for Economic Co-operation and Development/G20 Inclusive Framework on Base Erosion and Profit Shifting agreed to a two-pillar accord that seeks to implement a global minimum tax rate of 15%.

[57] As noted above, certain legislative proposals would allow the carry forward of net tested loss. Such proposals are beyond the scope of this Report.

is able to take a foreign tax credit with respect to the foreign tax paid, then the Inclusion Shareholder would have significantly less incentive to traffic in attributes that would reduce its share of CFC income. For example, if an Inclusion Shareholder is in an "excess credit" position with respect to GILTI, then an additional GILTI inclusion might allow taking additional foreign tax credits.

On the other hand, an acquiror can benefit from a target CFC's attributes in what appears to be an improper manner, in that the economic losses or expenditures giving rise to such tax attributes did not accrue during the acquiror's ownership period. Without a limitation regime, any built-in loss assets and Section 163(j) carryforwards would become eligible to the acquiror, regardless of the year in which those attributes arose. In the case of a mid-year acquisition of a corporate Inclusion Shareholder (e.g., USP, which has its own CFCs, acquires UST, which also has its own CFCs[58]), an acquiror can benefit from the current year tested loss of the corporate Inclusion Shareholder's CFCs. Similarly, an acquiror can cause one of its CFCs to acquire the assets of a foreign target corporation in a Section 381 transaction, and thus cause its CFC to succeed to the tax attributes of the foreign target. The loss importation rules of Section 334(b)(1)(B) and Section 362(e)(1) do not prevent this because they do not apply to a CFC acquiring corporation or parent corporation.[59] The foregoing could lead to loss-generating assets being transferred to a CFC in a manner inconsistent with Averaging Policy and Anti-Trafficking Policy. Overall, the government does appear to have a legitimate interest in policing trafficking of tested losses and other attributes of CFCs and we believe that a loss limitation regime should apply.

Determining what regime should apply is another difficult question. As explored in detail in this Report, although Section 382 was not designed to apply to CFCs, and adapting it for this purpose creates significant complexity, we nonetheless believe that Section 382 is the most appropriate loss limitation regime that is currently available.

At a minimum, Section 382 is an existing system which appears to literally apply, is intended to police the type of loss trafficking that can occur in the acquisition of foreign loss corporations, and there is significant statutory authority to alter the existing rules to more narrowly tailor Section 382 to the CFC context. Thus, absent the creation of a new regime, we believe that Section 382 provides the best existing framework to protect the fisc and discourage trafficking in the attributes of foreign loss corporations.

If Treasury is interested in exploring a new loss limitation regime that would apply to CFCs, we would be pleased to explore this further in a future report. For example, because the Inclusion Shareholder, not the CFC, is subject to US tax, a shareholder-level regime might provide a better

[58] Although UST's year would end upon joining the USP consolidated group, this is referred to in this report as a "mid-year acquisition" because the years of UST's CFCs do not end upon UST joining the USP consolidated group.

[59] Sections 334(b)(1)(B) and 362(e)(1) generally prevent a US corporation from importing an aggregate built-in loss from foreign corporations that were not previously subject to US tax by requiring that the basis of each asset be adjusted to equal the fair market value of the asset. The Regulations provide that gain or loss that would be recognized by a CFC or PFIC is not considered subject to US tax for these rules solely because it could affect an inclusion under Subpart F or the PFIC rules, and thus, a transfer to a CFC would not be subject to these loss importation rules, but a transfer from a CFC to a US corporation *would* be subject to these rules. *See* Reg. §1.362-3(d)(3).

alternative (although a shareholder regime might cause even greater complexity than Section 382). For example, such a regime could require an Inclusion Shareholder to compute its pro rata share of its Subpart F and GILTI inclusions without regard to the CFCs pre-existing built-in losses. Alternatively, the acquiring Inclusion Shareholder could be required to step down its pro rata share of CFC asset basis to its fair market value under rules analogous to Section 743(b). As another example, Section 362(e)(1) could be augmented and modified to address the importation of built-in losses for transactions that are not currently addressed, such as the contribution of a CFC with built-in loss assets by a foreign parent to its domestic subsidiary. Such possibilities are discussed in part below, but are fairly disconnected from any currently applicable regime and thus would be better addressed in response to a legislative change contemplating such a system. In contrast, Section 382(m) appears to grant Treasury broad authority to issue Regulations under Section 382, making the application of Section 382 to CFCs an easier lift in comparison.

In any case, a shareholder-level regime would not reduce complexities, and in many cases, could significantly increase the administrative burdens as it would require shareholder-level determinations of numerous CFC attributes that are currently calculated at the CFC level.

Another possible regime discussed below is Section 384. While Section 384 would govern a narrower set of transactions (generally, 80% stock acquisitions and Section 381 transactions) and a narrower scope of limitation (the limitation only applies to the extent the pre-change losses of the target/acquiror would be used to offset built-in gain of the acquiror/target, respectively), it could be a "halfway" approach that catches many of the most abusive cases. However, Section 384 provides limited regulatory authority, and there have been no Regulations promulgated under Section 384, meaning that a robust application of Section 384 to CFCs could prove difficult.

The remainder of this Report first discusses *how* Section 382 should apply, followed by further discussion of *whether* it should apply.

IV. Discussion

A. Relevant Owner Shifts and Other Ownership Change Mechanics

As described above, the identity of the shareholder is generally not relevant to the application of Section 382, in that any shareholder, whether US or foreign, taxable or tax-exempt, individual or corporate, can benefit in its capacity as a shareholder from acquiring stock of a corporation with tax attributes (e.g., by contributing income-producing assets into, or diverting income-producing opportunities to, the corporation). In contrast, in the GILTI and Subpart F regimes that govern CFCs and their US shareholders, the identity of the shareholder is of utmost importance, because it is the shareholder (and only certain shareholders), and not the CFC itself, that includes the income items of a CFC, pursuant to an inclusion regime. Thus, foreign shareholders and tax-exempt shareholders (as well as US taxable shareholders that actually or constructively own less than 10% of a CFC[60]) generally are not concerned with taxable income of a CFC, because they do not have tax liability arising from the inclusion regimes. Considering these differences, assuming that Section 382 applies (or will, pursuant to Regulations, apply) to a CFC not engaged in a US trade or business, one of the threshold issues is whether the rules for determining when a loss corporation undergoes an ownership change should apply to CFCs in the same manner that they apply to domestic loss corporations – in particular, whether all shareholders, or only certain shareholders, should be taken into account when determining whether an ownership change has occurred.

In order to determine whether an ownership change has occurred, Treasury can follow either the Purposive Approach or the Ownership Tracking Approach to identify which owner shifts are relevant. In this context, the Purposive Approach will try to police acquisitions that generally implicate loss trafficking in attributes of a CFC that an Inclusion Shareholder is able to access, whereas the Ownership Tracking Approach will more closely follow all trackable transactions, regardless of the particular circumstances.

1. Whether Owner Shifts Should be Limited to Inclusion Shareholders

<u>Issue</u>: *Should relevant owner shifts be the same as in the domestic context (i.e., identity of shareholders not relevant)? Or should owner shifts be limited to only those shareholders that can conceivably traffic in attributes (i.e., Inclusion Shareholders)?*

As described above, Section 382 was enacted to prevent trafficking in tax benefits and preserve the integrity of the NOL carryover provisions. Even where a shareholder of a domestic loss corporation is tax exempt (e.g., under Section 501(c)(3)) or is a non-US person without a US trade or business, the attributes of the loss corporation can still be utilized by the loss corporation to offset its own income that would otherwise be subject to US tax and thus economically benefit the shareholder. Because these attributes provide a direct benefit to the loss corporation through the reduction of its tax liability and an indirect benefit to the shareholder through increased equity value (regardless of the tax status of the shareholder), there is an incentive for any shareholder to traffic in loss attributes. Thus, acquisitions of loss corporation stock by tax-indifferent shareholders implicates Anti-Trafficking Policy. Consistent with this, Section 382 in the domestic context does not distinguish between the types of shareholders that acquire stock in a loss corporation, and instead it looks to whether a specific amount of stock in a loss corporation is acquired by large shareholders, regardless of their tax status, over a specific time period.

By contrast, the taxable income of a CFC loss corporation is only included by an Inclusion Shareholder, and generally only an Inclusion Shareholder can benefit from a CFC's tax attributes by contributing income-producing assets to the CFC. Only the Inclusion Shareholder is subject to US federal income tax under the Subpart F and/or GILTI rules with respect to such CFC loss corporation. Thus, to the extent a CFC loss corporation is owned by shareholders other than Inclusion Shareholders (or it does not have an Inclusion Shareholder, because it is a CFC by reason

[60] Such shareholders are taxed upon receiving distributions from a CFC, and thus are concerned with earnings and profits ("**E&P**") of a CFC. Section 382 generally does not apply for E&P purposes, and E&P can be favorable to certain shareholders, typically domestic corporations, with respect to certain transactions.

of constructive ownership), its attributes cannot be used to offset income that will be taxed in the US pursuant to an inclusion regime. To such extent, unlike in the case of a domestic loss corporation, the US government is not effectively "reimbursing" any party for the tax attributes of the CFC loss corporation because the transfer has not occurred "in a way that permits a loss to offset unrelated income."[61] Thus, Averaging Policy is not violated by the acquisition of CFC stock by a non-Inclusion Shareholder. Similarly, because only an Inclusion Shareholder could traffic in attributes of a CFC loss corporation, Anti-Trafficking Policy would limit the application of Section 382 with respect to CFCs to acquisitions of CFC loss corporation stock by Inclusion Shareholders. Such an approach would be consistent with the way Section 382 treats certain other transactions that do not appear to be motivated by loss trafficking.[62] In particular, in the domestic context, Section 382 follows the Purposive Approach in certain situations to track only transactions that would violate Averaging Policy or Anti-Trafficking Policy. As discussed above, final Regulations under Section 382 were issued that employ objective criteria to allow loss corporations to disregard certain changes in its ownership by Small Shareholders because such changes in ownership do not implicate the policy considerations behind Section 382.

Section 382, as applied in the domestic context, effectively presumes a loss trafficking intent of acquirors by setting forth an objective definition of ownership change, and then carving back certain acquisitions that do not appear to violate Averaging Policy or Anti-Trafficking Policy (with the carve-backs still being objective and mechanical). This helps the Service administer the rule, because requiring a proof of taxpayer intent is difficult.[63] Furthermore, in the domestic context, loss trafficking is possible for any shareholder, as any shareholder can benefit from owning a domestic corporation with valuable tax attributes. Contrast that with the CFC context, where loss trafficking is not even possible where an owner shift does not involve an Inclusion Shareholder. Where loss trafficking is not possible, making a different presumption – that certain acquisitions are <u>not</u> relevant for Section 382 – is consistent with Anti-Trafficking Policy.

Consider the following examples that illustrate the issue of whether the only relevant owner shifts of a CFC are acquisitions by Inclusion Shareholders:[64]

> **Example 1a: *Non-Inclusion Shareholder acquires 60% from another non-Inclusion Shareholder*.** A, a US person, owns 40% of the stock of FT, a foreign loss corporation, and retains this 40% interest. B, an unrelated[65] non-US person, owns the remaining 60%

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[61] *See* supra note 26 and accompanying text (discussing the legislative history to Section 382).

[62] *See generally* Section 382(l)(3)(B) (disregarding stock acquired by reason of death, gift, divorce, separation, etc. for purposes of measuring whether an ownership change has occurred); Reg. §1.382-3(j)(2) (small issuance exception); Reg. §1.382-3(j)(3) (cash issuance exception); Reg. §1.382-3(j)(14) (small redemption exception).

[63] As described above, prior to the enactment of Section 382, the Service relied on Section 269 to police trafficking of tax attributes. *See supra* note 22.

[64] Changes in proportionate interests of a loss corporation are measured by reference to stock value under Section 382(k)(6)(C). Unless otherwise specified, these examples assume that the relevant corporation has a single class of stock outstanding and all shares of stock have the same material terms. Consequently, references herein whereby percentage ownership is determined by reference to the number of shares acquired are for ease of illustration and are intended to correspond to the value of the loss corporation.

[65] Unless the context requires otherwise, a reference in this Report to a corporation that is "unrelated" to another corporation means that when a sale of loss corporation stock by one corporation to the other corporation is relevant for Section 382 (e.g., when the seller is a 5% shareholder of the loss corporation or the buyer is, or by virtue of the

of FT. FT is a CFC through downward attribution[66] because B owns 100% of the stock of a US corporation. B sells 60% of the stock of FT to C, an unrelated non-US person that also owns a domestic corporation, and FT remains a CFC.

Absent modification of Section 382 to limit the relevant owner shifts to acquisitions by Inclusion Shareholders, FT would be subject to a Section 382 limitation. However, because C is not subject to US tax (i.e., C is not an Inclusion Shareholder), it is not possible for C to utilize the attributes of FT to reduce US tax, absent a further transfer by C to a US person.[67] Moreover, the historic shareholder, A, would be burdened by FT's Section 382 limitation although its ability to utilize the tax attributes of FT has not changed. Although non-transferring shareholders can suffer from a Section 382 limitation in the domestic context, this only happens when there is an acquisition of 50% of the loss corporation by shareholders that possibly could benefit from the attributes of the loss corporation. In order to further Anti-Trafficking Policy and Averaging Policy, the statute draws a line at 50%, meaning that non-transferring shareholders can find themselves impacted in an arguably unfair manner (i.e., the statute essentially allows loss trafficking of up to 50%, but any additional loss trafficking results in a cliff effect burdening all shareholders; however, in such a case, Anti-Trafficking Policy and Averaging Policy are furthered by reason of the 50% or more that is actually transferred. In contrast, in the CFC context such as this Example 1a, application of Section 382 appears to be inappropriate because the only Inclusion Shareholder, A, retains its interest, and the 60% interest transferred is acquired by C, a person completely unable to utilize CFC's US tax attributes. Thus, neither Averaging Policy nor Anti-Trafficking Policy would be served by taking into account B's transfer to C as an owner shift and thus causing an ownership change that would detriment A.

Example 1b: *Inclusion Shareholder acquires 40% and non-Inclusion Shareholder acquires 60%.* A, US person, owns 100% of the stock of FT, a foreign loss corporation. A sells 40% of FT stock to B, an unrelated US person, and sells the remaining 60% of FT to C, an unrelated non-US person. FT remains a CFC through downward attribution because C owns 100% of the stock of a US corporation.

In this Example 1b, the 40% acquisition by B, a US person, should be an owner shift that is taken into account. The 60% acquisition by C, a non-US person, notwithstanding that it is simultaneous with the acquisition by US person B, is similar to Example 1a (Non-Inclusion Shareholder Acquires 60% from another non-Inclusion Shareholder) in that it does not violate Averaging Policy or Anti-Trafficking Policy. C, as a non-US person, cannot use any of FT's US tax attributes, and thus the loss carryforward rules of the Code are not being utilized for something more than an averaging function. In fact, the US tax attributes of FT are effectively eliminated to the extent of C's 60% acquisition. Similarly, C's acquisition does not violate Anti-Trafficking Policy, because C cannot use FT's US tax attributes, and thus would not have any interest in acquiring FT at a

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sale becomes, a 5% shareholder of the loss corporation), 100% of the shares sold represent an owner shift (e.g., there are no 5% shareholders of the loss corporation that are 5% owners of both the selling corporation and the purchasing corporation, and thus no overlap that would reduce the amount of the owner shift).

[66] As noted *supra* note 43, the House Bill and the Wyden Bill would remove downward attribution, similar to pre-2018 Section 958(b)(4). Certain examples in this Report would be analyzed materially differently if such legislative proposals were enacted in current form. Such legislative proposals are beyond the scope of this Report.

[67] *See* Example 5a below for a description of successive transfers.

premium or assigning any consideration to FT's US tax attributes. The fact that C's acquisition is contemporaneous with B's acquisition does not appear to make any difference to Averaging Policy or Anti-Trafficking Policy.

However, if B and C were related, and together B and C acquired 100% of FT, then this would implicate Anti-Trafficking Policy because B and C could rightsize B's acquisition and use related party transactions to maximize the use of FT's US tax attributes. In other words, ignoring all ownership percentages of non-Inclusion Shareholders may be underinclusive in the case of multiple related acquirors. For example, a foreign-parented group could jointly acquire stock of a CFC with its US subsidiary and ensure that the US subsidiary does not acquire more than 50% of the stock of the CFC. In that case, there would be no ownership change if looking solely to increases in ownership percentage by Inclusion Shareholders, but the Inclusion Shareholder would be able to benefit from a proportionate amount of the tax attributes of the CFC, implicating Averaging Policy and Anti-Trafficking Policy. Further, the related acquirors could engage in related party transactions and alter the capital structure in a way to maximize the Inclusion Shareholder's benefit from the acquired CFC's US tax attributes. Thus, a special rule aggregating ownership percentage increases by Inclusion Shareholders and persons related to Inclusion Shareholders would be justified.

> **Example 1c:** ***60% Issuance of stock to non-US person in a primary offering***. A, a US person, owns 100% of the stock of FT, a foreign loss corporation. FT, in a primary offering, issues 60% of its stock to B, an unrelated non-US person which owns a domestic corporation, and FT remains a CFC through downward attribution.

In the domestic context, this would be an ownership change because a new 5% shareholder, B, has acquired 60% of the loss corporation. Even if instead of B, the 60% interest was issued to the public in an IPO, the IPO would be an ownership change because the public group, treated as a single 5% shareholder, would acquire 60% of the loss corporation. In the domestic context, such results are consistent with Averaging Policy and Anti-Trafficking Policy, because B would benefit from the US tax attributes of the loss corporation by reason of lower tax liability going forward and thus increased shareholder value. Further, B could contribute income-producing assets to the loss corporation, or divert income-producing activities to the loss corporation, to maximize the utilization of its tax attributes. However, in the CFC context, if only owner shifts that increase ownership by Inclusion Shareholders are taken into account, this transaction would not be an ownership change. Although 60% of the stock of FT has been acquired by B, B is not an Inclusion Shareholder. As described below, in the CFC context, limiting relevant owner shifts in such manner is also consistent with Averaging Policy and Anti-Trafficking Policy.

On one hand, FT can use the equity capital contributed by B to purchase income-producing assets and then more fully utilize FT's US tax attributes, which would benefit A, the Inclusion Shareholder that has simply retained its FT shares.[68] Potentially, if the transaction were not an

[68] The concern that FT will use the capital infusion to purchase income-producing assets generally is not present in Example 1a because in that case shareholder C paid the consideration to shareholder B, who disposed of its shares of FT. Absent further investment from C, no extra capital is available to FT.

ownership change, this would allow A to "monetize" FT's tax attributes through the acceptance of a new investor, with the income from the newly acquired assets being offset by the pre-issuance FT tax attributes. As a result, A would be incentivized to cause FT to accept an equity investment from B, even though B does not itself have a US tax motivation.

However, B receives no benefit from the US tax attributes of FT, and so would have been willing to pay fair market value consideration for the FT stock even without any US tax attributes. Further, the price for FT stock would reflect at least the fair market value of its assets regardless of the purchaser's identify or tax status. Thus, this transaction does not appear to implicate Anti-Trafficking Policy, which typically involves a purchaser paying a premium over fair market value to acquire the tax attributes of the target (or being presumed to pay such a premium).

A question arises whether Treasury has the authority to issue Regulations modifying the definition of an owner shift to take into account only owner shifts involving Inclusion Shareholders. Section 382(m) provides that the "Secretary shall prescribe such Regulations as may be necessary or appropriate to carry out the purposes of this section and section 383, including (*but not limited to*)" five enumerated purposes (emphasis added). Although the enumerated purposes do not discuss altering which owner shifts are taken into account in the case of a CFC, Treasury changed the relevant owner shifts in Reg. §1.382-3 pursuant to the Purposive Approach. Therefore, there appears to be authority to make similar changes.[69] Further, the list is non-exhaustive and delegates authority to the Secretary "as may be necessary or appropriate to carry out the purposes" of Section 382. This grant, "as may be necessary or appropriate," is generally understood as a broad grant of authority.[70] As described above, application of Anti-Trafficking Policy and Averaging Policy differs with respect to acquisitions of domestic loss corporations and foreign loss corporations, and this supports the conclusion that different owner shifts are relevant for purposes of the application of Section 382 to a CFC.

Assuming that only owner shifts involving Inclusion Shareholders would be taken into account, the measurement of whether an ownership change has occurred would look to the aggregate increase in stock ownership by Inclusion Shareholders over the testing period.

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[69] Similarly, the Conference Report to the Tax Reform Act of 1986 further supports the notion that Congress intended a broad grant of authority under Section 382(m), stating "[t]his grant of authority contemplates any rules that the Treasury Department considers appropriate" to prevent the avoidance of the purposes of Section 382, and provides as an example potential rules that would limit the tax benefits that may be derived from certain partnership allocations to a partner that is a loss corporation, even though that loss corporation partner has not undergone an ownership change. *See* H.R. Rep. No. 99-841, vol. II, at 194 - 95 (1986) (Conf. Rep.)

[70] *See* New York State Bar Association Tax Section, *Report on Legislative Grants of Regulatory Authority* (Nov. 3, 2006) (discussing the types of grants of authority). The report provides as an example the grant of authority in Section 338(i), which provides that the Secretary "shall prescribe such regulations as may be necessary or appropriate to carry out the purpose of this Section, including" two enumerated items. The report notes that such language includes both a general grant of authority to promulgate necessary rules, as well as specific directions as to the needed rules, and that Regulations under Section 338 have been promulgated with respect to the enumerated items as well as a host of other issues, including departing, where appropriate, from certain literal statutory rules in the Section 338 consistency rules.

> **Example 1d:** ***Measuring increases by Inclusion Shareholders***. F, a non-US person, owns 100% of the stock of FT, a foreign loss corporation. In March of Year 1, F sells 40% of the stock of FT to US1, a US corporation that is owned by FP, a foreign corporation. On September 1 of Year 1, US1 sells 5% of the stock of FT to unrelated non-Inclusion Shareholder USX and sells 10% of the stock of FT to unrelated US2. As a result, as of September 1 of Year 1, US1 owns 25%, USX owns 5%, and US2 owns 10%.

On the September 1 testing date, US1, an Inclusion Shareholder, has increased its ownership in FT by 25 percentage points (0% to 25%) during the testing period (because US1 no longer owns, directly or indirectly under Section 958(a), the 5% it sold to USX and the 10% it sold to US2), and US2, an Inclusion Shareholder, has increased its ownership in FT by 10 percentage points (0 to 10%). Thus, the aggregate increase by Inclusion Shareholders over the testing period would be 35%. Although USC has increased its ownership by 5%, this increase is not taken into account because USX is not an Inclusion Shareholder.

For purposes of measuring whether an ownership change has occurred, various approaches are possible. The most straightforward approach is to include increases by Inclusion Shareholders in the numerator, while reflecting shares owned by both Inclusion and non-Inclusion Shareholders in the denominator (the "**Full Denominator Approach**"). Thus, under this approach, in Example 1d, there would be a 35% owner shift. The Full Denominator Approach is consistent with the Purposive Approach, in that it looks to all the shares of the loss corporation that could be potentially acquired with a loss-trafficking intent (i.e., all of the outstanding shares), and then measures the amount of shares that were potentially acquired with a loss trafficking intent over the testing period (i.e., aggregate increases by Inclusion Shareholders). Further, the Full Denominator Approach is consistent with the operation of Section 382 in the domestic context, in that allows presumed loss trafficking transactions, but only to the extent of 50% of the total value of the loss corporation. For example, assume that Individual A owns 40% of the stock of X, a US loss corporation, and the remaining 60% is owned by a public group. If Individual A sold 40% of the X stock to Individual B, there would still only be a 40% owner shift of X (e.g., 400 of the total 1000 outstanding shares), notwithstanding that 60% of the stock of X is held by a public group that is less able to traffic in attributes (i.e., the 600 shares held by the public group is not subtracted from the denominator).

An alternative approach would be to exclude ownership by non-Inclusion Shareholders from both the numerator (shares acquired) and denominator (total shares) (the "**Reduced Denominator Approach**"). Conceptually, the argument for the Reduced Denominator Approach is that the existence of non-Inclusion Shareholders, and transactions among non-Inclusion Shareholders, should neither benefit nor detriment the Section 382 analysis applicable to Inclusion Shareholders. However, in practice, this approach is under-inclusive in some scenarios and over-inclusive in other scenarios, as it can cause an ownership change to occur in both less-than-50% and more-than-50% acquisitions of CFCs by Inclusion Shareholders.[71]

For example, assume Inclusion Shareholder A owned 40% of FT, and non-Inclusion Shareholder B owned the remaining 60% of FT. If non-Inclusion Shareholders are completely ignored, then A's ownership percentage is already 100% (e.g., 40 shares owned out of 40 total shares deemed outstanding). Thus, if A acquired B's 60% of FT shares, A's percentage ownership would start at 100% and remain at 100%, which would not be an owner shift at all. Similarly, if instead of A acquiring B's 60% interest, FT redeemed B's 60% interest, A's deemed ownership would start and remain at 100%. The result in each of these cases *should* be an ownership change, but the Reduced Denominator Approach does not result in an ownership change, making such approach under-inclusive.[72]

The Reduced Denominator Approach can also be over-inclusive. Assume instead that FT is owned solely by non-Inclusion Shareholders but is a CFC through downward attribution. Inclusion Shareholder A acquires 10% of FT. Under the Reduced Denominator Approach, A's ownership started at 0 and became 100% (e.g., 10 shares owned out of 10 total shares deemed outstanding by ignoring the 90 shares owned by non-Inclusion Shareholders). Thus, this would be an ownership change under the Reduced Denominator Approach, but finding an ownership change on these facts would be inconsistent with Section 382 policy. An ownership change occurs when acquisitions implicating Averaging Policy or Anti-Trafficking Policy exceed 50 percentage points. Through application of the Purposive Approach, Treasury can identify which acquisitions implicate Averaging Policy or Anti-Trafficking Policy, and can exclude transactions that do not implicate those policies, but for Section 382 to apply, in all cases the relevant owner shifts must exceed 50 percentage points. Thus, the Reduced Denominator Approach is over-inclusive on these facts.

Recommendation: Consistent with our prior recommendations and the approach adopted in Reg. §1.382-3(j), any rules concerning the application of Section 382 should be informed by the Purposive Approach. These rules should be (i) tailored to address circumstances where abuses are most likely to occur, (ii) provide clear and administrable mechanical standards that do not rely on subjective intent, and (iii) adequately protect the policy interests underlying Section 382 without causing undue burden or complexity on taxpayers. Accordingly, only owner shifts involving an Inclusion Shareholder should be taken into account.[73] In particular, owner shifts of a CFC should

[71] As discussed further below, we recommend that the ownership percentage point threshold for an ownership change should not be different for a CFC than it is for a domestic corporation (i.e., such threshold should remain at 50 percentage points).

[72] This under-inclusive result could potentially be mitigated through a further alternative, which would essentially apply the Full Denominator Approach when an existing Inclusion Shareholder increases its interest in the CFC, and apply the Reduced Denominator Approach in all other circumstances. This approach seems overly complex and would still cause ownership changes to occur when less than 50% of the stock of a CFC is acquired, causing this approach to be inconsistent with the operation of Section 382 in the domestic context as well as our recommendation in this report that the ownership change threshold for CFCs should remain at 50%.

[73] For the avoidance of doubt, except as provided otherwise (e.g., discussion of certain multi-step transactions in Part IV.A.5), the analysis starts with whether there is an owner shift as defined in Section 382(g)(2) and Reg. §1.382-2T(e)(1), and if so, then this Report discusses whether certain modifications should be made to that analysis. Thus,

only be taken into account in determining whether an ownership change has occurred to the extent that an Inclusion Shareholder (in the case of an Inclusion Shareholder that is an individual), or a public group that indirectly owns the CFC stock through ownership of an Inclusion Shareholder (in the case of an Inclusion Shareholder that is a domestic entity), increases its ownership percentage of CFC stock. This rule would be consistent with the Purposive Approach adopted by Reg. §1.382-3, and would further Anti-Trafficking Policy and Averaging Policy. Further, in the case of acquisitions of CFC stock by multiple related acquirors, the percentage increase by an Inclusion Shareholder should include the percentage increase of the related acquirors (whether or not such related acquirors are Inclusion Shareholders) during the three-year testing period.

2. Indirect Owner Shifts

<u>Issue</u>*: Should owner shifts be limited to direct acquisitions of foreign loss corporation stock by an Inclusion Shareholder? How should an indirect acquisition of CFC stock through an entity that is an Inclusion Shareholder be treated?*

As described above, an owner shift is any change in the ownership of the stock of a loss corporation that affects the percentage of such stock owned by any 5% shareholder.[74] For these purposes, the ownership percentage of a loss corporation includes (1) any direct ownership interest and (2) each indirect ownership interest in the loss corporation as a 5% owner of any one first-tier entity or higher-tier entity but only to the extent that each direct or indirect ownership interest is 5% or more of the stock of the loss corporation.[75]

In the domestic context, Section 382 also applies to an indirect acquisition of a loss corporation through an acquisition of an entity that owns a loss corporation. In the CFC context, if the only relevant owner shifts are those that involve Inclusion Shareholders, then the question arises as to how to treat transactions in which stock of an Inclusion Shareholder (but not stock of the CFC itself) is directly acquired. In such a case, although the ownership of the Inclusion Shareholder changes, the Inclusion Shareholder's ownership of the CFC does not change.

> **Example 2a:** ***60% acquisition of US Inclusion Shareholder by non-US person*****.** FS, a non-US person, owns 100% of the stock of UST, which, in turn, owns 100% of the stock of CFC, a foreign loss corporation. FS sells 60% of the stock of UST to FB, a non-US person. Alternatively, an individual sells 100% of the stock of FS to another individual.

Compared to a direct acquisition of CFC stock, it is less clear whether it is appropriate to treat the sale of the stock of UST (the Inclusion Shareholder) to FB as an owner shift. On the one hand, Section 382 generally applies by reference to the ultimate indirect ownership by individuals. Here,

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for example, where a transaction does not result in any change to the ultimate economic ownership of a loss corporation, there would generally not be an owner shift under Section 382(g)(2) and Reg. §1.382-2T(e)(1) and, except as otherwise provided, the recommendations in this Report would not create one.

[74] Section 382(g)(2); Reg. §1.382-2T(e)(1). Transfers of stock that affect only the interests of Small Shareholders are not owner shifts and do not count toward an ownership change. Reg. §1.382-2T(e)(1)(ii).

[75] Reg. §1.382-2T(g)(3).

FB, a 5% shareholder, has indirectly acquired 60% of CFC, which normally would result in an ownership change.

On the other hand, because the Inclusion Shareholder remains the same, Anti-Trafficking Policy is not as readily applicable. In this instance, UST and FT remain in their historic relationship, and, absent additional facts (e.g., stuffing income-producing assets into CFC, combining CFC with other CFCs that FB indirectly owns through its ownership of other Inclusion Shareholders), it does not appear that the purchaser, FB, derives a benefit attributable to the CFC tax attributes.

FB has the ability to monetize the tax attributes of CFC by stuffing – contributing capital or an income-generating business to UST which would, in turn, contribute such capital or income-generating business to CFC. However, it is not clear what FB has ultimately accomplished in that case – FB would be taking assets not subject to US tax, making them subject to a US inclusion regime by dropping them down the chain to CFC, and then using tax attributes of CFC to mitigate the effect of the inclusion regime. FB does not seem any better off than if it had simply kept the assets entirely outside of the US tax net. However, FB could also benefit from CFC's tax attributes by aggregating the ownership of CFC and other CFCs owned by FB through its ownership of other Inclusion Shareholders. For example, if FB also owned USS, which owned income-producing CFCs, FB could cause UST and USS to combine (or for one to become a subsidiary of the other, with the resulting group filing a consolidated return), and then use the target CFC's US tax attributes to offset income of USS's CFCs. The same analysis would also apply if UST was acquired indirectly, through the acquisition of FS.

> **Example 2b**: ***Acquisition of corporate Inclusion Shareholder by consolidated group***. FS, a non-US person, owns 100% of the stock of UST which, in turn, owns 100% of the stock of CFC, a foreign loss corporation. FS sells 100% of the stock of UST to USP, the parent of an unrelated consolidated group, and UST joins the USP consolidated group.

In this instance, because UST joins USP's consolidated group, the attributes of CFC can be used to offset items of other CFCs owned by USP's consolidated group without any further restructuring, because GILTI items are generally determined by aggregating items of CFCs owned by all members of a consolidated group. This clearly implicates Anti-Trafficking Policy, as USP can directly benefit from CFC's pre-change tax attributes to offset the income from the USP group's other CFCs. Thus, a consolidated group's acquisition of a corporate Inclusion Shareholder (and thus indirect acquisition of CFC stock) is effectively the same as an Inclusion Shareholder's direct acquisition of CFC stock, insofar as the transactions relate to Anti-Trafficking Policy.

<u>Recommendation</u>: Similar to Section 382 in the domestic context, an owner shift of a CFC should include an indirect acquisition. In particular, an owner shift should include the direct or indirect acquisition by any 5% shareholder (including a public group) of an equity interest in a corporate (or partnership) Inclusion Shareholder to the same extent such acquisition would be an ownership change if the CFC were a domestic corporation. Thus, there should be no special rule preventing such acquisitions from being an owner shift, even if the Inclusion Shareholder owns 100% of the CFC before and after the acquisition. Although the justification for this rule would be most persuasive in the case where a consolidated group acquires a domestic target corporation that owns CFCs with US tax attributes, such as Example 2b, this rule should apply to any acquisition of an

interest in an Inclusion Shareholder, directly or indirectly, even outside of the consolidated group context, such as Example 2a, because even in such a context, trafficking is plausible.

3. Threshold for Ownership Change

<u>Issue</u>: *Should there be a threshold other than 50 percentage points for an ownership change with respect to a foreign loss corporation?*

As discussed above, under Section 382(g)(1), there is an ownership change if, immediately after any owner shift involving a 5% shareholder or any equity structure shift, the percentage of stock of the loss corporation owned by one or more 5% shareholders has increased by more than 50 percentage points over the lowest percentages of stock of the loss corporation owned by such shareholders over the testing period (i.e., the preceding three years). However, it should be considered whether the 50 percentage point threshold is appropriate in the context of foreign loss corporations, since an Inclusion Shareholder can access the attributes of a foreign loss corporation by virtue of acquiring enough stock that it becomes an Inclusion Shareholder (i.e., 10%, or even less, provided that the Inclusion Shareholder owns 10% vote or value constructively), even without stuffing income-producing assets into the CFC. Consider the following examples:

> **Example 3a:** ***Less than 50% acquisition.*** A, a US person, owns 100% of the stock of FT, a foreign loss corporation and a CFC. A sells 30% of the stock of FT to B, a US person.

> **Example 3b:** ***More than 50% acquisition.*** A, a US person, owns 100% of the stock of FT, a foreign loss corporation and a CFC. A sells 30% of the stock of FT to B, a US person, and A also sells 30% of the stock of FT to C, a US person.

Should these examples yield different results under Section 382? From the perspective of B, the potential benefits of acquiring 10 - 49% of the stock of FT are the same: access to a proportionate percentage of FT's attributes. Moreover, B is actually incentivized to prevent an ownership change, which would limit its access to FT's attributes, from occurring with respect to FT. Under this view, it would arguably be appropriate to apply a different threshold by, for example, subjecting B to FT's Section 382 limitation when B acquires 30% (regardless of whether C later acquires 30%).[76] For the avoidance of doubt, in Example 3b, there is an acquisition of 60% of FT stock by Inclusion Shareholders (B and C), and so each of A, B, and C should take into account items of FT that reflect FT being subject to a Section 382 limitation.

On the other hand, Section 382 has a specific threshold upon which its limitations are triggered. Congress tolerated a certain amount of loss trafficking, but drew the line at acquisitions of more than 50 percentage points during a three-year period. In the domestic context, an acquiror could derive a benefit from acquiring less than 50% of the stock of a domestic loss corporation, but nonetheless Section 382 would not apply. Congress has made a deliberate choice that aggregate

[76] Applying Section 382 at the shareholder level, A's items from FT would not be subject to FT's Section 382 limitation, because from A's perspective, all it has done is sold 30% of FT stock. If Section 382 applied at the CFC level, both A and B's items would reflect FT being subject to Section 382 limitation. *See infra* Part IV.D. for a discussion of applying Section 382 at the shareholder level versus the CFC level.

acquisitions below a certain threshold are not Section 382(g) ownership changes, even if such acquisitions could be motivated by trafficking.

One could argue that once relevant owner shifts are limited pursuant to the Purposive Approach (see Part IV.A.1), that consistency requires also making changes throughout Section 382 to find as many transactions as possible that implicate Anti-Trafficking Policy, even where such transactions would not trigger a Section 382 limitation in the domestic context. However, such an argument would create a false equivalency. The Purposive Approach does not alter the fundamental principles of Section 382, which require a 50 percentage point owner shift, regardless of subjective intent, to cause an ownership change. Rather, the Purposive Approach works within that framework, but mechanically excludes certain owner shifts that are do not implicate Averaging Policy or Anti-Trafficking Policy. In the case of Reg. §1.382-3, those excluded owner shifts involved small issuances, small redemptions, and cash issuances. In the case of a CFC, the proposal is to exclude owner shifts involving increases by non-Inclusion Shareholders. Both are applications of the Purposive Approach. In contrast, the 50 percentage point threshold is the line below which Congress thought loss trafficking was tolerable. Changing that threshold would extend beyond the Purposive Approach and would instead fundamentally alter how Section 382 works.

Recommendation: The ownership percentage point threshold for an ownership change should not be different for a CFC than it is for a domestic corporation (i.e., such threshold should remain at 50 percentage points).

4. Treatment of Acquisitions by Individuals

Issue: If a CFC is acquired by an Inclusion Shareholder, should it make a difference whether the Inclusion Shareholder is a US individual or a US corporation?

Under the GILTI rules, individuals are not eligible for the Section 250 deduction. In addition, US individuals are not eligible for the 245A deduction for the foreign-source portion of a dividend out of untaxed E&P, and are disallowed any deduction for deemed paid foreign tax credits under Section 960(d). While a US individual that is an Inclusion Shareholder may make an annual election under Section 962 to access the Section 960 tax credits and to be taxed on Subpart F and GILTI inclusions at the same rates as a domestic corporation, there are limitations to the benefits of this election.[77]

Arguably, even after taking into account the election under Section 962, there are already sufficient tax detriments, without Section 382, that would deter a US individual from becoming an Inclusion Shareholder. However, for US individuals that are already Inclusion Shareholders of CFCs, the harsher treatment with respect to those CFCs provides an even greater incentive for acquiring a CFC with favorable tax attributes. Consider the following example:

[77] The election under Section 962 has no relevance for purposes of the foreign derived intangible income deduction under Section 250(a)(1)(A) because individuals and non-US corporations do not have foreign derived intangible income under Section 250(b). Also, the repatriation of earnings from CFCs to individuals only benefits from the PTEP regime of Section 959 to a limited extent.

Example 4a: ***Benefits to individual Inclusion Shareholder of acquiring CFC tax attributes.*** Individual A owns 100% of the outstanding stock of CFC1, which has no QBAI and generates $100 of tested income each year. A has a $100 GILTI inclusion each year and makes no Section 962 election to be taxed at the same rate as domestic corporations. Accordingly, assume A pays $40 per year of US federal income tax because A is an individual Inclusion Shareholder of CFC1 with an effective US federal income tax rate of 40% and cannot take a Section 250 deduction or claim foreign tax credits.

At the beginning of Year 2, A acquires CFC2 from an unrelated seller for $50. CFC2 has a basis of $675 in certain of its intellectual property assets (i.e., CFC2 has a built-in loss attributable to the intellectual property assets, perhaps arising because of an unsuccessful acquisition). Assume that CFC2 amortizes the intellectual property assets at a rate of $45 per year for 15 years.

In the above example, if Section 382 did not apply, A would be able to reduce its annual GILTI inclusion by $45 per year (from $100 to $55), and therefore, its tax liability would be reduced from $40 to $22 per year. A would have received a tax benefit equal to its entire $50 investment in under three years (an $18 reduction in tax liability each year), in part because individuals face unfavorable treatment under the GILTI regime. This enhanced benefit available to individuals suggests that Section 382 should take into account owner shifts involving US individuals that are Inclusion Shareholders, and not be limited to owner shifts involving US corporations.

On the other hand, the language of Section 382 suggests that it is intended to affect items on a corporate tax return, not an individual tax return. Section 382(a) provides that "[t]he amount of the taxable income of any new loss corporation for any post-change year which may be offset by pre-change losses shall not exceed the Section 382 limitation for such year," suggesting that Section 382 applies at the corporate level. Although ownership changes are tested with reference to direct and indirect ownership by individuals, the actual tax returns affected are those of the loss corporation. If Section 382 is intended to only affect corporate tax returns, then presumably either (i) owner shifts by individuals are not taken into account for determining whether there has been an ownership change, (ii) even if there is an ownership change (e.g., by reason of other acquirors that are corporations), an individual's pro rata share of GILTI tested income should not be affected, or (iii) both (i) and (ii). Computing separate GILTI items for an individual Inclusion Shareholder such that the individual's pro rata share is not affected by a Section 382 limitation of a CFC, whereas a corporate Inclusion Shareholder's pro rata share *is* affected by a Section 382 limitation, would be extremely complicated, and even more so if the CFC has classes of stock outstanding with different economic rights (e.g., preferred and common).[78]

Recent guidance related to other changes under the Act may undermine the argument that Section 382 is not intended to affect individual tax returns. For example, final Regulations under Section 163(j) treat an S corporation's Interest Carryforward as a pre-change loss subject to a Section 382

[78] *See infra* Part IV.D.12.

limitation following an S corporation's ownership change.[79] Application of Section 382 to an S corporation's Interest Carryforward implies that Section 382 can affect what is on an individual's tax return (or the tax return of a shareholder generally, e.g., through an inclusion regime).[80]

Further, applying the Section 382 limitation to a CFC loss corporation whose items show up on an individual's tax return is not different in kind from applying a Section 382 limitation to a domestic corporation target whose items show up on an acquiring consolidated group's tax return.

Recommendation: Owner shifts involving Inclusion Shareholders that are individuals should be taken into account in the same manner as owner shifts involving Inclusion Shareholders that are corporations, and an individual's pro rata share of CFC items should be affected by a Section 382 ownership change the same way as a corporation's pro rata share would be affected.

5. Subsequent Transfers to a Domestic Corporation

Issue: If owner shifts are limited to Inclusion Shareholders, then in the case of a foreign acquiror, are special rules necessary where the acquired CFC is subsequently transferred to an Inclusion Shareholder related to the acquiror?

Assuming that only owner shifts that increase ownership by Inclusion Shareholders are taken into account, and no further rules were adopted, there would be a possibility for certain taxpayers to abuse the rules by using multiple transfers each of which, if tested by itself, would not be an owner shift. For example, foreign-parented multinational groups that own US subsidiaries that in turn own income-producing CFCs could avoid Section 382 by engaging in post-acquisition restructuring. The foreign parent could first acquire the foreign loss corporation, and then transfer the foreign loss corporation to a US subsidiary that owns income-producing CFCs.

> **Example 5a: *Acquisition by a Foreign corporation followed by transfer to related US person.*** FA, a foreign corporation, owns 100% of the stock of USS, a domestic corporation. FA acquires 100% of the stock of FT, a foreign loss corporation from an unrelated person. Subsequently, FA contributes FT to USS.

In Example 5a, absent an additional rule addressing this fact pattern, there would be no Section 382 ownership change because (i) FA's acquisition of FT is not an owner shift because FA is not an Inclusion Shareholder and (ii) FA's transfer to USS is not an owner shift because there is no change in the ultimate indirect ownership of FT as a result of the contribution (i.e., the shareholders of FA indirectly own 100% of FT stock both before and after FA's transfer of FT to USS). By contrast, if FT was a US corporation, Section 382 would apply to FA's initial acquisition since a 5% shareholder would have acquired 100% of the stock of FT.

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[79] *See* Reg. 1.163(j)-6(*l*)(10).

[80] Nonetheless, the Preamble to the final Section 163(j) Regulations summarizes one commentator's recommendation that Section 382 apply *only to those attributes that are carried forward and taken into account at the corporate level*. Treasury agreed and noted that "because disallowed business interest expense is an attribute of the S corporation," the S corporation's disallowed business interest expenses are subject to a Section 382 limitation.

As described above, consistent with the Purposive Approach, this Report recommends that acquisitions by non-Inclusion Shareholders should not be cognizable acquisitions for purposes of Section 382 under the presumption that acquisitions of foreign loss corporation stock by non-Inclusion Shareholders cannot be motivated by loss trafficking. However, where a non-Inclusion Shareholder subsequently contributes a foreign loss corporation to a domestic corporation, the non-Inclusion Shareholder can indirectly benefit from the attributes of the loss corporation through a net reduction in US tax paid by the non-Inclusion Shareholder's domestic corporation. Consequently, this presumption is no longer appropriate as the transfer to the domestic corporation implicates Anti-Trafficking Policy.

Thus, it is appropriate to incorporate a rule providing that any subsequent transfer to the Inclusion Shareholder should result in a cognizable acquisition for purposes of Section 382, even if such subsequent transfer is not an owner shift under normal Section 382 rules by reason of there being no change in ultimate indirect ownership in the subsequent transfer.[81] However, because this rule would operate to cause an owner shift that had previously been disregarded for Section 382 purposes to be taken into account as a result of actions undertaken at a point in time after the original disregarded acquisition, it represents a significant departure from the existing framework of Section 382 and consideration must be given as to how this rule would mechanically operate.

First, this rule must address the applicable time period in which a subsequent transfer could cause an initially disregarded acquisition to be taken into account for purposes of Section 382. Because Section 382 generally applies by reference to an ownership change within a specific measurement period (i.e., three years), we recommend that any rule addressing subsequent transfers to Inclusion Shareholders would be similarly time-limited. One possibility would be to use a three-year period, consistent with the testing period for ownership changes under current Section 382. However, because the timing of the subsequent transfer is within the control of FT, the transfer of FT to USS is not analogous to a sale of FT to an unrelated party and, consequently, a three-year period could lead to inappropriate results. For example, if FP were to transfer FT to USS three years after the original acquisition and FT subsequently recognized its NUBIL, USS would have obtained a benefit from FT's NUBIL that it could not have obtained if it had directly acquired FT at the outset. Consequently, we think that a five-year period would be more appropriate as it would correlate with the recognition period for RBIL and RBIG and foreclose the possibility that parties could achieve better results where the foreign loss corporation is initially acquired by a Non-Inclusion Shareholder.[82]

[81] We note that the same concerns are not present where the foreign loss corporation is merged into the domestic corporation. In this case, Section 362(e)(1) generally seems sufficient to police this fact pattern as it would prevent the importation of a net built-in loss in the assets of the foreign loss corporation. By contrast, where the foreign loss corporation is contributed to a domestic corporation, Section 362(e)(1) would only operate to prevent the importation of a net built-in loss in the *stock* of the foreign corporation held by the domestic corporation and would have no effect on a net built-in loss in the assets held by the foreign corporation.

[82] If FP waited until the end of the five-year recognition period to contribute the stock of FT to USS then USS could utilize the benefit of FT's RBIL without limitation (assuming that the five-year clock for RBIL begins on the acquisition of FT by FP; this issue is discussed below). However, under current Section 382, USS could have

Second, this rule would have to address two related points – when should NUBIG/NUBIL be measured and when should the owner shift be deemed to occur. Regarding the timing of the measurement of NUBIG/NUBIL, if the subsequent transfer results in an ownership change, it would be most consistent with current Section 382 to measure NUBIG/NUBIL at the time of the original acquisition, since the original acquisition is the point in time when FP acquired its interest in FT with a presumed intent of loss trafficking (as evidenced by the subsequent transfer). By contrast, if NUBIG/NUBIL were measured at the time of the subsequent transfer, it could have the effect of causing Section 382 to limit losses that were economically incurred after the original acquisition. As discussed further in Example 5b, limiting losses economically incurred after the event giving rise to trafficking would be inconsistent with the purposes of Section 382. Measuring NUBIG/NUBIL at the time of the original acquisition by FP would require FP to maintain records of the fair market value and basis of FT's assets at the time of the original acquisition, this burden is consistent with Section 382(h), where the loss corporation has the burden of establishing that any gain is RBIG while any recognized loss is presumed to be RBIL unless the loss corporation can prove otherwise.[83]

Regarding when the owner shift should be deemed to occur, it would similarly be consistent with Anti-Trafficking Policy if the owner shift were deemed to occur upon the original acquisition (i.e., retroactively), since that is the acquisition that is presumed to be motivated by loss trafficking (as evidenced by the subsequent transfer). However, this approach would have the effect of causing a retroactive ownership change, which would cause significant complexity. For example, if the foreign loss corporation had other Inclusion Shareholders since the time of the original acquisition,[84] then the retroactive ownership change could change the tax consequences for these Inclusion Shareholders in previous tax years (some of whom may not even own their shares in the foreign loss corporation at the time of the subsequent transfer). Thus, the approach seems impractical and difficult to administer. On the other hand, if the owner shift is deemed to occur at the time of the subsequent transfer, administration of the rule would be relatively straightforward. However, this approach of treating the owner shift as occurring at the time of the subsequent transfer could have the effect of extending the recognition period for RBIG/RBIL beyond five years from the original acquisition. For example, if in example 5a, FP purchased FT in Year 1, contributed FT to USS in Year 5, and FT was then subject to a five-year recognition period it would cause RBIL recognized in Years 5-10 to be subject to the Section 382 limitation, which

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acquired FT directly and waited similarly waited until the end of the five-year recognition period to recognize the NUBIL without limitation under Section 382.

[83] Specifically, Section 382(h)(2)(A) requires that the loss corporation establish that it held the gain asset immediately before the ownership change and that the recognized gain did not exceed the unrealized gain in the asset at the time of the ownership change in order for the recognized gain to constitute RBIG. In contrast, Section 382(h)(2)(B) provides that any loss recognized during the recognition period is RBIL except to the extent that the loss corporation establishes that it did not hold the loss asset immediately before the ownership change or that the unrealized loss immediately prior to the ownership change was less than the actual loss on the disposition of the asset.

[84] For example, assume the same facts as in example 5a except FP purchased 90% of FT, rather than 100% and the other 10% of FT was owned by an unrelated Inclusion Shareholder. Note that FT would a CFC at the time of the original acquisition through downward attribution to FP's subsidiary USS.

departs from the normal Section 382 rules that stop tracking RBIG and RBIL once 5 years has passed since the acquisition giving rise to trafficking (i.e., the original acquisition).

Instead of picking one moment in time (i.e., either the original acquisition or the subsequent transfer), and not the other moment in time, for determining when NUBIG/NUBIL is measured and for determining when the owner shift/ownership change takes place, a hybrid approach that uses both dates would have significant merit. In particular, pursuant to a hybrid approach, the time of the original acquisition could be used to measure NUBIG/NUBIL and to start the 5-year recognition period for RBIG/RBIL, but the subsequent transfer to an Inclusion Shareholder could be used as the time of the actual owner shift/ownership change, such that there would be no Section 382 limitation (and no retroactive Section 382 limitation) until the subsequent transfer that causes the ownership change. A sensible consequence of this approach is to permit other Inclusion Shareholders at the time of the original acquisition to utilize their proportionate share of the attributes of the foreign loss corporation without limitation until the time of the subsequent transfer to an Inclusion Shareholder, and not recalculate prior inclusions based on a retroactively effective Section 382 limitation.

A possible concern with this hybrid approach (original acquisition date used for NUBIG/NUBIL determination and RBIG/RBIL recognition period, and date of the subsequent transfer used for the owner shift) is that it could facilitate stripping out gain assets in an abusive manner between the original acquisition and the subsequent transfer. For example, assume that FA acquires FT in Year 1 when FT has no NUBIL because it has offsetting gain and loss assets; in Year 2, FT disposes of the gain asset; and, in Year 3, FA contributes FT to USS. Under our recommended approach, since NUBIL is determined at the time of the original acquisition, FT would not be a loss corporation. Thus, the subsequent contribution to USS would not result in the built-in loss being subject to a Section 382 limitation. On one hand, because FT had no NUBIL at the time of the original acquisition, it could be argued that FP did not acquire FT with a loss-trafficking intent and thus the subsequent changes causing FT to have a NUBIL should not cause the acquisition of FT to be an ownership change. On the other hand, it does not seem appropriate that FP can remove the gain assets from FT without incurring US tax but also import FT's built-in losses into the US tax net without limitation.

As explored further below, we do not think it is appropriate that Section 382 should operate to limit losses where there has been no change in ultimate indirect ownership, even though such losses could be imported into the US tax system for abusive purposes. This suggests that NUBIG/NUBIL should be determined at the time of the original acquisition, because if NUBIG/NUBIL were measured at the time of the subsequent transfer, this would have the effect of limiting built-in losses that were economically accrued during a period in which there were no changes in ultimate indirect ownership (i.e., during the period that FP, and FP's shareholders, owned FT), similar to economic losses accrued by FT if FT had always been wholly owned by FP.[85]

[85] As discussed *supra* note 81, Section 362(e)(1) would not apply to reduce the basis of the assets of FT upon FP's contribution of FT to USS. An alternative new approach would be to amend Section 362(e)(1) such that the basis of

> **Example 5b:** ***Transfer to a related US person without a previous acquisition by foreign owner.*** FA, a foreign corporation, owns each of USS, a domestic corporation, and FT, a foreign loss corporation. The same individuals have owned FA since the formation of FA, and FA has owned FT since the formation of FT. FA contributes 100% of the stock of FT to USS.

Similar to Example 5a, the contribution of FT to USS causes the attributes of FT to be generally available to offset income that would be included by USS (e.g., if USS owns CFCs that generate tested income). On the one hand, it does not seem appropriate that attributes which have never been relevant to the US tax system can now be used to reduce US tax, effectively causing the US government to reimburse losses that occurred outside of the US tax system. On the other hand, in Example 5b, FA and its shareholders are the parties who have economically borne the loss giving rise to the attributes of FT and, because no new shareholder has directly or indirectly acquired an interest in FT, the transaction should not violate Anti-Trafficking Policy. Consequently, notwithstanding the policy concerns with this type of transaction, it seems inconsistent with the purposes of Section 382 to cause Section 382 to apply to a situation where there has been no change in ultimate indirect ownership. If Treasury is concerned with this fact pattern, we recommend that they consider alternatives outside of Section 382 to address this issue.[86]

Recommendation: To the extent an ownership increase is excepted from contributing to an owner shift for purposes of Section 382 because the acquiror is a non-Inclusion Shareholder, a subsequent direct or indirect transfer within five years of the original acquisition by the non-Inclusion Shareholder to an Inclusion Shareholder should be taken into account as an owner shift (even if such subsequent transfer, by itself, would not be an owner shift under normal Section 382 rules). In such a case, while there are several different potential methodologies for the timing of the ownership change, the NUBIG/NUBIL determination, and the RBIG/RBIL recognition period, a sensible approach would measure NUBIG/NUBIL and begin the recognition period for RBIG/RBIL at the time of the original acquisition and would treat the owner shift (and ownership change) as occurring at the time of the subsequent transfer. Alternatively, measurement of NUBIG/NUBIL and the beginning of the RBIG/RBIL recognition period could also be at the time of the subsequent transfer. In any case, because of the problems associated with a retroactive ownership change, the owner shift should take place as of the subsequent transfer.

6. Pre-CFC Owner Shifts

Issue: Should owner shifts of a foreign corporation prior to it becoming a CFC (other than owner shifts that are pursuant to plan to become CFC) be taken into account?

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the assets of FT would be equal to the fair market value of such assets at the time of the contribution to USS to address the potential for abuse (instead of, or in addition to, reducing USS's basis in FT stock to fair market value).

[86] For example, through modifications to the rules under Section 362(e)(1), as noted above. This type of transaction is similar to a SRLY-relevant fact pattern where FP drops US1 into US2 in a transaction that is not a Section 382 ownership change. SRLY is discussed further below in this Report.

Example 6a: ***Owner shift prior to becoming a CFC, multiple acquirors***. FA, a foreign corporation, owns 100% of the stock of FT. FT has never been a CFC. In Year 1, Corporation X, an unrelated US corporation, acquires 40% of the stock of FT, and FT continues to not be a CFC. In Year 2, in an unrelated transaction, Corporation Y, an unrelated US corporation, acquires 20% of the FT stock from FA, causing FT to become a CFC by reason of Corporation X's and Corporation Y's collective 60% ownership.

In Example 6a, at the time of Corporation X's Year 1 acquisition, FT is not a CFC, and Corporation X, under these facts, would have no reason to believe its acquisition of 40% of the stock of FT would lead to FT becoming a CFC. Thus, Corporation X might have no reason to believe that FT's pre-acquisition tax attributes would become available to reduce the tax liability of Corporate X from an inclusion regime (and in fact may have preferred for FT to not become a CFC). Indeed, for acquisitions by domestic corporations in which the foreign target does not become a CFC, Section 245A provides an incentive for Corporation X to acquire a non-CFC foreign target with built-in gain assets (as opposed to built-in loss assets), such that E&P created from the disposition or operation of such assets can be repatriated without US tax and without reducing stock basis.[87] Thus, if FT remained a non-CFC owned 40% by Corporation X, FT's earnings would effectively reduce future gain that Corporation X has in FT stock. This feature causes FT earnings to have significant value to Corporation X. In contrast, if FT (as a non-CFC) had built-in losses, triggering them would reduce E&P and limit the ability to repatriate the earnings tax-free without reducing stock basis. Further, Corporation X would be incentivized to keep FT a non-CFC such that Corporation X would not be required to include GILTI with respect to FT. Thus, it may be logical to presume that Corporation X did not acquire its stock with a loss-trafficking intent and, consistent with the Purposive Approach, one could argue that Corporation X's acquisition should not result in an owner shift, notwithstanding that FT later becomes a CFC.

In contrast, if Corporation X had a plan to cause FT to become a CFC, then Corporation X may be motivated to engage in the sort of attribute trafficking Section 382 is intended to prevent, by finding a foreign target with the sort of attributes that would offset Corporation X's tax liability (i.e., tested losses to offset tested income of Corporation X's CFCs).

Example 6b: ***Owner shift prior to becoming a CFC, creeping acquisition by unrelated acquirors pursuant to a plan***. FA, a foreign corporation, owns 100% of the stock of FS. FS has never been a CFC. In Year 1, Corporation X, an unrelated US corporation, acquires 40% of the stock of FS. In Year 2, pursuant to the same plan as Corporation X's acquisition, Corporation Y, an unrelated US corporation, acquires an additional 20% of the stock of FS, causing FS to become a CFC.

Example 6c: ***Owner shift prior to becoming a CFC, creeping acquisition by single acquiror (with or without a plan)***. FA, a foreign corporation, owns 100% of the stock of

[87] The House Bill and the Wyden Bill would alter the application of Sections 245A and 1059, in certain cases denying the Section 245A DRD to shareholders of non-CFC "10/50 companies" and requiring stock basis reductions for dividends received attributable to CFC earnings generated in (or economically attributable to) periods before it was a CFC. As noted, such legislative proposals are beyond the scope of this Report.

FS. FS has never been a CFC. In Year 1, Corporation X, an unrelated US corporation, acquires 40% of the stock of FS. In Year 2, Corporation X acquires an additional 20% of the stock of FS, causing FS to become a CFC.

In each of these examples 6a, 6b, and 6c, if FT were a domestic entity, FT would have undergone an ownership change and would be subject to a Section 382 limitation. As described above, in Example 6a, Corporation X acquires the stock of FT without a loss-trafficking intent while, in Example 6b, Corporation X can be presumed to have acquired its FT stock with a loss-trafficking intent since the acquisition was part of a plan to cause FT to become a CFC. Consistent with the Purposive Approach, it could be argued that Corporation X's acquisition should only contribute to an owner shift when a loss-trafficking intent is possible, and consequently Section 382 should only take into account owner shifts involving shareholders that are Inclusion Shareholders of a CFC at the time of acquisition (or that become Inclusion Shareholders of a CFC pursuant to the same plan as the acquisition).

On the other hand, such a rule would turn on the intent of the taxpayer at the time of the acquisition. As mentioned above, Section 382 provides a set of objective mechanical rules to implement its Anti-Trafficking Policy and Averaging Policy objectives, and an intent-based rule would be inconsistent with this objective mechanical approach. In addition, as demonstrated in Example 6c, the determination of intent can be further complicated by the fact that a single taxpayer may engage in multiple acquisitions. While additional objective rules could support this intent-based determination, such as presumptions that all acquisitions by a single taxpayer or related taxpayer are pursuant to a plan to cause FT to become a CFC and, consequently, would contribute to an owner shift, on balance, this complexity arising out of the departure from a simple and objective standard is unwarranted. Moreover, in Example 6a, it is still possible that Corporation X acquired its stock with a loss-trafficking intent, even if Corporation X had no plan to cause FT to become a CFC, if Corporation X acquired the FT stock with the expectation that another party would similarly recognize the value in FT's attributes and acquire sufficient stock to cause FT to become a CFC. Consequently, on balance, it seems appropriate to take into account owner shifts of a foreign corporation during the testing period, pursuant to the normal Section 382 rules, even if such acquisitions occur prior to the corporation becoming a CFC.

Recommendation: Owner shifts during the testing period of a non-CFC foreign loss corporation that subsequently becomes a CFC should be taken into account for purposes of determining whether there has been an ownership change of a CFC.[88]

B. Section 382 Limitation, Types of CFC Income

[88] Consistent with Section 382(k)(1), Reg. §1.382-2, and Reg. §1.382-2T, owner shifts at a time when the foreign corporation is not a "loss corporation" would not be taken into account.

7. Application to Different Types of CFC Income

<u>Issue</u>: *Should the disallowed portion of a CFC's RBIL be subject to a carryforward rule?*

In a typical case, Section 382 places limits on a loss corporation that has undergone an ownership change from using its own tax attributes against its own income. Applying Section 382 to the non-ECI of a CFC presents some novel questions because it would, in effect, extend the Section 382 limitation to the income inclusions of the CFC's Inclusion Shareholder, rather than the CFC itself. Generally, Inclusion Shareholders include in income four different categories of income with respect to CFCs: (1) GILTI, (2) Subpart F income, (3) Section 956 inclusions, and (4) actual dividends.

The amount of an Inclusion Shareholder's Subpart F and Section 956 inclusions are generally limited by the relevant CFC's E&P. In the case of Subpart F income, the inclusions are limited by the CFC's current year E&P and certain "qualified deficits" of E&P carried forward from prior years. In the case of Section 956 inclusions, the inclusions are limited by the CFC's accumulated E&P, without taking into account any accumulated deficits from prior taxable years. Similarly, under the GILTI regime, CFCs are not permitted to carryforward tested losses or excess foreign tax credits in the GILTI basket to future taxable years. As a result, the use of carryforwards by CFCs is generally limited to the NOLs of a US branch and qualified deficits with respect to Subpart F income. A CFC without a US branch will not have NOLs to which Section 382 would apply. For these CFCs, RBIL is the primary attribute to which the Section 382 limitation would apply.

Section 382(h)(4) provides that if any portion of an RBIL is subject to a Section 382 limitation and disallowed, the disallowed portion may be carried forward "under rules similar to the rules for the carrying forward of net operating losses." As previously mentioned, CFCs generally may not carry forward NOLs unless they are associated with a US trade or business. Accordingly, it is somewhat unclear whether a CFC would be permitted to carryforward the disallowed portion of an RBIL if the RBIL is not associated with the CFC's US trade or business. If a CFC were not permitted to carry forward the disallowed portion of an RBIL, it would result in the Section 382 limitation causing a permanent disallowance in every situation where the CFC has a NUBIL and the RBIL cannot be fully allowed in the year of sale or other recognition (e.g., depreciation or amortization) because of the Section 382 limitation. This is inconsistent with the purpose of Section 382, which is generally not intended to permanently disallow the use of a loss corporation's attributes, but rather require those attributes be used over a longer period of time.

<u>Recommendation</u>: We recommend that Treasury exercise the grant of regulatory authority under Section 382(m) to clarify that CFCs are permitted to carryforward all disallowed RBIL, regardless of whether associated with a US trade or business. This clarification should not require Congressional legislation because Section 382(h)(4) says that RBIL is carried forward under rules "similar" to the rules for NOLs. It does not require that the rules be identical.

Furthermore, the fact that a CFC's tested loss cannot be carried forward under Section 951A does not affect our recommendation (or further, if legislative proposals that would allow a tested loss carryforward are adopted, that would, if anything, strengthen the argument that CFCs should be allowed to carry forward RBIL). In effect, GILTI is a snapshot of a CFC's tested income and loss for the particular taxable year. A tested loss generally becomes an Inclusion Shareholder level attribute available to the Inclusion Shareholder to offset tested income realized from another CFC in the same taxable year. In contrast, RBIL disallowed by a Section 382 limitation is not available to be utilized by the CFC or the Inclusion Shareholder in the taxable year recognized. Without a carry forward, a CFC's disallowed RBIL will always expire without being utilized.[89] In this respect, we believe that RBIL should be treated similar to a CFC's section 163(j) excess BIE, which can be carried forward.

8. Determining Equity Value under Section 382(e)(3) in the Case of a Foreign Loss Corporation

<u>Issue</u>: *How should the equity value of a foreign loss corporation be determined?*

A loss corporation that undergoes an ownership change must generally calculate its Section 382 limitation for a post-change year according to the formula provided under Section 382(b)(1). Section 382(b)(1) provides that the Section 382 limitation amount is equal to the product of (a) the value of the old loss corporation and (b) the long-term tax-exempt rate in effect. Under Section 382(e)(1) the value of the old loss corporation is generally determined by the value of the corporation's stock immediately before the ownership change.

However, Section 382(e)(3) treats foreign corporations differently than domestic corporations. Under Section 382(e)(3), an old loss corporation which is a foreign corporation only takes into account items connected with a US trade or business to determine its equity value. Consequently, in determining the Section 382 limitation for a foreign loss corporation, only the value of the foreign corporation's US branch's assets and liabilities would be taken into account. In the GILTI or Subpart F context, application of Section 382(e)(3) to a CFC could lead to nonsensical and unfair results. For example, CFCs that are not engaged in a US trade or business will always have a Section 382 limitation of zero. Even if a CFC is engaged in a US trade or business, it makes little sense to determine the CFC's Section 382 limitation with respect to its foreign source income based on the value of its US trade or business assets. In the majority of cases, we would expect that a CFC's US branch activities will be substantially smaller than its foreign activities.

While Section 382(e)(3) provides the Secretary with an express grant of regulatory authority to issue Regulations permitting foreign corporations to include other items in determining its equity value for purposes of Section 382, no Regulations have been issued under Section 382 to date. Nevertheless, we are aware that many taxpayers have taken the position that a CFC may include the value of foreign items under Section 382(e)(3). The basis for this position is that Reg. §1.952-

[89] One approach could be that RBIL carryover should be limited to the extent the RBIL could have been utilized in the year recognized at the Inclusion Shareholder level (i.e., the RBIL expires unused to the same extent that an actual tested loss would have expired unused). However, this approach would be exceptionally complex, unduly burdensome and impractical. Among other things, it would require varying results where there are multiple Inclusion Shareholders, and would suffer from the same issues as calculating other limitations at the Inclusion Shareholder level, as discussed below in Part IV.D of this Report.

2(a) provides that a CFC's gross income is generally determined as if the CFC were a domestic corporation.

Recommendation: We recommend that Treasury resolves any uncertainty in this area and exercise its authority to issue Regulations under Section 382(e)(3) permitting a CFC to include the value of non-ECI items. The approach we would recommend is to segregate a foreign corporation's US branch from its remaining operations. Separate equity values would be computed for each as if they were held by separate and distinct corporations and the CFC, as described below, would have separate Section 382 limitations with respect to its US trade or business activities and its other activities.

9. Allocating the Section 382 Limitation Among Different Types of CFC Income

Issue: Typically, a loss corporation that undergoes an ownership change calculates an aggregate NUBIG/NUBIL and has a single Section 382 limitation. What approach should be used for a CFC loss corporation with different categories of income?

A domestic loss corporation that undergoes an ownership change has a single Section 382 limitation and calculates a single aggregate NUBIG or NUBIL with respect to all of its assets. There is generally no reason to allocate the Section 382 limitation among different categories of income, or consider asset types when calculating the corporation's NUBIG or NUBIL, because a domestic corporation generally pays US federal income tax on all of its income and gains at the same 21% corporate tax rate. On the other hand, an Inclusion Shareholder of a CFC is generally subject to different effective rates of tax on GILTI versus Subpart F income and Section 956 inclusions because of the Section 250 deduction available against GILTI.[90] As a result, the manner in which a CFC's Section 382 limitation is allocated against these different types of income and whether there are built-in gains or losses in assets that produce GILTI versus other types of income could have a significant effect on the tax liability of the Inclusion Shareholder.

We have identified two potential alternative manners to calculate the limitation. The first option is to calculate a single Section 382 limitation (and a single equity value and aggregate NUBIG/NUBIL amount, as well) and then allow the existing allocation and apportionment rules to apply (the **"Aggregate Approach"**). The second option is to calculate separate Section 382 limitations and NUBIG/NUBIL amounts for each of GILTI and Subpart F income (the **"Segregated Approach"**). Regardless of which option is adopted, as discussed above in Section IV.B.8, we would recommend that a CFC with a US branch have a separate Section 382 limitation and NUBIG/NUBIL with respect to the US branch.

> **Example 9a: *Netting of Built-in Gains and Losses*.** In year 1, FA, a foreign corporation which does not have a US branch, owns two assets and undergoes an ownership change. It owns Factory A, which earns GILTI income and has a built-in gain of $10 at the time of

[90] Currently, an Inclusion Shareholder that is a corporation generally pays tax on GILTI at an effective tax rate of 10.5% and pays tax on Subpart F income and Section 956 inclusions at a rate of 21%. An Inclusion Shareholder that is an individual will generally pay tax on all CFC income inclusions at 37%, unless it makes an election under Section 962, in which case it will pay tax on CFC inclusions at the same rate as a domestic corporation until the earnings are repatriated.

> the ownership change. It also owns Factory B, which earns foreign base company sales income and has a built-in loss of $5. Assume that FA's section 382 limitation is $1. After the ownership change, FA has a single corporate Inclusion Shareholder, US1, that owns 100% of its stock. In year 2, FA has $10 of tested income, $5 of Subpart F income, and sells Factory B and recognizes the $5 pre-change built-in loss.

In Example 9a, if the Aggregate Approach is used, then FA has a NUBIG of $5. Because FA has a NUBIG at the time of the ownership change, its use of the $5 RBIL from the sale of Factory B is not subject to its $1 Section 382 limitation. As a result, US1 has $10 of tested income and zero Subpart F income with respect to FA. Example 9A illustrates that the Aggregate Approach would permit a built-in gain in one category of income producing assets to be netted against and offset a built-in loss in another category.

> **Example 9b *Order of Recognizing RBIG*.** The facts are the same as in Example 9a, except that (i) Factory A has a built-in gain of only $5 and (ii) FA also owns Asset C, which generates GILTI and has a built-in loss of $10 at the time of FA's ownership change. In year 2, FA sells Asset C and recognizes the $10 pre-change built-in loss. In year 3, FA sells Factory B, recognizing a pre-change built-in loss of $5.

In Example 9b, if the Aggregate Approach is utilized, then FA has a NUBIL of $10. The $10 of loss recognized by FA on the sale of Asset C is an RBIL, which is subject to FA's $1 Section 382 limitation (if our recommendation is adopted, the remaining $9 of RBIL will be carried forward and will be usable in the future subject to the applicable Section 382 limitation[91]). However, the loss upon the sale of Asset C fully absorbs FA's $10 NUBIL. As a result, when FA sells Factory B in year 3, it will be able to fully utilize that loss. Example 9b illustrates that the Aggregate Approach also provides CFCs with a NUBIL with some electivity as to which asset sales trigger RBIL and absorb the NUBIL. In this example, FA chose to absorb the NUBIL using a GILTI asset. Although the full loss cannot be utilized to offset it's $10 of GILTI, that income is subject to a reduced 10.5% effective tax rate. US1 is then free to fully utilize the built-in loss recognized upon the sale of Factory B in year 3 to offset Subpart F income subject to tax at a 21% effective tax rate.

If the Segregated Approach were utilized in Example 9b, then FA would have separate Section 382 limitations and NUBIG/NUBIL amounts with respect to GILTI and Subpart F/Section 956. FA would have a $5 GILTI NUBIL and a Subpart F NUBIL of $5. As a result, the sale of Factory B in year 3 would be an RBIL whose use is subject to FA's $1 Section 382 limitation (if our recommendation is adopted, the remaining $4 of RBIL will be carried forward and will be usable in the future subject to the applicable Section 382 limitation). Accordingly, the Segregated Approach would prevent gains in one category of assets from offsetting losses in another category of assets and would also eliminate the ability of taxpayers to selectively choose which built-in loss assets absorb a NUBIL.

[91] If GILTI RBIL and Subpart F RBIL are both carried forward, then there would need to be an ordering rule, perhaps in Section 383, which governs the order of utilization of other attributes after an ownership change, to determine which RBIL is used.

Recommendation: The majority of members of the Executive Committee have significant concern that under the Segregated Approach it would be very difficult, perhaps impracticable, for taxpayers to categorize assets as GILTI or Subpart F assets.[92] This complexity may result in remaining ambiguities, that, even with targeted guidance, could leave taxpayers with open questions on how to properly allocate the Section 382 limitation using the Segregated Approach. In addition, a CFC that has a US branch and earns GILTI and Subpart F income would have three different Section 382 limitations. As noted above, taxpayers using the Aggregate Approach could calculate a single Section 382 limitation and apply the current allocation and apportionment rules making the Aggregate Approach far less difficult to administer. Accordingly, we recommend Treasury issues guidance adopting the Aggregate Approach. However, if instead Treasury was to determine that the Segregated Approach or a similar approach should be adopted, then we recommend that Treasury issues clear and pragmatic guidance on categorizing assets as GILTI or Subpart F assets.

C. Other Relevant CFC Attributes

10. Application to other CFC Attributes.

Issue: To what attributes of a CFC should Section 382 apply?

In addition to Interest Carryforwards and built-in losses, CFCs also have other relevant tax attributes such as "qualified business asset investment," as such term is defined in Section 951A(c)(2)(B)(i) and Reg. §1.951A-2(b)(2) (i.e., QBAI) and foreign tax credits.

The concept of QBAI was created in response to the administrative complexity of identifying income attributable to intangible versus tangible assets for purposes of GILTI. Congress provided that GILTI should be determined based on a formulaic approach by which a 10% notional return is attributed to certain tangible assets. Each dollar of income above such threshold, or "normal return," is then deemed income derived from intangible assets and subject to GILTI.[93]

While it is possible that an Inclusion Shareholder could attempt to acquire a CFC with significant QBAI in order to reduce its GILTI inclusions, we do not believe that Section 382 should apply to QBAI. QBAI is not a loss, deduction, or credit that should be considered a "pre-change loss." Instead, it is a category of income (i.e., the amount of deemed tangible income return) that Congress determined should not be subject to GILTI.

Similarly, we recommend that Section 382 should not apply to the foreign tax credits at the CFC level. The use of foreign tax credits by an Inclusion Shareholder is already subject to numerous and complex limitations that are determined at the shareholder level. For example, excess foreign

[92] For example, in the real world, it is possible that Factories A and B in Examples 9a and 9b are used to manufacture some products that produce Subpart F income and some that produce GILTI.

[93] See Senate Committee on the Budget, 115th Cong., Reconciliation Recommendations Pursuant to H. Con. Res. 71, at 365 (Comm. Print 2017).

tax credits in the GILTI basket already cannot be carried forward.[94] Moreover, a particular Inclusion Shareholder's ability to utilize foreign tax credits can be limited by Section 904 based on its particular facts and circumstances, such as the amount of its foreign source income and the amount of deductions allocated and apportioned against that income. After the Act, and the repeal of the deemed-paid foreign tax credit under Section 902 of the Code, subjecting foreign tax credits to another limitation is even less justified because no credits carry forward at the CFC level. Further, foreign tax credits can already be subject to limitation under Section 383 at the Inclusion Shareholder level. In order to avoid duplicative, and possibly conflicting, limitations on foreign tax credits, we recommend that any limitations under Section 382 on the use of foreign tax credits derived from CFC inclusions should be limited to the Inclusion Shareholder level, and not apply at the CFC level.

Recommendation: Other than Interest Carryforwards, built-in losses, and the pre-change portion of current year losses (in the case of a mid-year acquisition of a corporate Inclusion Shareholder), Section 382 should not apply to other CFC attributes.

D. Applying Section 382 at Shareholder vs Corporate Level, CFC Groups

11. Acquiring Stock of Inclusion Shareholder: Allocating Value under Reg. §1.382-8

The Section 382 controlled group rules likely have increased relevance in the case that Section 382 applies to CFCs, because the rules apply to non-consolidated groups of related corporations. In the domestic context, the controlled group rules apply less often by reason of related domestic corporations typically joining a consolidated group.

First, an overview of the controlled group rules is helpful, before applying them to an ownership change of an Inclusion Shareholder and CFCs. Reg. §1.382-8 has mechanics for an ownership change of a non-consolidated group of related corporations, referred to as a controlled group. Reg. §1.382-8 provides rules to adjust the value of a loss corporation that is a member of controlled group of corporations so that the same value is not included more than once in computing the Section 382 limitation for the loss corporations that are members of the controlled group (e.g., if P acquires S, which owns nonconsolidated S1, there is an ownership change of S and also S1, and the value of the S1 stock should not be duplicated to provide Section 382 limitation for S1 and also for S).

In general, Reg. §1.382-8 reduces the value of the loss corporation by the value of the stock of each component member of the controlled group that the loss corporation owns immediately after the ownership change. So, if loss corporation S owns S1, the value of the S stock would be reduced by the value of the S1 stock. Reg. §1.382-8(c)(2) provides that the other member of the controlled

[94] The House Bill and the Wyden Bill each propose a temporary five-year carryforward for excess foreign tax credits in the GILTI basket, after which the GILTI carryforward period would extend to ten years. The House Bill and the Wyden Bill also provide for a jurisdiction-by-jurisdiction calculation of foreign tax credits in the GILTI basket. The impact of this House Bill or the Wyden Bill, or other proposed legislation, is beyond the scope of this Report.

group can elect to restore the loss corporation's value from the subsidiary member back up to the parent member. If such an election is made, S can keep all of its stock value for purposes of the Section 382 limitation, including the value attributable to its ownership of S1 stock, and S1's value would be reduced by the amount restored to S for purposes of determining S1's Section 382 limitation.

Reg. §1.382-8(b) provides that a controlled group loss is a pre-change loss or NUBIL of a loss corporation that is attributable to the tax year in which the loss corporation was a member of a controlled group. The controlled group is comprised of the loss corporation and each other corporation that is a component member of the controlled group both (1) with respect to the taxable year to which the controlled group loss is attributable; and (2) on the date the loss corporation has an ownership change.

The definition of a "controlled group" has the same meaning as in Section 1563(a), but by using a 50% standard.[95] The definition of "component member" has the same meaning as in Section 1563(b), but without regard to certain exclusions (e.g., the exclusion of foreign corporations). Reg. §1.382-8(e)(4) excludes from the definition of "foreign component member" foreign corporations that have effectively connected income.

Previously, in the absence of an election, the default mechanic under these rules provided that value was subtracted from the upper-tier loss corporation to the extent of value of its subsidiaries, even if its subsidiaries were foreign corporations without a US trade or business. Practitioners viewed this as a trap for the unwary, because taxpayers routinely failed to make the election to reattribute value back from a subsidiary to an upper-tier loss corporation, and as a result, the Section 382 limitation in the upper-tier loss corporation was reduced by reason of the default rule applying. While this resulted in a higher Section 382 limitation in the foreign subsidiary, the increased Section 382 limitation in the foreign subsidiary would only be valuable to the extent that the taxpayer applied Section 382 to the foreign subsidiary, which historically has been very uncommon outside of the ECI context. To address this, Treasury created a special rule for foreign corporation component members under Reg. §1.382-(8)(h)(2), which reverses this default mechanic with respect to foreign corporation component members, providing that their value is restored to the upper-tier domestic corporation, unless the taxpayer elects otherwise.

If Section 382 applies to CFCs with GILTI attributes (or Subpart F attributes) and there is an ownership change of both the US corporate Inclusion Shareholder and the CFC, the incentives to make the election would change. Depending on the nature of the attributes limited by Section 382

[95] Section 1563(a) provides that a "controlled group of corporations" means any group of one or more chains of corporations connected through stock ownership with a common parent if (1) stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote or at least 80% of the total value of shares of all classes of stock of each of the corporations, except the common parent corporation, is owned (within the meaning of Section 1563(d)(1)) by one or more of the other corporations; and (2) the common parent corporation owns (within the meaning of Section 1563(d)(1)) stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote or at least 80% of the total value of shares of all classes of stock of at least one of the other corporations, excluding, in computing such voting power or value, stock owned directly by such other corporations.

and on the income projections going forward, there may be a desire to keep value at the CFC level as opposed to restoring value back up to the US corporation.

> **Example 11a**: ***Value of keeping Section 382 limitation at CFC; acquisition of corporate Inclusion Shareholder.*** Acquiror purchases UST from an unrelated seller for $1000. UST owns CFC, the value of which is equal to $600. The applicable long-term tax-exempt rate is 2%. UST has $40 of NOL carryovers, and CFC has a NUBIL of $60. The CFC's NUBIL is expected to be recognized during the five-year recognition period, and the RBIL deduction will be allocated to tested income.

Before the Act and enactment of the GILTI rules, there was likely little benefit in keeping value at the CFC level but, following the Act, and assuming that a CFC can carry forward disallowed RBIL, there could be a benefit (in a much narrower set of cases, there can be a Subpart F benefit as well). Here, under the default mechanic which provides that UST's value is restored by the amount of CFC's value, UST would be able to use its $40 NOL carryover during the two years following the ownership change because UST's Section 382(a) limitation is $20 (i.e., UST's aggregate $1000 value * 2% rate). Further, under this default mechanic, CFC's Section 382 limitation would be $0 (i.e., $0 value * 2% rate) and CFC's RBIL could never be utilized.

By contrast, if CFC elects not to restore value to UST, then UST's Section 382 limitation would be $8 (i.e., UST's standalone $400 value * 2% rate) and CFC's Section 382 limitation would be $12 (i.e., $600 * 2%). In this case, the absorption of USP's NOL would be slowed, requiring five years to fully utilize the $40 NOL rather than two years as above, but CFC's $60 NUBIL could also be fully utilized in five years, instead of being eliminated. Thus, an election to retain value at CFC could unlock attributes and bring significant benefits.

> **Example 11b**: ***Using CFC value for Section 382 limitation at Inclusion Shareholder: acquisition of corporate Inclusion Shareholder with no standalone value.*** Acquiror, the parent of a consolidated group, purchases UST from unrelated seller for $1,000. UST owns CFC. UST consistently generates losses, has significant NOL carryforwards, and its standalone value is $0. The value of CFC is $1000 but CFC has no tax attributes.

In Example 11b, should it make a difference that UST has no standalone value? In this instance, Acquiror is incentivized to restore CFC's value to UST, as it would have the effect of increasing UST's Section 382 limitation, thereby permitting Acquiror to access UST's attributes. On the other hand, if UST is not allowed to benefit from CFC's value, then this would require valuations for CFC and any other nonconsolidated subsidiaries of UST, which may be unduly burdensome.

Further, the value of CFC corresponds to income that CFC will earn that generally will be included by UST under the GILTI or Subpart F regimes. UST's NOL carryforwards, even without an ownership change, would be available to offset its inclusions of CFC's income. There are complex interactions between the NOL rules, GILTI/Subpart F rules, foreign tax credit rules, and Section 250 deduction that would be necessary to analyze in order to determine how the NOL carryforward would be used to offset post-ownership change GILTI and Subpart F inclusions of CFC, and what the value of those NOLs would be (i.e., whether the NOLs would offset "21% income" or "10.5% income"). One could argue that a CFC generally creates "10.5% income" for the Inclusion

Shareholder, and so in a case such as Example 11b, the value of CFC stock should only contribute towards a Section 382 limitation at the corporate Inclusion Shareholder (UST) level equal to the proportionate tax rate imposed on CFC income as compared to the tax rate imposed on UST. For example, in Example 11b, assuming the tax rate on UST's income is 21% and the tax rate on CFC's income is 10.5%, then one could argue that $1,000 of value in CFC stock, if the parties choose to keep that value up at the UST stock level pursuant to Reg. §1.382-8, should only give rise to Section 382 limitation equal to $500 multiplied by the applicable rate.

However, in practice, it would be extremely difficult to predict the effective tax rate on CFC income. First, it can be difficult to predict whether a CFC will produce GILTI, Subpart F income, or residual income (i.e., through QBAI or tested losses from other CFCs) (or whether the Inclusion Shareholder will sell the CFC stock, generally resulting in 21% tax for a corporate seller). Second, even nominally lower-taxed GILTI can absorb domestic NOLs at a 21% rate, due to the operation of Section 250. Under Section 250, if there is no domestic income for the domestic NOLs to offset, the domestic NOLs will offset a GILTI inclusion dollar-for-dollar before giving effect to the Section 250 deduction. The use of NOLs is particularly relevant in determining the proper role of Section 382. Finally, the tax rates on US corporate income and GILTI income, and the relationship between the two rates, may fluctuate over time. For these reasons, any approach which attempts to calculate a proportionate value of CFC stock to be included in UST's Section 382 limitation based on these factors appears to be impractical.

<u>Recommendation</u>: The current regulatory framework for treatment of non-consolidated controlled groups of corporations should continue to apply and, if there is an ownership change of a corporate Inclusion Shareholder which owns a CFC, Regulations should retain the taxpayer electivity in Reg. §1.382-8 as to which Section 382 limitation (the corporate Inclusion Shareholder's or the CFC's) benefits from the value of CFC stock.

12. CFC Attributes as Inclusion Shareholder Attributes

<u>Issue</u>: Could the attributes of CFCs be considered attributes of the Inclusion Shareholder (i.e., the US loss corporation) subject to limitation at the level of that shareholder?

An alternative approach would be to apply Section 382 only to an ownership change of a corporate Inclusion Shareholder and view the attributes of the CFC as attributes of the Inclusion Shareholder. However, this approach appears to require the CFC to keep multiple sets of books – at least one calculation of all of its tax items for each Inclusion Shareholder that undergoes an ownership change, as well as another calculation of all of its tax items for each Inclusion Shareholder that has not undergone an ownership change. Consider the following example:

> **Example 12a**: ***Ownership changes of multiple Inclusion Shareholders over time.*** US1 owns 10% of CFC, and US2 owns 10% of CFC. US1 and US2 are unrelated. At the end of Year 1, US1 undergoes an ownership change. At the end of Year 2, US2 undergoes an ownership change.

In this example, if CFC's attributes are considered attributes of US1 and US2, respectively, because both US1 and US2 underwent ownership changes, CFC would calculate its tested income

(i) in Year 1, normally, (ii) in Year 2, in a manner that reflects a portion of US1's Section 382 limitation for purposes of US1's pro rata share, and normally for purposes of US2's and the other Inclusion Shareholders' pro rata shares, and (iii) in Year 3, in a manner that reflects a portion of US1's Section 382 limitation for purposes of US1's pro rata share, in a manner that reflects a portion of US2's Section 382 limitation for purposes of US2's pro rata share, and normally for purposes of other Inclusion Shareholder's pro rata shares. In addition, if CFC's attributes are considered attributes of its Inclusion Shareholders, each time an Inclusion Shareholder undergoes an ownership change, the CFC would be required to recalculate that shareholder's NUBIL and NUBIG, and each such shareholder would have its own RBIL and RBIL account. This approach appears to be unduly complex and burdensome for CFC to administer.

Nonetheless, if this approach were adopted, one advantage would be that it could utilize the existing infrastructure of Sections 382 and Section 383 and treat CFC attributes as just another attribute of a domestic loss corporation (i.e., the corporate Inclusion Shareholder) that undergoes an ownership change. However, Section 383 does not list a CFC's GILTI attributes, such as an Inclusion Shareholder's pro rata share of tested losses, as tax attributes subject to limitation. Therefore, if this approach is desired, Treasury would either need to rely on the general authority grant under Section 382(m), which would potentially be an overbroad extension of this authority, or request a statutory amendment.

> **Example 12b**: ***CFC attributes as a Section 383 attribute of corporate Inclusion Shareholder.*** USP, which owns some or all of CFC, undergoes an ownership change at the beginning of Year 1. As a result of the ownership change, USP has a $100 Section 382 limitation. At the time of the ownership change, USP has $180 NOLs and $90 pre-change credits. USP's share of CFC's Interest Carryforward is $260.

For purposes of this example, if CFC's attributes were treated as an attribute of USP, assume that the Section 383 order of utilization would place CFC's attributes after USP's NOLs and before USP's pre-change credits. Consequently, USP would utilize its $100 Section 382 limitation as follows: (i) in Year 1, USP would utilize $100 of NOLs and USP's remaining attributes would be $80 of NOLs, $260 of CFC's Interest Carryforward, and $90 of pre-change credits; (ii) in Year 2, USP would utilize its remaining $80 NOLs and $40 of CFC's Interest Carryforward[96] and USP's remaining attributes would be $220 of CFC's Interest Carryforward and $90 of pre-change credits; (iii) in Year 3, USP would utilize $200 of CFC's Interest Carryforward and USP's remaining attributes would be $20 of CFC's Interest Carryforward and $90 of pre-change credits, and (iv) in Year 4, USP would utilize the remaining $20 of CFC's Interest Carryforward and $90 of pre-change credits, leaving USP with no attributes at the end of Year 4.

Treating a CFC's attributes as attributes of a corporate Inclusion Shareholder would require a determination of such Inclusion Shareholders' pro rata share of the CFC attributes (e.g., USP's

[96] The $40 of Interest Carryforward that is utilized is twice the remaining Section 382 limitation, under the assumption that the utilization of CFC attributes would reflect the relative effective rates of GILTI Inclusions being half that as compared to US income (i.e., 10.5% vs. 21%); as noted in the discussion of Example 11b, above, determining the relative effective rates would be impractical.

$260 pro rata share of CFC's Interest Carryforwards in Example 12b). While this determination would be straightforward in the case of a wholly-owned CFC, the determination could be quite complicated where there are multiple owners of a CFC and even more so where there are both multiple owners and multiple classes of CFC stock. Reg. §1.951A-1 uses a complex hypothetical distribution model to allocate GILTI-relevant items to owners of a CFC. Potentially, Treasury could leverage the existing infrastructure of this regulation such that USP's share of CFC's attributes could be determined with reference to USP's share of such items, under Reg. §1.951A-1, assuming counterfactually that CFC had actually recognized them in the year preceding the ownership change. However, these items could be allocated in a completely different way once CFC actually recognizes them. In other words, if a tax attribute of CFC is considered, for purposes of Section 382, as a tax attribute of its corporate Inclusion Shareholder, then determining the amount of this attribute in the hands of the Inclusion Shareholder is very difficult and, in some cases, impossible.

For example, assume Inclusion Shareholder owns preferred stock of CFC that generates a 10% preferred coupon on an issue price of $100, but otherwise does not participate in profits. If a particular built-in loss would reduce post-ownership change income of the CFC from $9 to $7, then the preferred stock owned by Inclusion Shareholder would bear the entire amount of the built-in loss; but if the built-in loss reduced post-ownership change income from $14 to $12, the preferred stock owned by the Inclusion Shareholder would not bear any of the loss, because it would receive its $10 coupon with or without the loss. Thus, it is often impractical, and potentially impossible, to determine an Inclusion Shareholder's pro rata share of CFC attributes at the time of an ownership change. Accordingly, we do not recommend an approach which treats the attributes of a CFC as attributes of the CFC's Inclusion Shareholder.

<u>Recommendation</u>: Section 382 should apply directly to the CFC, as opposed to the CFC's attributes being considered attributes of a corporate Inclusion Shareholder.

13. Acquisition of Wholly-Owned CFCs – Separate Entity or Aggregate Approach?

<u>Issue</u>: *If a US person acquires 100% of the stock of multiple CFCs from a single seller, should the acquired CFCs have a single group Section 382 limitation? What about an aggregate valuation and aggregate NUBIG/NUBIL calculation? Is it relevant that certain calculations are aggregate (Section 163(j) and tested income) vs. entity (Subpart F)?*

The Section 382 limitation is generally computed on a separate-company basis, other than in the case of a consolidated group. It should be considered whether this separate entity approach makes sense in the context of a foreign loss corporation, as the tax attributes of the foreign loss corporation can potentially be used to reduce the tax liability of an Inclusion Shareholder by offsetting income items of other CFCs owned by that Inclusion Shareholder.

The ability to utilize attributes of a foreign loss corporation to offset income generated by other corporations is similar to the acquisition of a target loss corporation (or target consolidated group) by an acquiring consolidated group in the domestic context. In the case of an acquisition of a domestic target (or group) by a consolidated group, the Section 382 consolidated return rules under

Reg. §1.1502-91 to -99 generally use a single Section 382 limitation and determine ownership changes with respect to common parent stock in recognition that separate-entity treatment would be inappropriate in this context.[97] Essentially, where two or more corporations could share losses prior to an ownership change it is consistent with the neutrality principle to permit these corporations to continue to share losses following the ownership change as if they were a single corporation.[98]

If the tax liability of an Inclusion Shareholder was determined on an entity-by-entity basis with reference to items of a CFC and not potentially offset by items of a different CFC, as under Subpart F, it would seem consistent to compute the Section 382 limitation on a separate-company basis. However, because the GILTI inclusion is calculated on an aggregate basis with respect to all CFCs owned by an Inclusion Shareholder, and similarly, the Section 163(j) limitation can, by election, be determined with respect to the adjusted taxable income and business interest income of a group of CFCs, consideration should be given to apply Section 382 to CFCs on a groupwide basis, consistent with the neutrality principle. Two questions arise – first, as discussed in this Part D.13, whether an aggregate group approach is appropriate when 100% of the stock of multiple CFCs is acquired from a single seller, and second, as discussed in Part D.14, what threshold should constitute a CFC group when less than 100% of the stock of a CFC is acquired.

> **Example 13a: *Acquisition of 100% of multiple CFCs – Section 382 Limitation***. USS owns 100% of the stock of CFC1 and CFC2. Each of CFC1 and CFC2 has a NUBIL, the deductions from which would be allocated to tested income. The value of CFC1 is $50 and the value of CFC2 is $100. The applicable federal long-term tax-exempt rate is 2%. USS sells 100% of the stock of CFC1 and CFC2 to USB, an unrelated US corporation.

Assuming Section 382 applies, CFC1's Section 382 limitation on a standalone basis would be $1 and CFC2's Section 382 limitation on a standalone basis would be $2. If CFC1 and CFC2 were treated as a group, the aggregate Section 382 limitation would be $3. One advantage of applying a group approach is that it reduces the incentive to engage in related party transactions to place income in a certain entity. For example, assume that CFC1's Section 382 limitation, which was smaller than CFC2's, has been exhausted for the year, but CFC2 had remaining limitation – USB would be incentivized to cause CFC1 to make a deductible (but non-RBIL) payment to CFC2. As a result of such payment, CFC1 would deduct the item, reducing tested income, and CFC2 would include the item but offset the income with its remaining allowable pre-change loss. Consistent

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[97] Other than in certain limited circumstances with respect to subsidiary stock, dealing mostly with abusive cases.

[98] *See* Notice of Proposed Rulemaking, 56 Fed. Reg. 4194, at 4195 (Feb. 4, 1991), which provides:

> The single entity approach to section 382 reflects the ability of corporations filing consolidated returns to use each other's losses as well as the principle that the tax laws should operate in a neutral manner with respect to changes in ownership. Under the neutrality principle, losses that arise while two or more corporations are members of one group and that are therefore available to be used among the members should remain so available following an ownership change, subject only to the restrictions that would be imposed on a single entity in similar circumstances.

T.D. 8678 (June 27, 1996).

with the approach to Section 382 in the consolidated context, because the attributes of a CFC can be used to offset income of other CFCs owned by an Inclusion Shareholder, an aggregate calculation appears to be the most appropriate approach.

Recommendation: When 100% of the stock of multiple CFCs is acquired from a single seller (or single consolidated group) in an ownership change, the Section 382 limitation should be calculated on an aggregate basis.[99]

A similar question arises with respect to the calculation of NUBIG/NUBIL: should NUBIG/NUBIL be calculated on a separate company basis or on an aggregate basis?

> **Example 13b: *Acquisition of multiple CFCs – NUBIG/NUBIL Calculation***. USS owns 100% of the stock of CFC1 and CFC2. CFC1 has a NUBIL of $50 and CFC2 has a NUBIG of $100. USP sells 100% of the stock of CFC1 and CFC2 to USB, an unrelated US corporation. CFC1 recognizes the $5 loss attributable to its NUBIL.

On a separate entity basis, CFC1 has a NUBIL of $50 and CFC2 has a NUBIG of $100. Consequently, if calculated separately, CFC1's $5 loss would be RBIL, as CFC1 has a NUBIL at the time of the ownership change. Conversely, on an aggregate basis, CFC1 and CFC2 would have a NUBIG of $50, and thus CFC1's $5 loss could be deducted without limitation under Section 382.

Similar to the above, while the Regulations under Section 382 generally require that NUBIG and NUBIL be calculated on a separate-company basis, this determination is made on an aggregate basis in the consolidated return context. For similar reasons as those cited above in support of the calculation of the Section 382 limitation on an aggregate basis, we believe that it would be more appropriate to determine NUBIG/NUBIL and RBIG/RBIL on an aggregate basis.

Recommendation: Assuming the Section 382 limitation is calculated on an aggregate basis when 100% of the stock of multiple CFCs is acquired from a single seller (or single consolidated group) in an ownership change, NUBIG/NUBIL should similarly be calculated on an aggregate basis.

14. Acquisition of CFC Groups – What Constitutes a Group

Issue: Should a group rule apply to less-than 100% acquisitions of CFCs, and, if so, what is the appropriate threshold? Must the acquisition occur at a single time or within another pre-defined period? Should a group rule be limited to acquisitions from related sellers or apply more broadly?

If a decision is made to calculate the Section 382 limitation and NUBIG/NUBIL on an aggregate basis where 100% of the stock of multiple CFCs are acquired from a single seller, it should be considered whether group treatment would be limited to this context or would extend to other situations. In other words, if group treatment is to be expanded beyond this context, rules would

[99] A discussion of the acquisition of less than 100% of the stock of multiple CFCs from multiple sellers is discussed in Part D.14 *infra*.

be necessary to determine what is the appropriate CFC group for this purpose. Consider the following examples:

> **Example 14a: *Contemporaneous CFC acquisitions from unrelated sellers*.** In Year 1, USB, a US corporation, acquires 100% of CFC1 and 60% of CFC2 from two different, unrelated sellers. At the time of the acquisition, CFC1 has a NUBIG of $10 and CFC2 has a NUBIL of $5.

> **Example 14b: *Acquisition of various portions of multiple CFCs from same seller in single transaction***. In Year 1, USB, a US corporation, acquires 100% of CFC1 and 60% of CFC2 from the same seller in a single transaction. At the time of the acquisition, CFC1 has a NUBIG of $10 and CFC2 has a NUBIL of $5.

As discussed above, where 100% of the stock of multiple CFCs is acquired from a single seller (or single consolidated group) in an ownership change, applying an aggregate approach seems appropriate. That is, because the attributes of the CFCs could generally be utilized on a groupwide basis prior to the ownership change, it is consistent with the neutrality principle to aggregate the attributes of theses CFCs for purposes of Section 382.[100] The same treatment should obtain regardless of whether these CFCs are acquired from a single seller (or single consolidated group) in a single transaction or through a series of related transactions.

By contrast, where multiple CFCs are acquired from unrelated sellers, aggregate treatment would not be appropriate; it would be inconsistent with the neutrality principle because these CFCs could not share their attributes prior to the ownership change. Similarly, even where the stock of multiple corporations is acquired from related sellers, aggregate treatment would not be appropriate if the acquired corporations did not have the ability to share their attributes before the ownership change. For example, assume that US1 and US2 are members of an affiliated group that does not file a consolidated return, and US1 and US2 owned 100% of CFC1 and CFC2, respectively. Because the attributes of CFC1 and CFC2 could not be utilized on a groupwide basis beforehand, it would be inconsistent with the neutrality principle to apply aggregate treatment to CFC1 and CFC2 following an ownership change.

If less than 100% of a CFC is acquired from a single seller (or a consolidated group), the mechanics of an aggregate approach become less clear, thereby reducing the appeal of an aggregate approach. For example, in Example 14b, where USB acquires 100% of CFC1 and 60% of CFC2 from the same seller in a single transaction, assume that another Inclusion Shareholder, USX, owns the remaining 40% of CFC2. As described above, due to the function of Section 382, USX would suffer from CFC2's ownership change notwithstanding that it simply retains its 40% ownership of CFC2. Regardless of whether this result is appropriate, it would be anomalous, and difficult to justify, if CFC2's Section 382 limitation, which affects USX, was determined in part by reference to a different CFC not owned at all by USX.[101]

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[100] *See* Notice of Proposed Rulemaking, 56 Fed. Reg. 4194, at 4195 (Feb. 4, 1991), discussed *supra*.

[101] As discussed above, it would also be impractical and unduly burdensome to calculate different Section 382 limitations for different Inclusion Shareholders.

For that reason, it would be warranted to set the ownership threshold for group acquisitions having a single Section 382 limitation fairly high, thereby limiting anomalous results to situations where there was a clear majority shareholder and, by implication, minority shareholders would or should be aware of the potential for these results and, if necessary, could negotiate a tax sharing agreement similar to minority owners of subsidiaries of a consolidated group.

Recommendation: If the Section 382 limitation and NUBIG/NUBIL are determined on an aggregate basis, then the aggregate basis should apply by reference to a CFC group. A CFC group should be comprised of the CFCs acquired from a single seller (or single consolidated group) in a single transaction (or series of related transactions), where an amount of stock satisfying Section 1504(a)(2) (i.e., 80% vote and 80% value) of each CFC is owned by the acquiror (or by a related person) after the acquisition.

E. Should Section 382 Apply to CFCs not Engaged in a US Trade or Business?

15. Section 382 as corporate-level provision

Issue: Does it make sense to apply Section 382 to CFCs when the relevant tax burden being reduced is that of the Inclusion Shareholder (i.e., is it relevant that Section 382 normally operates to limit use of attributes by the loss corporation itself and doesn't care who acquires the loss corporation)?

Section 382 refers to a loss corporation and historically has been an entity-level determination. Section 382 is not tailored to inclusion regimes where the loss corporation is not a taxpayer itself but, rather, its items flow up to the loss corporation's owners. Despite this fact, it should be considered whether this concept is actually different from the context of a domestic corporation that is acquired by a consolidated group. Consider the following examples:

> **Example 15a: *Acquisition of US target by consolidated group.*** USP is the parent of a consolidated group and acquires 100% of the stock of UST, a loss corporation, in a transaction constituting an ownership change of UST. The amount of income on USP's consolidated return that can be offset by pre-change losses of UST is limited to the amount of UST's Section 382 limitation.
>
> **Example 15b: *Acquisition of CFC Target.*** USP acquires 100% of the stock of CFC, a loss corporation, in a transaction constituting an ownership change of CFC. If Section 382 applies to CFC, the amount of CFC's income on USP's consolidated return (through GILTI or Subpart inclusions) that can be offset by pre-change losses of CFC is limited to the amount of CFC's Section 382 limitation.

Although the application of Section 382 to S corporations has previously been unclear, Treasury has recently taken the position that Section 382 applies to the Interest Carryforwards of an S corporation.[102] Similar to a CFC, the items of an S corporation flow up to the entity's owners.

[102] *See supra* note 79 and accompanying text; Reg. 1.163(j)-6(*l*)(10).

However, in the case of a CFC, unlike an S corporation, only Inclusion Shareholders would be affected by a limitation on the use of a CFC's attributes. Rules which would adjust which owner shifts of a CFC are relevant (and disregard certain acquisitions), as discussed above, could help address this unique feature of CFCs, as compared to domestic S or C corporations.

Further, concerns regarding Anti-Trafficking Policy and Averaging Policy provide sufficient justification to support the application of Section 382 to CFCs. We recognize that the stakes are different with respect to application of Section 382 to CFCs as opposed to in the domestic context. For example, US acquirors of foreign target corporations will often make a Section 338(g) election in order to achieve basis step-up that can be used to increase QBAI, reduce tested income, and eliminate other pre-existing attributes of the CFC and the need to calculate those attributes. In addition, a US seller might prefer a Section 338(g) election to convert unrealized gain inside the CFC from being reflected as stock gain taxed to the seller at highest marginal rates into GILTI tested income included by seller at the lower effective rate. Because it results in the elimination of the attributes of the foreign target, a Section 338(g) election would make a Section 382 inapplicable to the foreign target.

Under the GILTI regime, CFCs cannot carry forward NOLs or capital losses from one year into another, effectively eliminating the specific abuse that Section 382 was originally designed to address,[103] and with respect to mid-year ownership changes, the Reg. §1.951A-1(d)(4) pro rata share rules automatically reduce an acquiror's share of tested loss by the proportion of the year that the buyer did not own the CFC. Also, if NUBIL is attributable to a QBAI asset, recognizing the corresponding RBIL by selling the asset to an unrelated party would also cause the detriment of losing the QBAI (although increased depreciation deductions with respect to the QBAI asset attributable to the NUBIL could be taken advantage of without disposing of the asset). Interest Carryforwards of a CFC are already limited by a SRLY-like rule in Reg. §1.163(j)-7, which, if a CFC joins a "CFC group," only allows the CFC's Interest Carryforwards to be used by the group to the extent the CFC contributes to the Section 163(j) limitation of the group.[104] Finally, an Inclusion Shareholder that benefits from a significant foreign tax credit would have less incentive to offset the tested income of its existing CFCs, and thus less incentive to acquire a target CFC with built-in losses or Interest Carryforwards.

On the other hand, NUBIL of a CFC (if not eliminated by a Section 338(g) election) is both available to a CFC and not subject to limitation under any other rule. Also, if not limited by Section 382, in the case of a mid-year acquisition of a corporate Inclusion Shareholder by an acquiring consolidated group, the pre-ownership change portion of a CFC's tested loss for the year would be available to the acquiring consolidated group—because there is no change in the Inclusion

[103] If legislation implements a jurisdiction-by-jurisdiction approach to tested losses, there may be more appetite at Treasury to allow loss carryforwards. Indeed, as discussed above, the House Bill and the Wyden Bill each propose that unused tested losses can be carried forward.

[104] If the CFC does not join a CFC group, the determination is made on a separate entity basis. While the SRLY-like limitation differs in purpose and scope than Section 382, it still provides an applicable limitation in this context.

Shareholder, there would be no reduction in pro rata share of tested loss under the special rule of Reg. §1.951A-1(d)(4) described above.

If it becomes clear that Section 382 does not apply to the acquisition of a CFC, then taxpayers could structure acquisitions to take advantage of NUBIL, and, in the case of acquired corporate Inclusion Shareholders, current year tested loss. Moreover, to the extent a taxpayer can manage the SRLY-like limitation of Reg. §1.163(j)-7, Interest Carryforwards of a target CFC could be utilized without limitation in order to reduce tested income. This appears to invite the possibility of the type of loss trafficking that Section 382 was enacted to prevent.

<u>Recommendation</u>: There should be some form of limitation on the use of CFC attributes when a CFC is acquired, and while the application of Section 382 to CFCs has material flaws, unless and until a new regime is enacted by Congress, the Section 382 regime (with certain modifications) is likely the best available option. Despite its imperfections, Section 382 is an existing system which appears to literally apply, is intended to police the type of loss trafficking that can occur in the acquisition of a CFC, and there is significant statutory authority to alter the domestic rules to more narrowly tailor Section 382 to the CFC context and address loss trafficking transactions in which abuse is most likely to occur. Moreover, the potential alternative loss limitation regimes that have been identified have equal or greater flaws. We would be happy to consider further options to limit the use of CFC attributes in the case of statutory amendments allowing for such options.

16. SRLY as an Alternative

<u>Issue</u>*: Do other approaches have merit? For example, would it make sense to apply a SRLY approach (similar to the Section 163(j) Regulations)? Could this approach be extended to NUBIL (or other relevant attributes)? While this approach has conceptual appeal (i.e., concern is the sharing of attributes of a CFC, rather than that CFCs use of its own attributes) are there practical concerns (e.g., stuffing concerns, combining a SRLY CFC with a profitable CFC, etc.)?*

As an initial matter, it is not clear that there is statutory authority for Treasury to adopt a SRLY-like limitation with respect to NUBIL of a CFC loss corporation. While the authority provided by Section 382(m) is broad, it appears to allow Regulations to implement Section 382 and not other provisions.[105] Moreover, the purpose of the SRLY regime is to reconcile inconsistencies between single-entity and separate-entity systems when a corporation with a separate return year joins (or leaves) a consolidated group, essentially replicating the separate-entity treatment of the SRLY member (to the extent it is possible to do so).[106] Unlike Section 382, the SRLY regime is not

[105] *But see supra* note 69 (noting that the Conference Report to the Tax Reform Act of 1986 indicates that the grant of authority under Section 382(m) is intended to be sufficiently broad to enact any rules appropriate to avoid the purposes of Section 382).

[106] *See, e.g.,* Federal Income Taxation of Corporations Filing Consolidated Returns, § 42.02 (Matthew Bender, Rev. Ed.) ("The SRLY rules represent an effort to reconcile the inconsistent single- and separate-entity treatment of members, to avoid disrupting reasonable expectations (on the part of both taxpayers and the government)."); TAM 200514019 (April 5, 2004) (Stating that the SRLY regime has "historically served to police the line between consolidated return years and separate return years" and that the ability to offset the losses of one member against the income and gain of other members "extends only to losses incurred during years of affiliation."); ILM 200924042

primarily intended to police trafficking in attributes, notwithstanding that it can impact the use and absorption of loss attributes of a SRLY member.

Nonetheless, there are conceptual advantages to a SRLY approach. Under such a regime, there would be no need to create complex ownership change rules applicable to CFCs, and instead, the SRLY limitation would apply as soon as a threshold target ownership percentage was acquired by an Inclusion Shareholder (e.g., 80%). When such threshold is acquired, the CFC could only use its RBIL to reduce tested income or increase tested loss to the extent the CFC's own positive tested income is allocated to the Inclusion Shareholder.

> **Example 16a: *SRLY limitation on CFC NUBIL.*** USP acquires 100% of the stock of CFC, a loss corporation that has a NUBIL. CFC recognizes RBIL during the year after the acquisition.

Under a SRLY approach, CFC would only be able to use the RBIL to the extent it generated positive tested income while owned by USP. In addition, even though no carryforward is generally available to CFCs currently, presumably some type of carryforward would be necessary for SRLY-limited losses, such that they could be used in a subsequent year when the CFC generates tested income (similar to the carryforward of limited RBIL, as discussed above).

While in some ways simpler than Section 382, the application of a SRLY approach would be too narrow to govern certain transactions. For example, if USP only acquired 10% of CFC, then assuming such a SRLY approach would similarly have an 80% ownership threshold,[107] a 10% acquisition would simply not be covered. In contrast, under Section 382, if a 10% acquisition caused an aggregate 50 percentage point owner shift along with other transactions within the three-year testing period, then a Section 382 ownership change would have occurred.

In addition, a SRLY approach would be easier to avoid than Section 382. For example, similar to the application of SRLY in consolidated groups, a SRLY approach would not prevent an acquiror from stuffing income-producing assets into a target CFC, diverting income opportunities to the target CFC, or merging the target CFC into another CFC in order to reduce the impact of the SRLY limitation. By contrast, because the Section 382 limitation is determined by the value of the loss corporation on the date of an ownership change and applies to the pre-change attributes of the loss corporation, the Section 382 limitation cannot be circumvented in the same manner.

<u>Recommendation</u>: SRLY would not sufficiently police loss trafficking in the CFC context and should not be used in place of Section 382.

(Jan. 30, 2009) (stating that the SRLY regime is intended to "replicate, to the extent possible, separate entity treatment of the SRLY member. In other words, the SRLY regulations were designed to produce an absorption result that varies as little as possible from the absorption that would have occurred, had the SRLY member not been acquired by the consolidated group.").

[107] A lower threshold, such as 50%, could also be utilized.

17. Section 384 as an Alternative to Section 382

What role should Section 384 play? What are potential advantages (e.g., better at preventing stuffing) and disadvantages (e.g., limited to 80% acquisitions and Section 381 transactions, so potentially under-inclusive).

Section 384 can be thought of as an enhanced form of SRLY limitation, but applicable only in limited situations: Section 384 would apply only where 80% of a CFC's stock is acquired (or CFC assets are acquired in a Section 381 transaction) and it would only limit pre-change losses from being used against RBIG of another corporation (in this case, presumably RBIG of another CFC owned by the same Inclusion Shareholder). Otherwise, Section 384 would not limit the use of a CFC's pre-change loss. In addition, Section 384 does not appear to apply to Interest Carryforwards. Finally, unlike the broad grant of authority under Section 382(m), there is limited statutory authority to alter Section 384 in order to narrowly tailor it to transactions involving CFCs, and there are no current Regulations implementing Section 384.

While Section 384 is more limited in the types of transactions it governs, and only limits the amount of RBIG that can be offset, Section 384 (where it applies) provides a more robust system that cannot be easily avoided, and would capture many of the "simplest" cases where loss trafficking motivates an acquisition (e.g., USP owns CFCs with built-in gains, and so acquires 100% of CFCs with built-in losses to offset the built-in gains). In particular, Section 384 (as compared to SRLY) is not as susceptible to stuffing income producing assets into the target CFC, because whereas SRLY would allow a pre-acquisition CFC loss to the extent that the target CFC now generates income (e.g., by reason of income-producing property being contributed to the CFC), Section 384 would simply preclude any pre-acquisition CFC loss from offsetting RBIG of another CFC (including income treated as RBIG), regardless of the post-acquisition income generated by acquired CFC. As a result, stuffing assets into the target CFC or combining the CFC with another corporation, would not alleviate the effect of the Section 384 limitation if the gain or income from such assets, or resulting from such combination, constitutes RBIG subject to Section 384. In contrast, such transactions might alleviate the effect of a SRLY limitation, because any post-acquisition income of the target corporation generally is allowed in calculating the SRLY register to unlock the SRLY-limited attribute (i.e., there is no restriction on using RBIG as positive income for this purpose).

Example 17a: ***Section 384 limitation on CFC.*** USP owns CFC1, which generates tested income and has $100 NUBIG. USP acquires 100% of the stock of CFC2, a loss corporation that has a $100 NUBIL. CFC1 recognizes its $100 RBIG and CFC2 recognizes its $100 RBIL during the year after USP's acquisition of CFC2. Under Section 384, CFC2's RBIL cannot be used to offset CFC1's RBIG. Assume further that CFC1 generates another $100 of tested income that is not RBIG. In that case, CFC2's pre-acquisition loss can be used to offset CFC1's $100 of non-RBIG tested income.

<u>Recommendation</u>: Section 384 could potentially police loss trafficking in the CFC context, but its application would be limited to at-least 80% acquisitions or Section 381 transactions. Further, there is limited statutory authority to alter Section 384 in order to narrowly tailor it to transactions

involving CFCs. If Treasury wants to adopt a "halfway" approach, Section 384 is a possibility, because it would capture the most basic transaction where loss trafficking motivates an acquisition (e.g., USP owns CFCs with built-in gains, and so acquires CFCs with built-in losses to offset the built-in gains). However, there would be significant obstacles, given its limited application and its narrow focus.