Final and Proposed GILTI Regulations and "Interim Final" Section 245A Regulations

Panelists

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Agenda

- The “Temporary Final” Section 245A Regulations
  - The Extraordinary Disposition Rules — Generally
  - The Interaction between the Extraordinary Disposition Rules and Treas. Reg. Section 1.951A-2(c)(5)
  - The Extraordinary Reduction Rules
- The Proposed GILTI High-Tax Exception Regulations
- GILTI and Partnerships
- The Section 951 Pro Rata Anti-Abuse Rule
- Other Final GILTI Regulation Issues

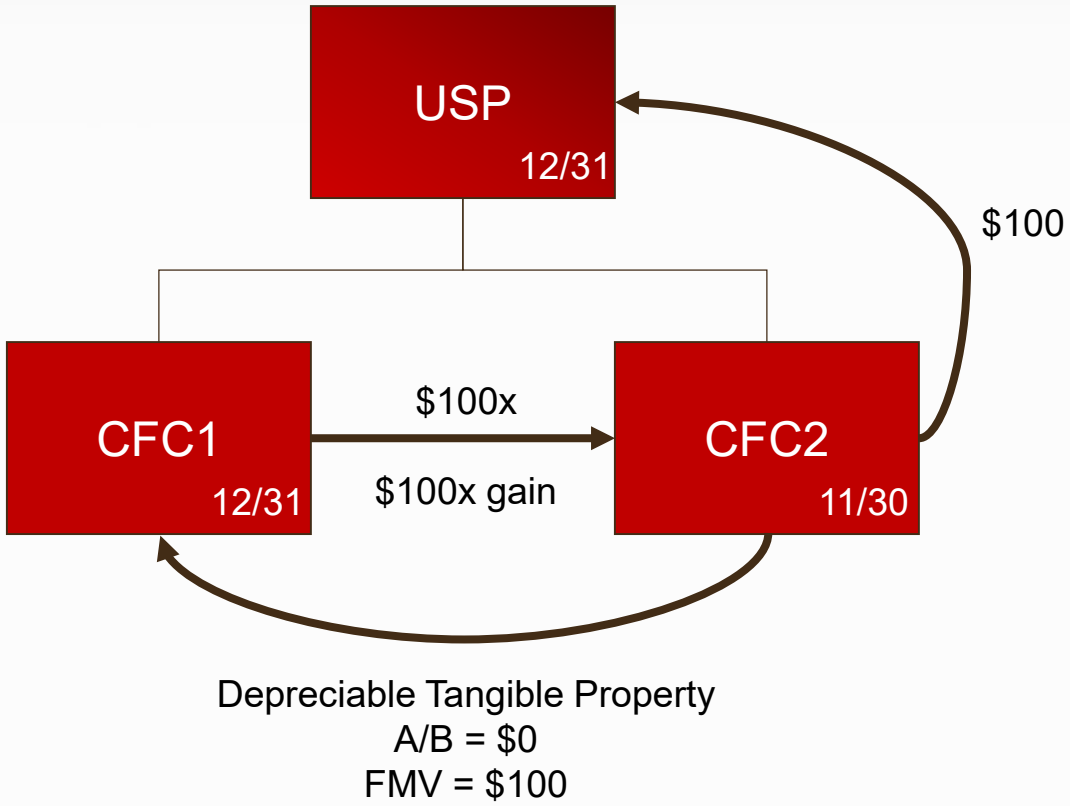
Overview of the "Final Temporary" Section 245A Regulations

- Section 245A provides a 100% dividends-received deduction ("DRD") on the foreign-source portion of dividends received by a U.S. shareholder from a specified 10%-owned foreign corporation ("SFC").
- Section 245A temporary regulations deny the section 245A DRD for the "ineligible amount" of any dividend, which can be created by,
  - Certain gain from property dispositions recognized by a SFC (extraordinary dispositions or "EDs") during its global intangible low-taxed income ("GILTI") "gap period" on a date on which it was a controlled foreign corporation ("CFC"), or
  - Certain changes in a controlling section 245A shareholder's ownership in a CFC (extraordinary reductions or "ERs") following which the subpart F income or tested income of the CFC is not taken into account by a U.S. person.
- Rules apply to dividends (including under sections 964(e) and 1248(a)) made **after December 31, 2017**.

The Extraordinary Disposition Rules

Treasury's Concern

- CFC2 transfers appreciated property to CFC1 after 12/31/2017 and prior to 12/1/2018 to a related person (CFC1) resulting in:
  - CFC1 having basis in tangible property increasing CFC1's QBAI;
  - CFC1 having depreciable basis with which to reduce its tested income; and
  - CFC2 having E&P eligible for the section 245A DRD
- CFC2 did not generate any tested income on the sale of the appreciated property to CFC1.



The Initial Response: Two Rules to Address QBAI and Tested Income Concerns

- Prior proposed regulations provided for two separate rules to address GILTI gap period concerns.
  - The GILTI gap period QBAI rule of Prop. Treas. Reg. section 1.951A-3(h)(2) addressed transactions where a CFC subject to GILTI acquires "specified tangible property" ("STP") from a related CFC that was not yet subject to GILTI.
  - The GILTI gap period tested income/tested loss rule of Prop. Treas. Reg. section 1.951A-2(c)(5) addressed where a CFC subject to GILTI acquires depreciable or amortizable property from a related CFC that was not yet subject to GILTI.

Prior GILTI Gap Period QBAI Rule
Prop. Treas. Reg. Section 1.951A-3(h)(2)

- Operative Rule: "Disqualified Basis" in STP is ignored for purposes of determining QBAI of a tested income CFC.

- In essence, if a CFC, during its "Disqualified Period," *transfers* property to a *related person* (regardless of whether the property is STP in the transferor CFC's hands) that results in a step up in basis (a "Disqualified Transfer"), the stepped up basis (referred to as "Disqualified Basis") is disregarded (except to the extent that the transfer results in U.S. tax either as ECI or a section 951(a)(1)(A) inclusion (the "Qualified Gain Amount")).

  – A "transfer" includes any disposition, sale or exchange, contribution, or distribution of STP, and includes an indirect transfer.

  – The "Disqualified Period" is, with respect to a transferor CFC, the period beginning on January 1, 2018, and ending as of the close of the transferor CFC's last taxable year that is not a CFC inclusion year.

  – A person is related to a CFC if the person bears a relationship to the CFC described in section 267(b) or 707(b) immediately before or immediately after the transfer.

Prior GILTI Gap Period Tested Income/Loss Rule: Prop. Treas. Reg. Section 1.951A-2(c)(5)

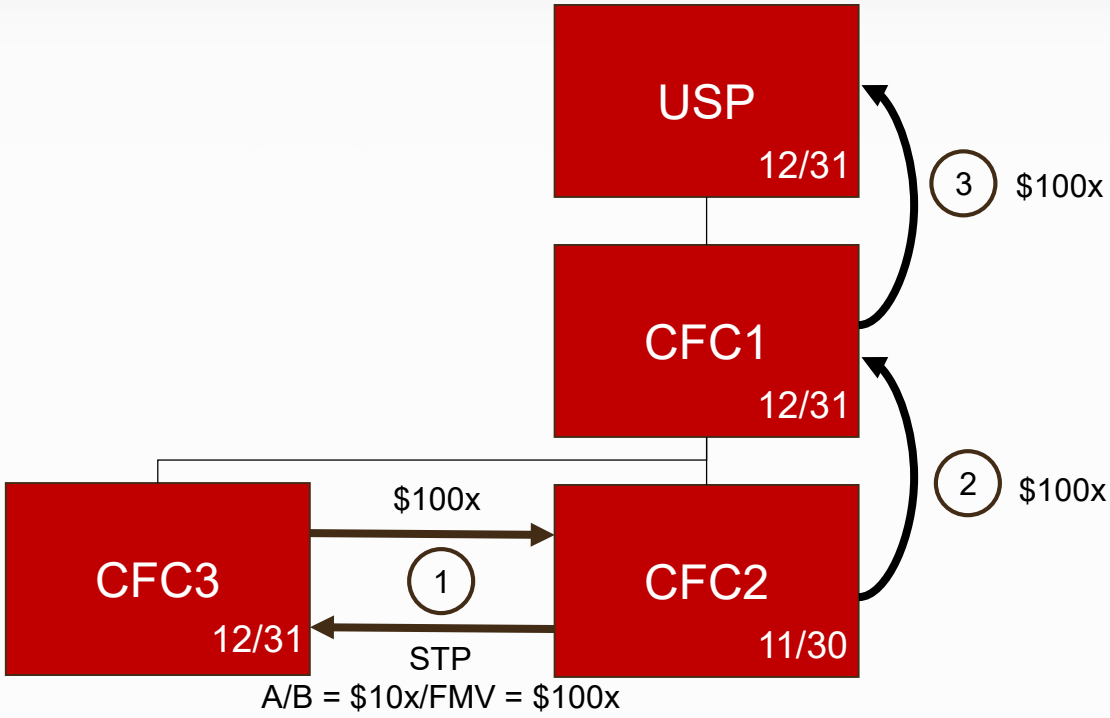
- Operative Rule: Any deduction or loss attributable to Disqualified Basis of any specified property allocated and apportioned to gross tested income is disregarded for purposes of determining tested income or tested loss of a CFC. Prop. Treas. Reg. section 1.951A-2(c)(5)(i).

- Specified property ("SP") is property deductible under section 167 or amortizable under section 197. Prop. Treas. Reg. section 1.951A-2(c)(5)(ii).

  - **This rule is broader than the QBAI GILTI gap period rule as it applies to both <u>tangible</u> and <u>intangible</u> property.**

- To the extent that SP has Disqualified Basis and basis other than Disqualified Basis, the aggregate basis is to be pro rated between the two basis categories. Prop. Treas. Reg. section 1.951A-2(c)(5)(i).

Subsequent Distributions of GILTI Gap Period E&P not Covered by 2018 Proposed Regulations



- The Step 2 distribution of untaxed E&P generally would be excluded from the definition of foreign personal holding company income ("FPHCI") under section 954(c)(6).
- The Step 3 distribution of untaxed E&P generally would be eligible for the section 245A DRD.

The Other Shoe Drops: The Extraordinary Disposition Rules

- Section 245A temporary regulations deny the section 245A DRD for the "**ineligible amount**" of any dividend, which can be created by certain gain from property dispositions recognized by a SFC (an "**extraordinary disposition**" or "**ED**") during its GILTI gap period on a date on which it was a CFC.

- Rules apply to dividends (including under sections 964(e) and 1248(a)) made **after December 31, 2017**.

Extraordinary Dispositions Defined

- An extraordinary disposition ("ED") is:
  - *any* disposition of property (with respect to which recognized gain would otherwise constitute gross tested income) by the SFC during its GILTI gap period and on a date on which it was a CFC ("referred to as the "disqualified period"),
  - to a related party (under either section 267(b) or 707(b)), but only if
  - the disposition occurs outside the ordinary course of the SFC's activities.
- Dispositions to related U.S. persons (including by distribution) and indirectly through certain flow-through entities are included.
- Whether a disposition is outside the ordinary course of the SFC's activities is based on all facts and circumstances.
- An SFC that is not a CFC is treated as engaging in an ED if "there is a plan, agreement, or understanding involving a section 245A shareholder to cause the SFC to recognize gain that would give rise to an [ED] if the SFC were a CFC."

Extraordinary Dispositions: *Per Se* Rule

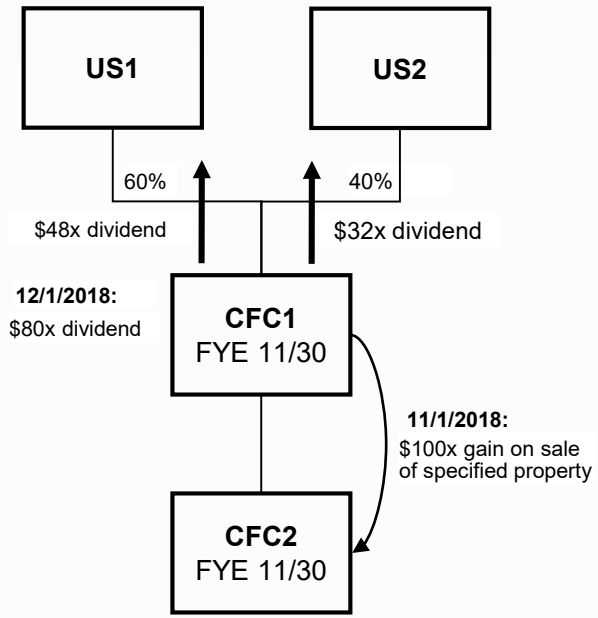
- Dispositions undertaken with a principal purpose of generating E&P or of ***intangible property*** (as defined in section 367(d)(4)) are deemed outside the ordinary course of the SFC's activities.
- Would Treasury and the IRS consider certain exceptions to treating the sale of intellectual property as *per se* outside the ordinary course of the SFC's activities*?*
- Might possible exceptions include:
  - Platform contribution transactions (especially when IP transfers were mandated under pre-existing agreements)?
  - Sales of inventory?
  - Post-merger integration (especially of foreign target when a section 338(g) election was available)?
  - Others?

Extraordinary Disposition Accounts and the Limitation of the Section 245A Dividends Received Deduction

- The gain recognized from all EDs gives rise to "ED E&P" that is proportionately tracked in an ED account specific to *each* section 245A U.S. shareholder of the SFC at the beginning of the SFC's Disqualified Period (or later if CFC status does not exist on that date).
- The ED account is used to determine the ED amount with respect to a dividend paid by the SFC.
  - In general, the ED account balance cannot increase after the close of the Disqualified Period and is reduced by certain dividends paid by the SFC.
- Once determined, **50% of the ED amount** is part of the ineligible amount of a dividend for which the section 245A DRD is disallowed.
- Ordering Rules
  - ***In general, dividends are treated as paid first out of non-ED E&P***. *But see* Slide 16.
  - Ordering rules are provided to account for multiple dividends paid in the same tax year.

Extraordinary Disposition Amount

Temp. Treas. Reg. Section 1.245A-5T(j)(2), Example 1



- **Extraordinary Disposition**: During the Qualified Period, CFC1 sells property to CFC2; the sale is not in the ordinary course of CFC1's activities and not eligible for the *de minimis* exception.
- The following year, CFC1 pays a $48x dividend to US1 and a $32x dividend to US2.
- CFC1 has $110 of E&P at the close of the year of the distributions, without regard to the distributions.

	CFC1	US1	US2
Extraordinary disposition E&P	$100x		
Non-extraordinary disposition E&P	$10x		
Extraordinary disposition account		$60x	$40x
Dividend received from CFC1		$48x	$32x
Paid first out of non-extraordinary disposition E&P		$6x	$4x
Extraordinary disposition amount		$42x	$28x
Ineligible amount (50%)		**$21x**	**$14x**

Extraordinary Dispositions: Successor Rules Temp. Treas. Reg. Section 1.245A-5(c)(4)

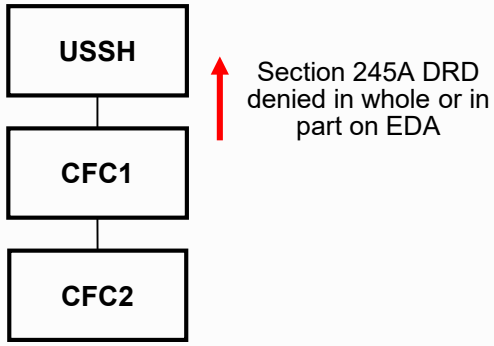
- **Generally:** A section 245A shareholder's ED account with respect to a SFC is proportionately decreased when the shareholder directly or indirectly transfers shares of the SFC to another section 245A shareholder and that transferee section 245A shareholder's ED account is proportionately increased.
  - The transferee shareholder's status as a section 245A shareholder is determined *immediately after* the transfer (taking into account all transactions related to the transfer).
- **Certain Section 381 Transactions:** When an SFC (the acquiring SFC) acquires the assets of another SFC (the target SFC) in a section 381 transaction, each section 245A shareholder's ED account with respect to the acquiring SFC is increased by the balance of that shareholder's ED account with respect to the target SFC.
  - If any boot is received by the target section 245A shareholder in the section 381 transaction is treated as a dividend (e.g., pursuant to section 356(a)(2) or Treas. Reg. section 1.301-1(*l*)), such shareholder's ED account with respect to the target SFC is reduced prior to determining the amount by which that shareholder's ED account is increased with respect to the acquiring SFC.
- **Section 355 Distributions:** If a D/355 transaction, then each section 245A shareholder of the distributing SFC must allocate its ED account between the distributing SFC and the controlled SFC.
- Special rules apply when an upper-tier SFC transfers shares of a lower-tier SFC. *See* Temp. Treas. Reg. section 1.245A-5(c)(4)(iv).

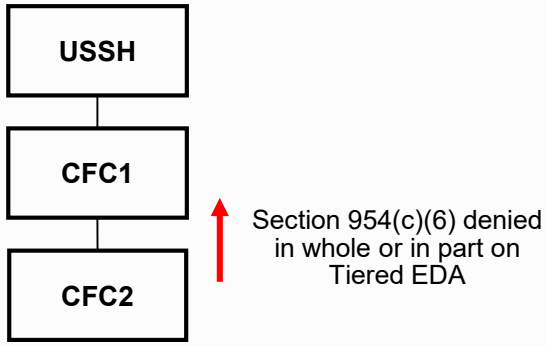
Extraordinary Dispositions: Loss-Related Issues

- ED E&P definition relates to the "net" gain recognized.
  - What is the reference to "net" intended to include? Is loss recognized on the sale of Specified Property to related parties during the Disqualified Period included in the ED E&P calculation?
  - Specified Property is defined as "any property *if gain recognized* with respect to such property during the disqualified period is not described in section 951A(c)(2)(i)(I) through (V)." Is the definition of Specified Property satisfied if the underlying property was sold at a loss?
- The ED regime appears to treat a section 245A shareholder's ED account as a "permanent" attribute such that if the relevant SFC suffers a subsequent loss that would otherwise reduce or eliminate the SFC's accumulated E&P, future E&P of the SFC would be reconstituted as ED E&P.
  - Is such treatment intended?
  - If yes, why did Treasury and the IRS draft such a rule?

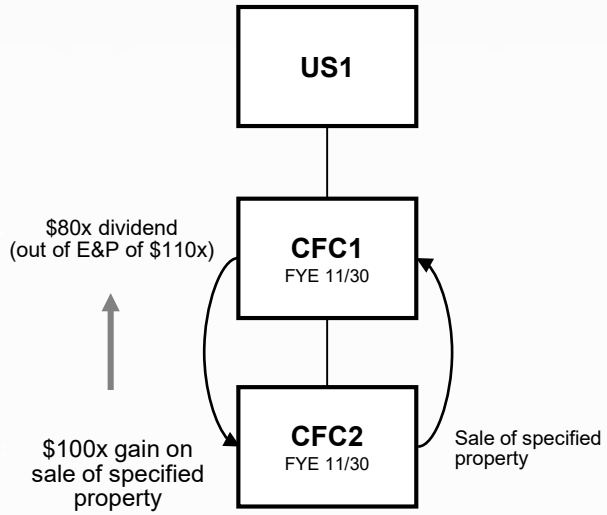
Limitation on Section 954(c)(6) Exception

- Provisions are applied to dividends received by a CFC by limiting application of section 954(c)(6) if a section 245A DRD would be denied if the dividend was paid directly to a section 245A shareholder, usually causing the dividend to constitute subpart F income.
- Application of section 954(c)(6) is generally denied on 50% of the tiered extraordinary disposition amount (**"Tiered EDA"**).





Tiered Extraordinary Disposition Amount
Example



- **Extraordinary Disposition**: Sale of specified property to a related party (CFC1) during the Disqualified Period and not in ordinary course of CFC2's activities

- Sample computation of **Tiered EDA**:

	CFC2	CFC1	US1
Ownership percentage of CFC2	-	100%	100%
ED E&P	$100x		
Non-ED E&P	$10x		
ED account (re CFC2)			$100x
Dividend received amount		$80x	
Paid first out of non-ED E&P		$10x	
Tiered EDA		$70x	
Divided by US1's ownership percentage of CFC1 (100%)		$70x	
Disqualified amount for section 954(c)(6) (50%)		**$35x**	

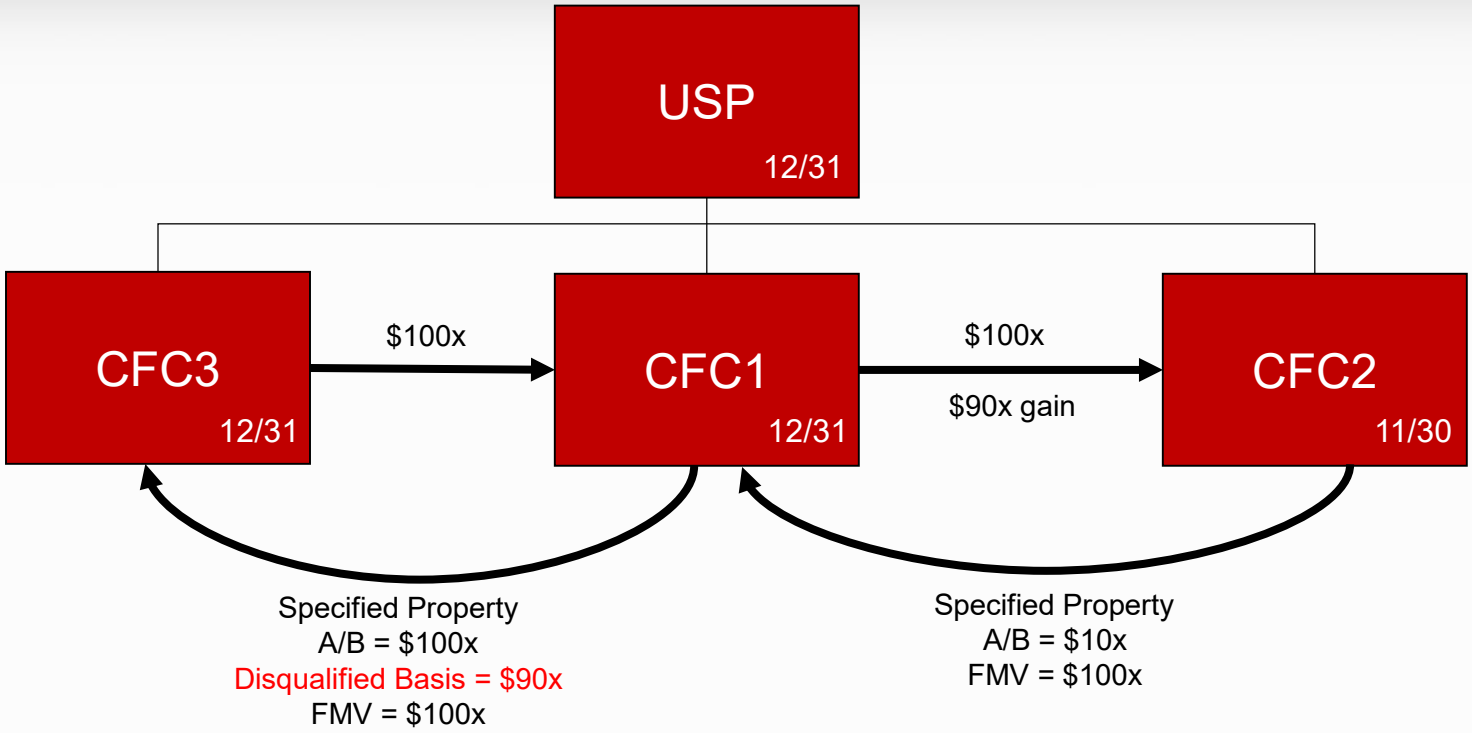
Section 954(c)(6)-Related Questions

- The inclusion of section 954(c)(6) dividends to the application of Temp. Treas. Reg. section 1.245A-5T came as a surprise to many taxpayers.
  - Would Treasury and the IRS consider a prospective effective date with respect to CFC-to-CFC dividend distributions of ED E&P?
  - Instead, would Treasury and the IRS consider, at least with respect to distributions occurring prior to June 18, 2019, providing for a rule whereby the section 245A shareholder's ED account would be reduced with respect to the distributing CFC and increased with respect to the distributee CFC? A similar set of rules already exists when lower-tier SFC stock is transferred by an upper-tier SFC. *See* Temp. Treas. Reg. section 1.245A-5(c)(4)(iv).

Changes to the Proposed Gap Period Tested Income Rule: Treas. Reg. Section 1.951A-2(c)(5)

- Clarification of the scope of "disqualified basis" relevance.
  - Generally denies "cleansing" of disqualified basis by on-selling to related party.
  - Disqualified basis is still available for sales to third parties at a gain. Note that the disqualified basis rule still applies to sales to third parties at a loss.
- Clarification that a deduction or loss attributable to Disqualified Basis is allocated and **apportioned solely to "residual CFC gross income,"** i.e., gross income other than:
  - Gross tested income;
  - Gross income taken into account in determining subpart F; or
  - Gross income that is ECI.
- Expansion of rule to provide that any depreciation, amortization, or cost recovery allowances attributable to disqualified basis is not properly allocable to property produced or acquired for resale under section 263, 263A, or 471.
  - Preamble provides that "this rule ensures that depreciation or amortization expenses attributable to disqualified basis are not permitted to indirectly reduce taxable income through the depreciation expense of other property or from the disposition of inventory."

The GILTI Gap Period Tested Income Rule
What if Specified Property Resold to a Related Party?



- Prop. Treas. Reg. section 1.951A-3(h)(2)(ii) provides that "Disqualified [B]asis may be reduced or eliminated through depreciation, amortization, *sales or exchanges*, section 362(e), and other methods." (Emphasis added).
- Treas. Reg. section 1.951A-3(h)(2)(B*)*(*1*)(*ii*) provides that Disqualified Basis in property is not reduced or eliminated if on-sold to a related party except to the extent:
  - any loss recognized on the transfer of such property is treated as attributable to the disqualified basis under Treas. Reg. section 1.951A–2(c)(5)(ii) (*see also* Treas. Reg. section 1.951A–2(c)(5)(iv)(C))*;* or
  - the basis is reduced or eliminated in a nonrecognition transaction within the meaning of section 7701(a)(45) (e.g., through the application of section 362(e) or 732(a) or (b)).

Interaction of GILTI Gap Period Tested Income Rule and GILTI Gap Period Section 245A Rule

- Together, the GILTI gap period tested income rule and the GILTI gap period section 245A rule cause the same section 245A shareholder to recognize income on (at least a portion of) the same gain twice.

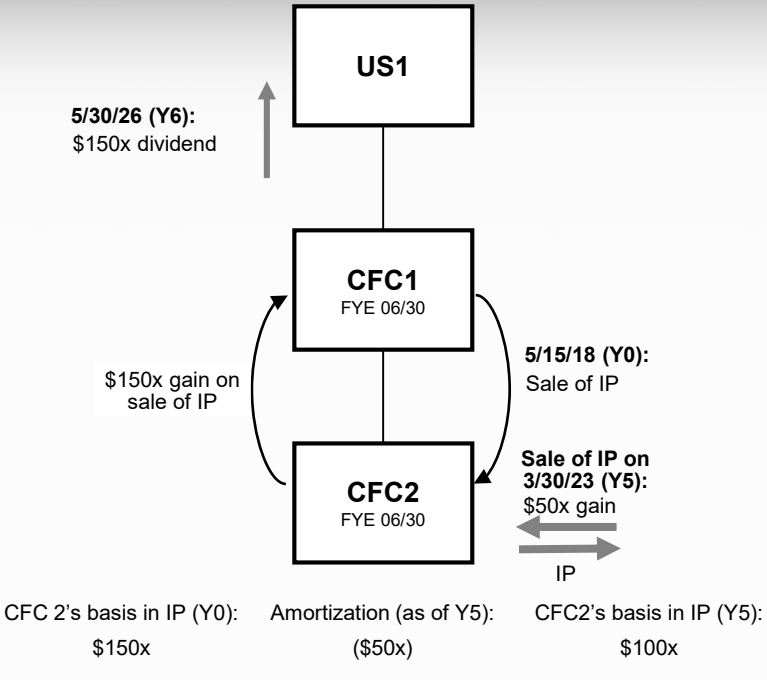
    1. Depreciation and amortization deductions effectively disallowed for purposes of calculating tested income and tested loss under Treas. Reg. section 1.951A-2(c)(5) in amount equal to Disqualified Basis **but** basis still not reduced for all other purposes of the Code (e.g., sales of assets to third parties and calculation of E&P).

    2. In essence, Temp. Treas. Reg. section 1.245A-5T disallows the section 245A DRD in an amount equal to the Disqualified Basis.

Alternatives to Harmonize Temp. Treas. Reg. Section 1.245A-5T with Treas. Reg. Section 1.951A-2(c)(5)

- Alternative 1: Reduce ED account to the extent depreciation and amortization deductions are allocated to residual CFC gross income under Treas. Reg. section 1.951A-2(c)(5).
- Alternative 2: Permit deductions against tested income to the extent ED E&P are included in income of section 245A shareholder.
  - Alternative 2.1: Same as Alternative 2 but with some form of retroactive re-computation or restoration of disqualified basis.
- Alternative 3: Allow taxpayers a one-time election to adopt mechanics of Alternative 1 *or* Alternative 2.
- Alternative 4: Each year in which no distribution out of ED account occurs, reduce ED account by amount of deductions allocated to residual CFC gross income. In year(s) in which a distribution out of ED account occurs, deductions allocated to tested income and residual baskets in proportion to percentage of ED E&P distributed to the initial ED E&P through the remaining life of the underlying asset.
- Alternative 5: Allow taxpayers to elect to treat an Extraordinary Disposition as a non-recognition transaction.
  - Alternative 5.1: Similar to Alternative 4, but clarify that (i) election creates a deficit in untaxed E&P, and (ii) turn off the hovering deficit rule of Treas. Reg. section 1.367(b)-7 for limited purpose of allowing SFC transferee and SFC transferor to merge together and permitting E&P deficit to offset ED E&P.

Interplay of Treas. Reg. Section 1.951A-2(c)(5) and Temp. Treas. Reg. Section 1.245A-5T: Alternative 1



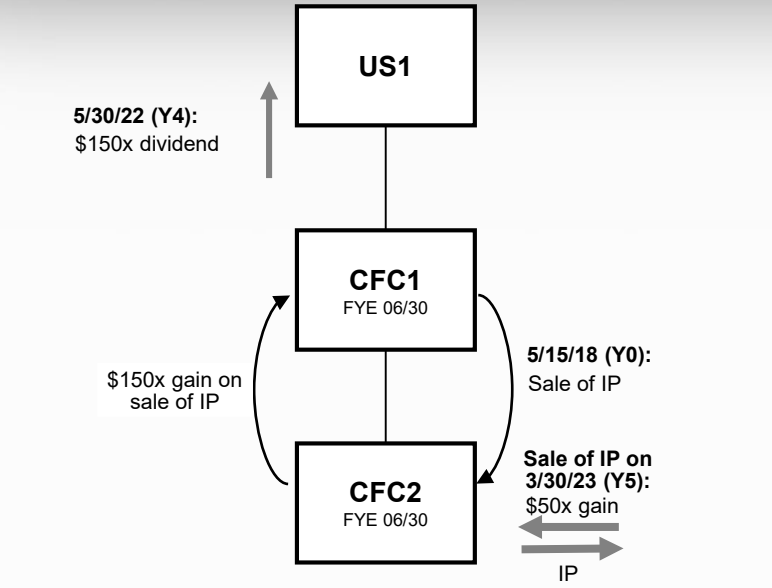
FACTS

- In Y0, CFC1 sells IP to CFC2 in exchange for $150x during the Disqualified Period. US1 has an ED account of $150x.
- CFC2 has a basis of $150x in the IP and amortizes it over the next five years ($10x/yr) but such amortization deductions are disallowed when calculating CFC2's tested income.
- In Y5, CFC2 sells the IP to an unrelated party in exchange for $150x. CFC2 recognizes $50x of gain ($150x (amount realized) - $100x (adjusted basis)) resulting in a tax of $5.25x.
- In Y6, CFC1 repatriates $150x as a dividend to US1 but is disallowed 50% of its otherwise allowable section 245A DRD resulting in a tax of to US1 of $15.75x.
- If CFC1 has sold IP to CFC2 outside the Disqualified Period, total gain recognized on IP would be $150x resulting in a tax to US1 of $15.75x rather than $21x.

Alternative 1: Reduce ED Account to Extent of Residual Allocation

- The amount of US1's ED account with respect to CFC1 is $150x.
- CFC2 has $150x of Disqualified Basis in the IP and its future amortization deductions would be allocated to residual CFC gross income.
- Under this approach, US1's ED account with respect to CFC1 would be reduced by $50x (the amount of amortization deductions allocated to CFC2's residual CFC gross income basket) to $100x.
- As a result, CFC1's distribution in Y6 results in a tax of $10.50x and when coupled with Y5 tax of $5.25x, the appropriate $15.75x of aggregate tax is recognized.
- **Concern:** If dividend is distributed by CFC1 to US1 prior to IP sale, then no ED account reduction and additional $5.25x tax paid.

Interplay of Treas. Reg. Section 1.951A-2(c)(5) and Temp. Treas. Reg. Section 1.245A-5T: Alternative 2



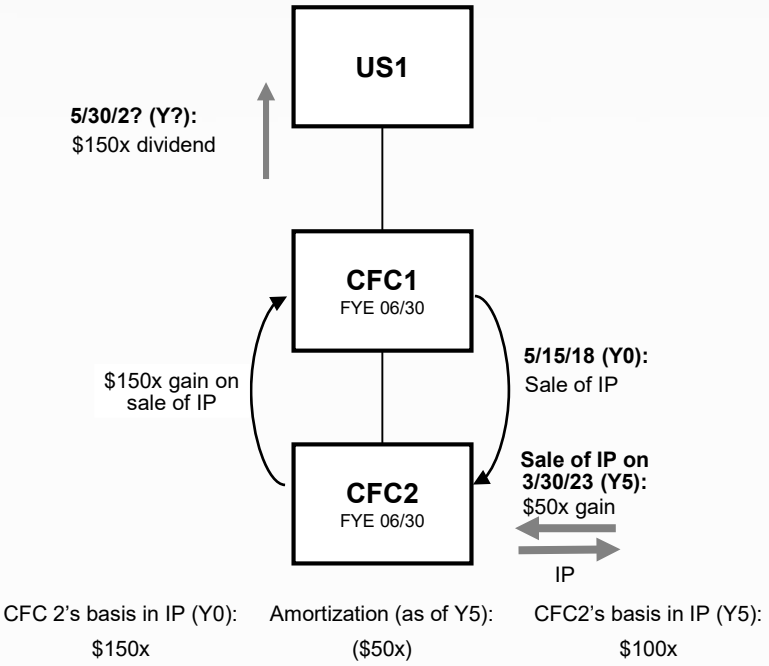
FACTS

- In Y0, CFC1 sells IP to CFC2 in exchange for $150x during the Disqualified Period. US1 has an ED account of $150x.
- CFC2 has a basis of $150x in the IP and amortizes it over the next five years ($10x/yr) but such amortization deductions are disallowed when calculating CFC2's tested income.
- In Y4, CFC1 repatriates $150x as a dividend to US1 but is disallowed 50% of its otherwise allowable section 245A DRD resulting in a tax of to US1 of $15.75x.
- In Y5, CFC2 sells the IP to an unrelated party in exchange for $150x. CFC2 recognizes $50x of gain ($150x (amount realized) - $100x (adjusted basis)) resulting in a tax of $5.25x.
- If CFC1 has sold IP to CFC2 outside the Disqualified Period, total gain recognized on IP would be $150x resulting in a tax to US1 of $15.75x rather than $21x.

Alternative 2: Permit Deductions to Extent of Section 245A DRD Denial

- The amount of US1's ED account with respect to CFC1 is $150x.
- CFC2 has $150x of Disqualified Basis in the IP and its future amortization deductions would be allocated to residual CFC gross income.
- Under this approach, US1 amortization deductions ($10x/year for 15 years) would be allocated to tested income (rather than residual CFC gross income).
- **Concern 1:** If dividend is distributed by CFC1 to US1 after IP sale, then amortization deductions not available to offset tested income but CFC2's basis in IP still reduced by $50x and additional $5.25x tax paid.
- **Concern 2:** If dividend is distributed by CFC1 to US1 before IP sale but after at least one amortization period, a mechanism would be needed to allow for retroactive re-allocation of deductions to tested income.

Interplay of Treas. Reg. Section 1.951A-2(c)(5) and Temp. Treas. Reg. Section 1.245A-5T: Alternative 3



Alternative 3: Hybrid Approach—Dividend Paid in Y4

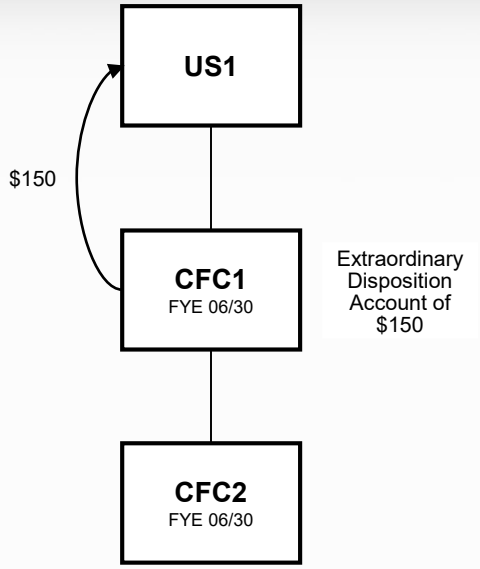
- Under this approach,
  - In each of Y1, Y2, and Y3, US1's ED account with respect to CFC1 would be reduced by $10x (the amount of amortization deductions allocated to CFC2's residual CFC gross income basket) resulting in a total reduction to $120x.
  - In Y4, the dividend distribution of $150x results in a tax of $12.60x. Further, CFC2's $10x of amortization deductions are allocated to the tested income basket thereby reducing CFC2's Y4 tested income by $10x.
  - In Y5, CFC2's $10x of amortization deductions are again allocated to the tested income basket thereby reducing CFC2's Y5 tested income by $10x. Further, CFC2's sale of IP results in gain of $50x (and a tax of $5.25x), and the appropriate $15.75x of aggregate tax is recognized (i.e., $17.85 less the $20x reduction in tested income saving $2.10x of tax).

Alternative 3: Hybrid Approach—Dividend Paid in Y6

- Under this approach,
  - In each of Y1, Y2, Y3, and Y4, US1's ED account with respect to CFC1 would be reduced by $10x (the amount of amortization deductions allocated to CFC2's residual CFC gross income basket) resulting in a total reduction to $110x.
  - In Y5, CFC2's sale of IP results in gain of $50x (and a tax of $5.25x) and US1's ED account with respect to CFC1 would be reduced by an additional $10x.
  - In Y6, the dividend distribution of $150x results in a tax of $10.50x and when coupled with Y5 tax of $5.25x, the appropriate $15.75x of aggregate tax is recognized.

Concern: The correct amount of tax is paid in exchange for a more complex regime—including complexity resulting from dividends paid out of ED E&P in multiple years.

Extraordinary Dispositions and Section 956



FACTS

- CFC1 has an ED account of $150.
- CFC1 makes an investment in United States property (loan to US1) of $150.
- US1 has an inclusion of $150 under section 951(a)(1)(B).
- What is the effect on the ED account?

Effect of Section 956 inclusion on Extraordinary Disposition Account

- An exception to section 956 applies to the extent a dividend from CFC1 to US1 would qualify for the section 245A DRD. Treas. Reg. section 1.956-1(a)(2). As a result, it appears that US1 would have a section 956 inclusion of $75 as only 50% of the hypothetical distribution would qualify for the section 245A DRD.
- This inclusion, however, does not appear to reduce the ED account as does not appear to be described in the definition of "prior ED amount" under Temp. Treas. Reg. section 1.245A-5T(c)(3)(i)(D).
- The application of these rules appears to deny the benefits of section 245A multiple times for the same ED.

Possible Alternative Approach

Another Possible Alternative Approach

The Extraordinary Reduction Rules

Extraordinary Reduction Amount

- As described above, the ineligible amount includes 100% of the ER amount [Temp. Reg. 1.245A-5T(b)(2)(ii)].
- If an ER occurs, the ER amount, with respect to a dividend received by a controlling section 245A shareholder of a CFC, is equal to the lesser of:
  - The amount of the dividend; and
  - The sum of the shareholder's pre-reduction pro rata share of the CFC's subpart F income and tested income for the taxable year *reduced by* the prior ER amount.

Extraordinary Reduction

- An ER occurs if either:
  - The controlling section 245A shareholder transfers, directly or indirectly, CFC stock representing more than 10 percent (value) of the CFC stock owned, directly or indirectly, as of the beginning of the CFC's tax year (and at least 5 percent of the total by value) (10% transfer event); or
  - As a result of one or more transactions, the controlling section 245A shareholder's ownership in the CFC as of two dates is reduced by more than 10 percent (value) and at least 5 percent of the total value (10% dilution event).
- The following exceptions apply:
  - E and F reorganizations are not 10% transfer events [Temp. Reg. 1.245A-5T(e)(2)(i)(A)(2)].
  - Transactions pursuant to which the CFC's taxable year ends (e.g., section 332 liquidations; A, C and D reorganizations), so long as the section 245A shareholder directly or indirectly owns the stock on the last day of the year, are not 10% transfer events [Temp. Reg. 1.245A-5T(e)(2)(i)(C)].
  - If the controlling shareholder makes an election to close the CFC's tax year for all purposes of the Code as of the end of the date on which the ER occurs, no amount is considered an ER amount [Temp. Reg. 1.245A-5T(e)(2)(i)(A)(2)].

Dates to Determine 10% Dilution Event Percentages

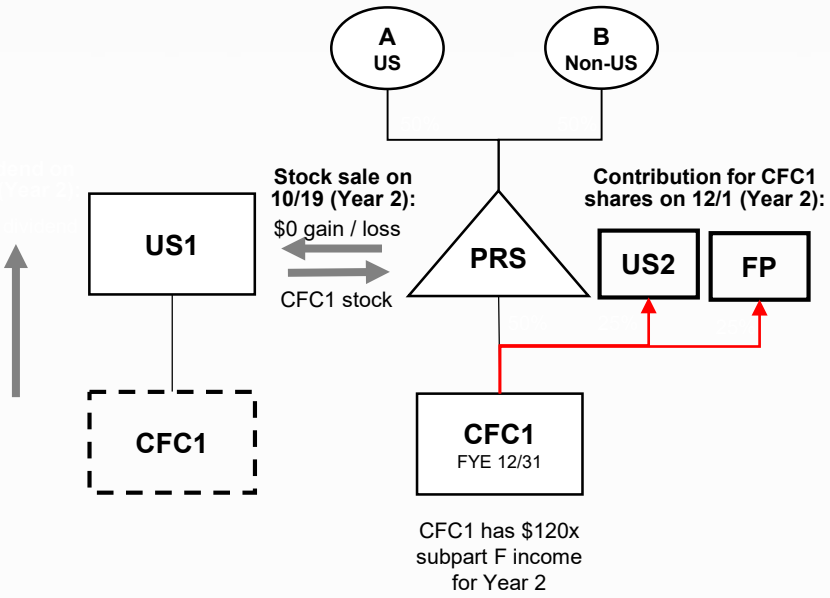
- The dates for purposes of establishing a baseline to determine whether a 10% dilution event has occurred are:
  - The day of the taxable year on which the controlling section 245A shareholder owns directly or indirectly its highest percentage of stock (by value) of the CFC; and
  - The day immediately preceding the first day on which stock was transferred in the preceding taxable year in a transaction (or a series of transactions) occurring pursuant to a plan to reduce the percentage of stock (by value) that the CFC owns directly or indirectly.

Pre-Reduction Pro Rata Share

- The pre-reduction pro rata share of a controlling section 245A shareholder with respect to a CFC is:
  - The shareholder's pro rata share of the CFC's subpart F income or tested income, determined based on the shareholder's direct or indirect ownership immediately before the ER;
  - Without regard to section 951(a)(2)(B) and Treas. Reg. section 1.951-1(b)(1)(ii);
  - But only to the extent that such subpart F income or tested income is not included in the controlling section 245A shareholder's pro rata share of the CFC's subpart F income or tested income.
- This amount is reduced to the extent U.S. tax residents' pro rata shares of subpart F income or tested income is increased as a result of a transfer of stock of the CFC by the controlling section 245A shareholder or an issuance of stock by the CFC.

Extraordinary Reduction Amounts

Temp. Reg. §1.245A-5T(j)(2), Example 4



- **Extraordinary Reduction:** US1 as a controlling section 245A shareholder has an ER because it transfers 100% of CFC1 stock, i.e., more than 5% of CFC stock and 10% of US1's stock (also decrease of more than 10% and five percentage points of US1's ownership)
- Sample computation of **ineligible amount**:

	CFC1	US1	US2	PRS
Subpart F income	$120x			
Ownership percentage of CFC1		100%		
Tentative amount of pre-reduction pro rata share		$120x		
Pro rata share of subpart F income **$60x reduced by section 951(a)(2)(B) prior distribution to US1*			$30x	$12x*
Pro rata share amounts taken into account under 951(a) by US persons			$30x	$6x (by A)
US1's pre-reduction pro rata share		$120x-36x = $84x		
ER amount, i.e., lesser of $120x and $84x		$84		
Ineligible amount		**$84x**		

Prior Extraordinary Reduction Amount

- A prior ER amount is the sum of the ER amounts of each prior dividend received by the section 245A shareholder from the CFC during the taxable year; *plus*
- A prior dividend received by the section 245A shareholder to the extent that the dividend was not eligible for the section 245A deduction by reason of section 245A(e) or the holding period requirement of section 246 not being satisfied (but would have been an ER amount); *plus*
- The portion of a prior dividend received from the CFC by an upper-tier CFC that was included in the section 245A shareholder's income by reason of section 245A(e) (but would have been an ER amount); *plus*
- The portion of a prior dividend received from the CFC by an upper-tier CFC during the taxable year that is a tiered ER amount and that is included in the income of the section 245A shareholder by reason of section 951(a).

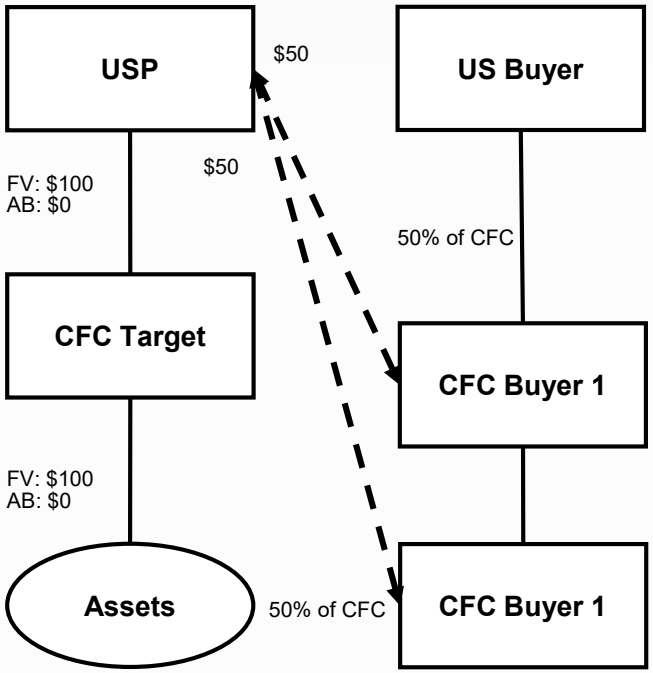
Elective Exception to Close CFC's Taxable Year

- If each controlling section 245A shareholder elects to close the CFC's tax year for all purposes of the Code as of the end of the date on which the ER occurred.
- Then no amount is considered either an ER amount or tiered ER amount.
- For purposes of applying this rule, a controlling section 245A shareholder is treated as owning the same amount of stock it owned immediately before the ER.
- Consequence of closing the year is generally to cause US shareholders of the CFC to include subpart F income and tested income that accrues prior to the ER.
- Foreign taxes are allocated:
  - To the pre-reduction year and the post-reduction year;
  - Based on the respective portions of the taxable income of the CFC attributable to the periods; and
  - Under the principles of Treas. Reg. section 1.1502-76(b); which is
  - Consistent with the treatment of mid-year transfers of disregarded entities under Treas. Reg. section 1.901-2(f)(4).
- Election is made with the original tax return of each controlling section 245A shareholder, subject to a transition rule for ERs that occurred before the publishing of the regulations.
- To make the election, all controlling section 245A shareholders and each other US tax resident that is a US shareholder of the CFC must enter into a binding commitment to close the CFC's year.

Tested Income Recognized After Extraordinary Reduction

Step 1: Bifurcated Sale

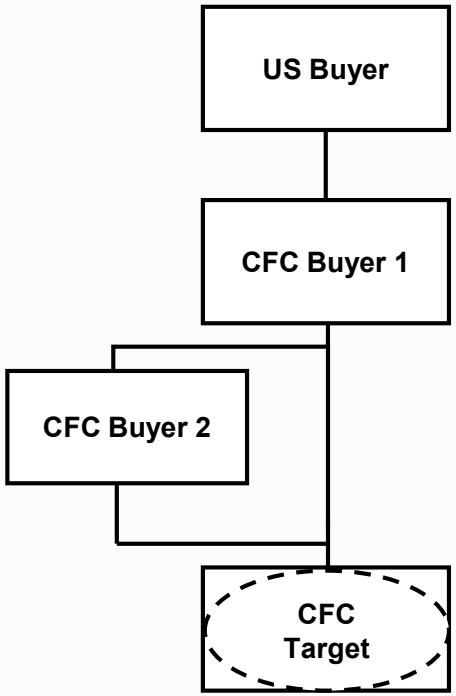
USP sells 50% of CFC Target to CFC Buyers 1 and 2 for $50 apiece.



Before Treasury's promulgation of anti-abuse regulations, under 1248(a), USP's $100x gain was included in USP's gross income and treated as a dividend pursuant to §§1248(j) and 245A (to the extent of CFC Target's E&P).

Step 2: CTB Election

Effective the day after Step 1, CFC Target elects to be classified as a disregarded entity for US tax purposes.



The temporary regulations deny USP's section 245A DRD to the extent that subpart F income or tested income would have been included by the USP had the transfer not occurred. However, the temporary regulations provide an election to close the CFC's tax year as of the day of the transfer and avoid the conversion of the gain to tested income or subpart F income.

Recommendations:

1. Deny USP's Section 245A DRD, but only up to 50% of $100x (the amount of the ER).

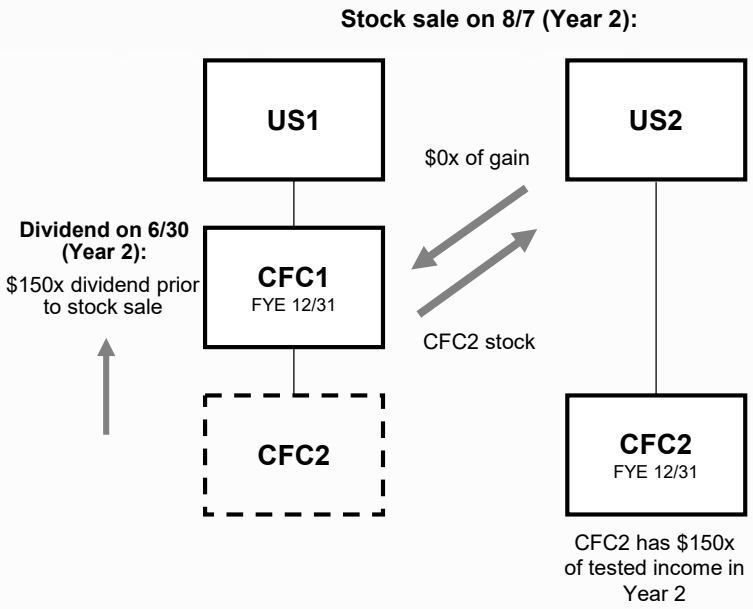
2. Close CFC Target's tax year for purposes of allocating E&P between USP and US Buyer. Pro rate E&P under 1.1248-3 principles (determine the number of days USP and US Buyer each held Target CFC stock, divide by number of days in the year, and multiply by E&P accumulated for taxable year).

Tiered Extraordinary Reduction Amount

- If there is an ER with respect to a lower-tier CFC, Section 954(c)(6) applies to any dividend from a lower-tier CFC to an upper-tier CFC only to the extent that the dividend exceeds the tiered ER amount.
- The tiered ER amount is:
  - The product of:
    - The sum of the amount of subpart F income and tested income of the lower-tier CFC for the taxable year; and
    - The percentage (by value) of the stock of the lower-tier CFC owned by the upper-tier CFC immediately before the ER.
  - Over amounts that are included in income by US tax residents or included in the subpart F income of the upper-tier CFC by reason of these rules or section 245A(e).

Tiered Extraordinary Reduction Amount

Example



- **Extraordinary Reduction**: US1 as controlling section 245A shareholder undertakes stock sale of more than 5% of CFC2 stock and 10% of US1's stock (also decrease of more than 10% and five percentage points of US1's ownership).

- Sample computation of **Tiered ERA**:

	CFC2	CFC1	US1	US2
Tested income	$150x			
Prior distributions under section 951(a)(2)(B) (limited to 219/365 based on 8/7 stock sale)			$90x	
Pro rata share of tested income taken into account under section 951A				$60x
Tested income multiplied by CFC1's ownership percentage of CFC2 (100%) before the ER	$150x			
Reduced by amount taken into account by US2		$150x-60x		
Tiered ERA (ineligible for section 954(c)(6))		**$90x**		
Amount eligible for section 954(c)(6) look-through treatment		**$60x**		

General Rules Applicable to Extraordinary Dispositions and Extraordinary Reductions

Anti-Abuse Rule: Temp. Treas. Reg. Section 1.245A-5T(h)

- The temporary regulations include an anti-abuse rule, pursuant to which:
  - "The Commissioner may make appropriate adjustments to any amounts determined under this section if a transaction is engaged in with a principal purpose of avoiding the purposes of this section."

- This anti-abuse rule is quite broad and raises a number of questions:
  - What adjustments are "appropriate"?
    - Increases to EDA and ERA (and tiered equivalents)?
    - To what extent?
  - What are the "amounts determined under" Temp. Treas. Reg. 1.245A-5T?
    - The EDA and ERA (and tiered equivalents)?
  - What are the "purposes of" Temp. Treas. Reg. 1.245A-5T?

Miscellaneous Rules

- ***De Minimis* Subpart F Income and Tested Income**
  - **EDA:** No amount is treated as an EDA if the sum of net gain recognized by an SFC with respect to specified property in all dispositions does not exceed the lesser of $50 million and 5% of the gross value of all of the SFC's property held immediately before the disqualified period.
  - **ERA:** No amount is treated as an ERA if the sum of the CFC's subpart F income and tested income is less than lesser of $50 million or 5% of the CFC's total income for the taxable year.
- **Source of Dividends:** A dividend received by any person is considered received directly by such person from the foreign corporation whose earnings and profits give rise to the dividend (e.g., lower-tier section 1248 dividends).
- **Section 964(e) Inclusions:** An amount included under section 964(e)(4) is considered a dividend received by the shareholder from the corporation whose earnings and profits give rise to the amount described in section 964(e)(1).
- **Stock Ownership and Transfers:** Generally, the principles of section 958(a) ownership apply without regard to whether the "specified entity" is foreign or domestic.
  - Specified entity means any corporation, partnership, trust or estate, except for domestic corporations.

Ordering Rules

Ordering of Hybrid Dividends, ERAs and EDAs

1. The dividend is subject to section 245A(e) if it is a “hybrid dividend” or “tiered hybrid dividend.”

2. To the extent that the dividend is not subject to section 245A(e), the ER amount portion of the dividend is denied a section 245A DRD or section 954(c)(6) exception.

3. Next, the dividend is treated as paid out of non-ED E&P.

4. Finally, the ineligible amount of the dividend is determined (and a section 245A DRD or section 954(c)(6) exception is denied).

Reporting Considerations

- Taxpayers **must report** ineligible amounts, tiered ED amounts, and tiered ER amounts on appropriate form under section 6038.

- Applies to transactions that occurred in tax years before Temporary Regulations issued.

The Proposed GILTI High Tax Exception

Proposed GILTI High Tax Exclusion – Overview

- Elective GILTI "high-tax exception" ("**HTE**") would generally exclude a "tentative gross tested income item" of a CFC to the extent the "tentative net tested income item" was subject to foreign effective rate of tax that is greater than 90% of the maximum rate under section 11 (so greater than 18.9%, or 90% of the current 21%).
- If elected, the GILTI HTE would,
  - Apply to all tentative gross income items of a CFC, at the level of each QBU of the CFC;
  - Is binding on all US shareholders of the CFC; and
  - Applies to all CFCs that are member of the same controlling domestic shareholder group.
- The Proposed GILTI HTE would only apply to taxable years of CFCs beginning on or **after** the date these proposed regulations are finalized (cannot be applied currently).
  - Would Treasury and the IRS consider permitting HTE elections to be made retroactively to taxable years starting after December 31, 2017 upon finalization of proposed GILTI HTE?

Gross Tested Income Eligible for the High Tax Exclusion

Identifying High-Taxed Tested Income: Multi-Step Process

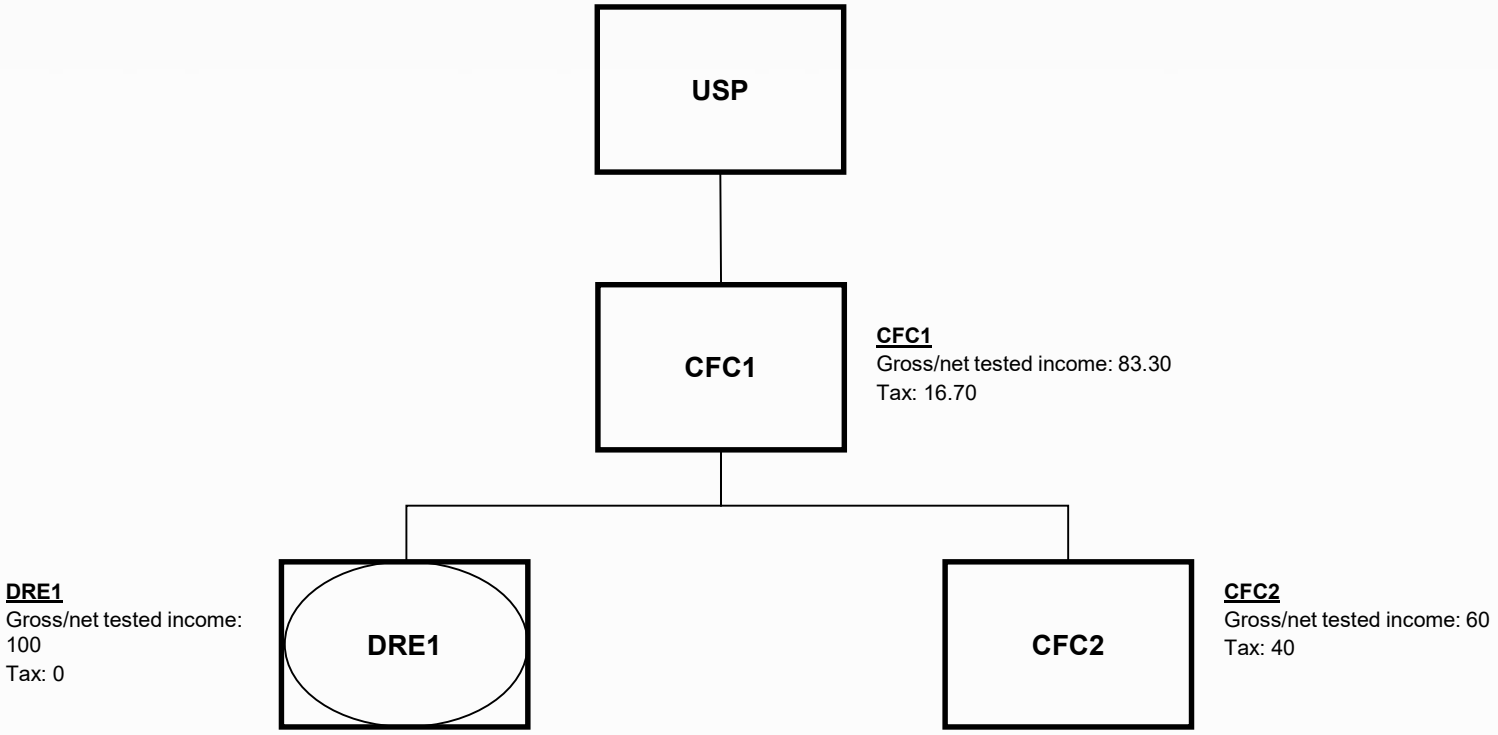
1. Identify each qualified business unit **(QBU)** of a CFC.
2. Determine the **gross tested income**, by basket, attributable to each QBU.
3. Adjust QBU income for **disregarded items**.
4. Allocate and apportion QBU **deductions** to arrive at "tentative net tested income items."
5. Determine the **foreign taxes** that are "properly attributable" to each tentative net tested income item.
6. Determine whether the foreign **effective tax rate** for each tentative net tested income item is greater that **18.9%** using the following formula:

$$\frac{\text{Properly Attributable Taxes}}{\text{Tentative Net Tested Income Item} + \text{Properly Attributable Taxes}}$$

Electing the Proposed GILTI HTE

Manner	► Attach a statement to an amended or originally filed return including specified information.
Scope	► If elected, the GILTI HTE applies to all gross tested income items of all CFCs that are members of a controlling domestic shareholder group.
Duration	► Effective for the election year and all subsequent years, unless revoked.
Revocation	► After revocation, a subsequent election cannot be made for 5 years ► Such subsequent election can not be revoked for another for 5 years.

Example: Application of the GILTI HTE



GILTI High Tax Exclusion

Prop. Reg. Section 1.951A-2(c)(6)

- **Final GILTI Regulations**
  - Released June 14, 2019, adopted the GILTI high tax exclusion of the proposed GILTI regulations that were released September 14, 2018 (the "**2018 Proposed Regulations**").
    - Under the final GILTI regulations, gross tested income does not include "[g]ross income excluded from foreign base company income…solely by reason of an election made under section 954(b)(4)."

- **Proposed GILTI Regulations**
  - Also released June 14, 2019, newly proposed regulations (the "**2019 Proposed GILTI Regulations**") would provide an election to exclude from gross tested income any gross income subject to a high rate of foreign tax (hereafter the "**GILTI HTE**").
    - Under the newly proposed regulations, gross tested income would not include "[g]ross income excluded from the foreign base company income…by reason of the exception described in section 954(b)(4) pursuant to an election under §1.954-1(d), **or a tentative gross tested income item of the corporation that qualifies for the exception described in section 954(b)(4) pursuant to an election under paragraph (c)(6) of this section."**

GILTI High Tax Exclusion

Prop. Reg. Section 1.951A-2(c)(6)

- **GILTI HTE Effective Date**
  - The new GILTI HTE would apply to taxable years of CFCs beginning on or after the date that final regulations are published in the Federal Register, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

- **General Rule**
  - The GILTI HTE excludes from gross tested income all of a CFC's tentative gross tested income items that are subject to foreign income tax at an effective rate that is greater than 90 percent of the maximum rate specified in section 11 (18.9 percent based on the current rate of 21 percent).

Tentative Gross Tested Income Item

Prop. Treas. Reg. Section 1.951A-2(c)(6)

- **Tentative Gross Tested Income Item**
  - A single "**tentative gross tested income item**" is the aggregate of all items of gross income attributable to a single qualified business unit ("**QBU"**) of the CFC that would be gross tested income but for the GILTI HTE, and that would be in a single tested income group (as defined in Treas. Reg. section 1.960-1(d)(2)(ii)(C)).

- **Multiple Items of Income in a Single CFC**
  - A CFC's QBUs includes QBUs owned by the CFC in addition to the QBU that is the CFC itself.
    - For example, a CFC that owns disregarded entities ("**DREs**") that each qualify as QBUs may have one item of income with respect to the CFC itself (which is a per se QBU) and another item of income with respect to each disregarded entity.
- **QBU Income**
  - A QBU is defined in section 989(a).
  - Gross income attributable to a QBU is determined by reference to the items of gross income properly reflected on the books and records of the QBU, determined under Federal income tax principles.
  - Income attributable to a QBU must be adjusted to account for certain disregarded payments, generally consistent with the new branch rules for disregarded payments under Prop. Treas. Reg. section 1.904-4(f)(2)(vi).

Tentative Net Tested Income Item

Prop. Treas. Reg. Section 1.951A-2(c)(6)

- **Tentative Net Tested Income Items**
  - After tentative **gross** tested income items are determined, they must then be reduced by properly allocable and apportionable deductions to arrive at "**tentative net tested income items,**" which is then tested as to its effective rate of foreign tax.
  - A tentative net tested income item is determined by allocating and apportioning deductions to tentative gross tested income items under the principles of Treas. Reg. section 1.960-1(d)(3), by treating each single tentative gross tested income item as gross income in a separate tested income group.

- **Effective Rate Test**
  - The effective rate at which taxes are imposed on a tentative net tested income item is—
    - (A) The U.S. dollar amount of foreign income taxes paid or accrued with respect to the tentative net tested income item; divided by
    - (B) The U.S. dollar amount of the tentative net tested income item, increased by the amount of foreign income taxes.

Taxes Attributable to Tentative Net Tested Income Items
Prop. Reg. Section 1.951A-2(c)(6)

- **Relevant Taxes: "Properly Attributable" Standard**
  - Prior to the TCJA, the taxes paid/deemed paid in respect of an item of income were the taxes that would be deemed paid under section 960 if the item were included in income pursuant to section 951.
  - The language in Treas. Reg. section 1.954-4(d)(3) has not yet been revised, but arguably is general enough to "work with" the proposed 960 regulations (which reflect the new "properly attributable" standard).
  - The 2019 Proposed GILTI Regulations propose to revise Treas. Reg. section 1.954-4(d)(3)—effective for both the existing high-tax exclusion GILTI HTE—to more smoothly/clearly align with the proposed 960 regulations/properly attributable standard.
  - Foreign income taxes corresponding to an item of income excluded from gross tested income pursuant to the GILTI HTE would not give rise to a deemed paid credit under section 960(d).

Making the GILTI HTE Election

Prop. Treas. Reg. Section 1.951A-2(c)(6)

- **Manner**
  - The GILTI HTE election is made by the CFC's controlling domestic shareholders by attaching a statement to an amended or filed return in accordance with forms, instructions, or administrative pronouncements (not yet released).

- **Scope**
  - The election applies to each CFC member of the "**controlling domestic shareholder group**."
  - A controlling domestic shareholder group is generally defined as two or more CFCs if more than 50 percent of the stock (by voting power) of each CFC is owned (within the meaning of section 958(a)) by the same controlling domestic shareholder (or persons related to such controlling domestic shareholder).
  - Consequently, if a GILTI HTE election is made, it generally must be applied to all items of tested income of all CFCs in a group of commonly controlled CFCs, to the extent the income meets the effective rate test.

Making the GILTI HTE Election

Prop. Treas. Reg. Section 1.951A-2(c)(6)

- **Duration**
  - The GILTI HTE is effective for the CFC inclusion year for which it is made and all subsequent years unless revoked by the controlling domestic shareholders.

- **Revocation**
  - An election may be revoked for any CFC inclusion year.
    - However, upon revocation, a new election generally cannot be made for any CFC inclusion year that begins within sixty months after the close of the CFC inclusion year for which the election was revoked.
    - A revocation is made in the same manner prescribed for an election.
  - Any subsequent GILTI HTE election (following a revocation) cannot itself be revoked for a CFC inclusion year that begins within sixty months after the close of the CFC inclusion year for which the subsequent election was made.
  - An exception to this 60-month limitation may be permitted by the Commissioner if the CFC undergoes a change of control.

Other Provisions
Prop. Treas. Reg. Section 1.951A-2(c)(6)

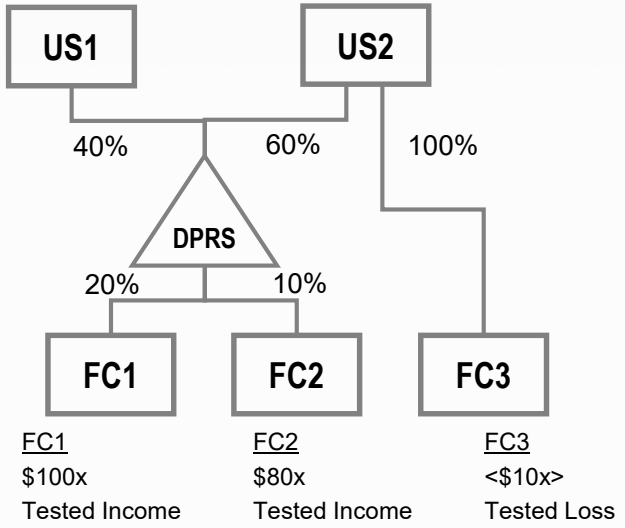
- **Excluded QBAI**
  - If an item of income is excluded from gross tested income by reason of the GILTI HTE, the property used to produce that income does not qualify as specified tangible property, in whole or in part, and therefore the adjusted basis in the property is not taken into account in determining QBAI.

Treatment of Domestic Partnerships under the GILTI Rules

Prop. Treas. Reg. Section 1.951A-5 Application to Domestic Partnerships

- A hybrid approach (entity for some purposes, aggregate for others) was proposed with respect to a domestic partnership that is a US shareholder of one or more CFCs (a "partnership CFC") and that has at least one partner that is also a US shareholder of a partnership CFC (a "U.S. shareholder partner").
  - For non-US shareholder partners, each non-US shareholder partner takes into account its distributive share of the domestic partnership's GILTI inclusion amount.
  - For US shareholder partners, the US shareholder partnership is treated as foreign for purposes of Section 951A, and thus, each US shareholder partner determines its pro rata share of each CFC tested item of a partnership CFC and includes these amounts in its calculation of its GILTI inclusion amount.
- Special rules are provided for tiered partnership structures.
- New schedule K-1 reporting requirements provided for U.S. shareholder partnerships to report relevant information to partners.

Prop. Treas. Reg. Section 1.951A-5 Application to Domestic Partnerships



Facts

- FC1, FC2, and FC3 are CFCs.
- FC1 and FC2 hold no specified tangible property
- All entities calendar tax years.

Anticipated Results:

Partnership-level calculation – PRS.

- Because the domestic partnership (DPRS) is a US shareholder partnership with respect to FC1 and FC2, DPRS must determine its GILTI inclusion.
- Because US1 is not a US shareholder partner with respect to FC1 (8% indirect ownership) or FC2 (4% indirect ownership), US1 includes in income its distributive share of DPRS's GILTI inclusion amount.
- US2 is a US shareholder of FC3.
- Because US2 is a US shareholder partner of FC1 (12% indirect ownership), DPRS is treated as foreign for determining US2's pro rata share of FC1's CFC tested items. US2 includes its pro share of FC1's CFC tested items with its FC3's CFC tested items to determine its GILTI inclusion.
- Further, because US2 is not a US shareholder partner with respect to FC2 (6% indirect ownership), US2 must take into account its distributive share of DPRS's GILTI inclusion without regard to the DPRS's pro rata share of any CFC tested items of FC1.

Domestic Partnerships: Comments Received

- Two comments received raising issues with the hybrid approach adopted by the proposed regulations, including:
  - Some partnerships would have difficulty in determining whether and to what extent its partners are U.S. shareholder partners in order to determine a partnership-level GILTI inclusion amount.
  - Administrability concerns under the 2015 BBA partnership audit rules.
  - Uncertainty with respect to the application of sections 959 and 961, basis adjustments with respect to partnership interests and partnership CFCs and capital accounts.
- These comments considered both a pure entity approach and a pure aggregate approach.
  - A pure entity approach is consistent with pre-TCJA rules regarding subpart F income, but is inconsistent with the purposes of section 951A, which is to compute a single GILTI inclusion with respect to all of a taxpayer's CFCs.
  - A pure aggregate approach is consistent with the purposes of section 951A, would reduce complexities associated with the hybrid approach and would avoid disparate and arbitrary effects of a pure entity approach.

Final Treas. Reg. Section 1.951A-5 Application to Domestic Partnerships

The final GILTI regulations treat a domestic corporation in the same manner as if it were a foreign partnership under section 958(a)(2) for purposes of determining a partner's GILTI inclusion for foreign subsidiaries of the domestic partnership.

In General

The final GILTI regulations:

- A domestic partnership is treated as foreign for purposes of determining the ownership of stock owned by the partnership within the meaning of section 958(a), but…
- The domestic partnership is still treated as domestic for determining US shareholder status, CFC status, and controlling domestic shareholder status.

Applicability

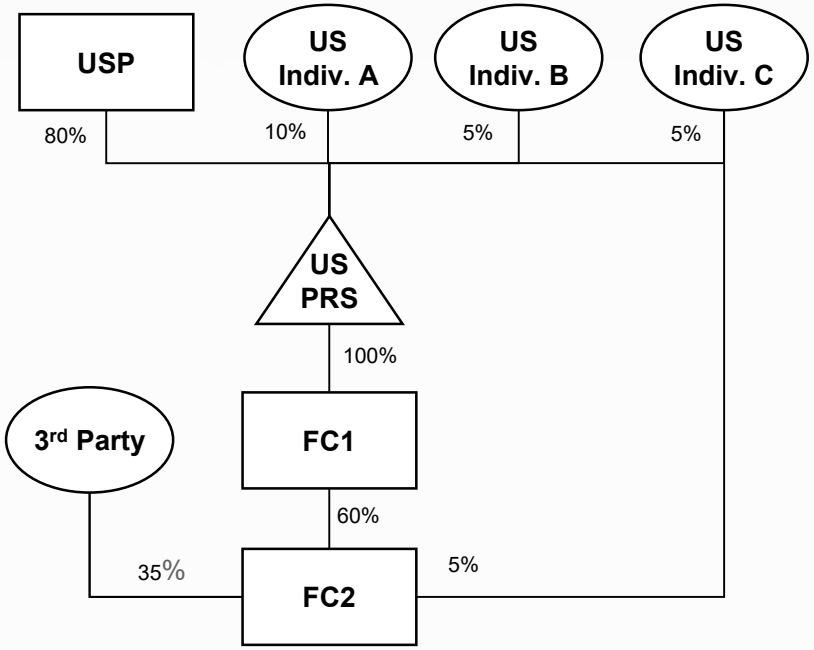
The final GILTI regulations apply:

- For purposes of section 951A and any provision that applies by reference to section 951A, and
- To tax years of foreign corporations beginning after December 31, 2017.

Subpart F Income

- The new proposed regulations would extend this rule to section 951 for tax years of foreign corporations beginning on or after the date final regulations are issued the regulations.
- However, domestic partnership can apply the proposed regulations for tax years of foreign corporation beginning after December 31, 2017.

Example: GILTI and Domestic Partnerships



- Anticipated section 951A results:

US Person	Foreign Subsidiary	§958(b) Ownership	US Shareholder?	Inclusion % / §958(a) Ownership
USP	FC1	80%	Yes	80%
	FC2	80%	Yes	48%
Indiv. A	FC1	10%	Yes	10%
	FC2	10%	Yes	6%
Indiv. B	FC1	5%	No	-
	FC2	5%	No	-
Indiv. C	FC1	5%	No	-
	FC2	10%	Yes	8%

- Other Considerations
  - Subpart F income inclusions
  - Section 961 basis adjustments

Application to Domestic Partnerships
Comments Requested

- Other provisions of the Code that apply by reference to ownership within the meaning of section 958(a).
- Whether to extend the treatment of domestic partnerships to the determination of controlling domestic shareholders of a CFC, such that some or all of the partners who are U.S. shareholders of the CFC, rather than the partnership, make any elections applicable to the CFC for purposes of sections 951 and 951A.
- Transition rules from the entity approach to the aggregate approach, including **necessary adjustments to PTEP and related basis amounts and capital accounts**.
- Application of the aggregate regime with respect to the PFIC regime.
- Whether aggregate treatment should be extended to other pass-through entities, such as certain trusts and estates.
- Application of the aggregate approach to S corporations, which are treated as a partnership for purposes of subpart F, including section 951A.

The Section 951 Pro Rata Anti-Abuse Rule

Ownership Provisions

Treas. Reg. Section 1.951-1

- **Pro rata share anti-abuse rule**
  - The 2018 Proposed GILTI Regulations provided that any transaction or arrangement with a principal purpose of which is the avoidance of Federal income taxation, including transactions to reduce a U.S. shareholder's pro rata share of the subpart F income of a CFC, is disregarded in determining such U.S. shareholder's pro rata share of the subpart F income of the corporation (the "**pro rata share anti-abuse rule**").
  - The final regulations clarify that the pro rata share anti-abuse rule applies only to require adjustments to the allocation of allocable E&P that would be distributed in a hypothetical distribution with respect to any share outstanding as of the hypothetical distribution date

- **Section 951(a)(2)(B) coordination**
  - The regulations under section 951(a)(2)(B) are revised to clarify that a dividend received during the taxable year by a person other than the U.S. shareholder reduces the U.S. shareholder's subpart F income and its pro rata share of tested income in the same proportion as its pro rata share of each amount bears to its aggregate pro rata share of both amounts (as opposed to reducing *both* by the amount of the dividend).

The Final GILTI Regulations

Section 951A - Overview

- Any U.S. person that is a U.S. shareholder of a CFC for any taxable year of the U.S. shareholder shall include in gross income its GILTI for such taxable year.

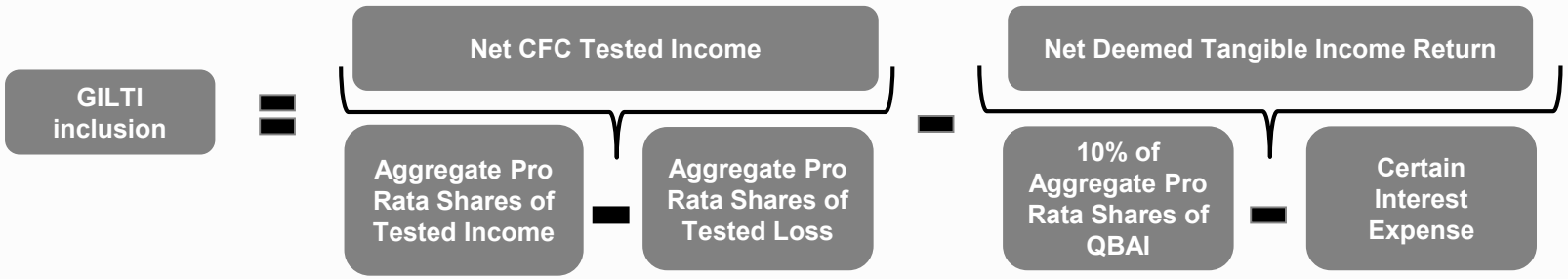
- Effective for taxable years of foreign corporations beginning after December 31, 2017, and taxable years of U.S. shareholders in which or with such taxable years of foreign corporations end.

- Proposed regulations related to GILTI were issued September 13, 2018.

- The final GILTI regulations issued June 14, 2019, largely adopted, with some modifications, the proposed regulations.

Section 951A - Overview

- A U.S. shareholder's GILTI inclusion represents certain net income of the US shareholder's CFCs to the extent it exceeds a specified return on certain tangible assets of the CFCs.
- A U.S. shareholder's GILTI amount for a taxable year equals the excess (if any) of:
  - The US shareholder's "**net CFC tested income**" for the taxable year, over
  - The US shareholder's "**net deemed tangible income return**" for the taxable year.



Final GILTI Regulations – Key Takeaways for 2018 Returns

- Certain domestic partnerships are treated as foreign, requiring GILTI items to be taken into account directly by certain U.S. partners (discussed in detail above).

- Tested income is a taxable income concept; but more guidance to follow regarding application of Code provisions expressly limited to domestic corporations.

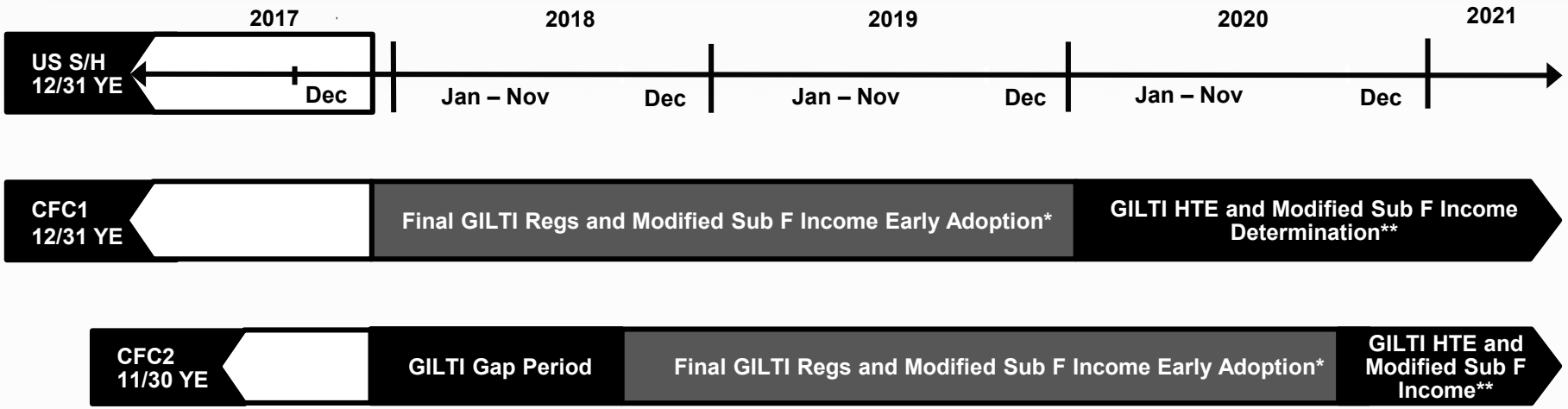
- Lack of clarity regarding application of section 961(c) to tested income determination.

Final GILTI Regulations – Other Changes

Key Changes and Confirmations	Anticipated Future Guidance	Rejected Recommendations

▸ Tested income and tested loss
  ▸ U.S. taxable income determination
  ▸ *De minimis* and full inclusion coordination
  ▸ Section 367(d) expense allocation
  ▸ Disregards qualified deficits
▸ Qualified Business Asset Investment (QBAI)
  ▸ Excludes section 168(k) property (software, film productions, etc.)
  ▸ Temporary ownership rule narrowed
  ▸ ADS transition rule
▸ Tested interest income and expense
  ▸ Section 163(j) definitions
  ▸ Netting for related party receivables
	▸ Application of "domestic" provisions to CFCs (including section 245A)
	▸ Interaction of sections 961 and 951A
	▸ Net used tested loss rules
	▸ Conforming FDII QBAI rules to new GILTI QBAI rules
	▸ Expanded automatic method changes for depreciation
		▸ No expense apportionment to GILTI
		▸ No elective subpart F income treatment for GILTI income
		▸ No tested loss carryforwards
		▸ Depletable assets not included in QBAI
		▸ No QBAI in tested loss CFCs

Effective/Applicability Dates



* "Modified Sub F Income Early Adoption" refers to an election to apply Prop. Treas. Reg. section 1.958-1(d) to determine a US person's subpart F income inclusion from a CFC held through domestic partnership.

** Assumes the GILTI HTE and Modified Subpart F Income Determination rules are finalized before the end of December 2018.

Tested Income and Tested Loss

Treas. Reg. Section 1.951A-2

- ***De Minimis* Rule:** Gross tested income includes any gross income excluded from subpart F under the *de minimis* rule.

- **Full Inclusion Rule:** Gross tested income excludes any gross income included in Subpart F under the full inclusion rule.

- **Interaction of Sections 961(c) and 951A:** Treasury did not offer guidance on whether section 961(c) basis adjustments should be taken into account in determining tested income.
  - Treasury indicated the interaction will be addressed in a guidance project on previously taxed E&P ("PTEP") under sections 959 and 961.

- **No Tested Loss Carryforward:** Treasury rejected recommendations for a carryforward provision.

- **Section 367(d) Expense Allocation:** Deemed payments under section 367(d) are treated as an allowable deduction for purposes of determining tested income and tested loss, and such deemed payments may be allocated and apportioned to gross tested income.

Tested Income and Tested Loss

Treas. Reg. Section 1.951A-2

- **Treatment of CFCs as Domestic Corporations:** Treasury and the IRS intend to address issues related to the application of Treas. Reg. section 1.952-2 in connection with a future guidance project.
  - Guidance is expected to clarify that, in general, any provision that is expressly limited in its application to domestic corporations, such as section 250, does not apply to CFCs by reason of Treas. Reg. section 1.952-2.
  - **What does this imply in the event that section 954(c)(6) is not extended?**

- **High Tax Exclusion:** The GILTI high-tax exclusion from the 2018 Proposed GILTI Regulations is adopted without modification.
  - Until the 2019 Proposed GILTI Regulations are finalized and effective, a taxpayer may not exclude any item of income from gross tested income under the high tax exception unless the income would otherwise be FBCI or insurance income but for the application of section 954(b)(4).

- **Qualified Deficits:** The section 952(c) coordination rule is modified to disregard the effect of a qualified deficit or a chain deficit in determining gross tested income (more detail below).

Section 952(c) & Prop. Treas. Reg. Section 1.951A-2

- Interaction With Section 952(c)
  - Section 952(c) does not apply for purposes of determining gross tested income. Prop. Treas. Reg. section 1.951A-2(c)(4)(i).
  - For purposes of applying the E&P limitation of section 952(c)(1)(A), the E&P of a CFC is increased by the amount of the CFC's tested loss. Section 951A(c)(2)(B)(ii); Prop. Treas. Reg. section 1.951A-6(d).
  - These rules can double count income as both tested income and subpart F income.

Interaction With Section 952(c): Example 1

- **Facts**
  - USSH owns CFC. USSH owns no other interests in CFCs.
  - In Year 1, CFC has foreign base company sales income of $100 and a tested loss of $100, resulting in E&P of $0.
- **Analysis**
  - For purposes of applying the E&P limitation of section 952(c)(1)(A), CFC's E&P is increased by the tested loss of $100.
  - Therefore USSH has a $100 subpart F inclusion.
  - This result applies even though the tested loss is not used to offset any other income in Year 1 and cannot be carried forward or back to any other year.
  - Is such a result appropriate?

Interaction With Section 952(c): Example 2

- **Facts**
  - USSH owns CFC.
  - In Year 1, CFC has foreign base company sales income of $100 and a loss allocable to foreign personal holding company income of $100, resulting in E&P of $0.
  - In Year 2, CFC has tested income of $100 and no other income or expenses, resulting in E&P of $100.

- **Analysis**
  - In Year 1, U.S. shareholder has no subpart F inclusion because of the E&P limitation of section 952(c)(1)(A).
  - In Year 2, CFC has $100 of E&P in excess of subpart F income, which is recharacterized as subpart F income under the recapture rule of section 952(c)(2). Therefore U.S. shareholder has a $100 subpart F inclusion.
  - Because section 952(c) does not apply for purposes of determining tested income, U.S. shareholder also has a $100 GILTI inclusion.

Interaction With Section 952(c): Example 3

- **Facts**
  - U.S. shareholder owns CFC1 and CFC2.
  - In Year 1, CFC1 has a tested loss of ($15x) from services-related activities resulting in a net CFC1 tested loss of ($15x) and a current E&P deficit of ($15x). CFC2 has tested income of $15x.
  - In Year 2, CFC1 has foreign base company services income of $15x from the same type of activities that gave rise to losses in Year 1.

- **Analysis**
  - In Year 1, U.S. shareholder has no GILTI inclusion because CFC1's tested loss of ($15x) offsets CFC2's $15x of tested income.
  - In Year 2, CFC1's foreign base company service income of $15x may be offset by CFC1's Year 1 E&P deficit of ($15x) as it is a qualified deficit.
  - Although section 951A(c)(2)(B)(ii) prohibits tested losses from reducing current E&P for purpose of subpart F calculations, the provision is specific to the application of section 952(c)(1)(A), and does not prevent a tested loss from creating a qualified deficit under section 952(c)(1)(B).
  - As a result, U.S. shareholder was able to use the same ($15x) economic loss to offset a total of $30x of income.

Interaction With Section 952(c) Comments

- **Double Inclusion of Same Income:** Comments recommended that:

  Treasury defines "gross income taken into account in determining the subpart F income" as any category of Subpart F Income as determined under sections 954(a) or 953, as the case may be, determined without regard to the application of section 952(c)(1) but with regard to the application of sections 952(c)(2) and 954(b)(3). This definition would in effect act as an ordering rule, ensuring that subpart F income is taxed as such and is not also subject to tax as GILTI. **This comment was rejected.**

- **Interaction with Qualified Deficit Rule:** Comments recommended that:

  The final regulations, notwithstanding Congress's failure to include a reference to section 952(c)(1)(B) in section 951A(c)(2)(B)(ii), should deny a U.S. Shareholder the ability to (i) offset tested income with tested loss and (ii) also allow that U.S. Shareholder to create or increase a "qualified deficit" as defined under section 952(c)(2) with the same economic loss. **This comment was accepted.**

  – New Qualified Deficit Rule: Treas. Reg. section 1.951A-2(c)(3) provides "[l]osses in other separate categories of income resulting from the application of [Treas. Reg. section] 1.954-1(c)(1)(i) cannot reduce any separate category of gross tested income, and losses in a separate category of gross tested income cannot reduce income in a category of subpart F income. In addition, deductions of a [CFC] that are allocated and apportioned to gross tested income under this paragraph (c)(3) are not taken into account for purposes of determining a qualified deficit as defined in section 952(c)(1)(B)(ii)."

Interaction of Treas. Reg. Section 1.951A-2(c)(5) and Section 901(m)

- **Base Case:** USP owns CFC1. CFC1 owns CFC2 and CFC3. CFC1 and CFC3 have November 30 taxable year ends and CFC2 has a December 31 taxable year end. During the Disqualified Period, a check-the-box election is made to treat CFC3 as a disregarded entity effective prior to CFC1's sale of CFC3 to CFC2 in exchange for cash in a value-for-value exchange.

- **Comment's Concern:** The concurrent application of section 901(m) and Prop. Treas. Reg. section 1.951A-2(c)(5) would penalize taxpayers by disallowing the depreciation or amortization deductions in computing gross tested income, while also reducing that taxpayer's foreign tax credits to neutralize the effect of those depreciation or amortization deductions even though they did not actually reduce the CFC's income to which those foreign tax credits relate.

- **Comment's Proposal:** Recommended that the Proposed Regulations provide that deductions or loss attributable to Disqualified Basis and thus allocated to the residual CFC gross income basket be disregarded for purposes of section 901(m). **Proposal rejected but…**

- **Election to Reduce Adjusted Basis:** The final regulations permit taxpayers to make an election to reduce the adjusted basis in property by the amount of the disqualified basis for all purposes of the Code, including section 901(m), ensuring no concurrent application of GILTI and section 901(m). *See* Treas. Reg. section 1.951A-3(h)(2)(ii)(B)(3).

Qualified Business Asset Investment

Treas. Reg. Section 1.951A-3

- **Tested Loss QBAI:** Confirmed that no QBAI is available for tested loss entities.
- **Depletable assets:** The definition of QBAI is not extended to include depletable assets.
- **Eligible Tangible Property:** The definition of tangible property that can be treated as QBAI excludes certain intangible property to which section 168(k) applies, namely, computer software, qualified film or television productions, and qualified live theatrical productions.
- **ADS Transition Rule:** In limited circumstances a CFC may elect, for purposes of calculating QBAI, to use US GAAP or another non-ADS method to determine the adjusted basis in property placed in service before the first taxable year beginning after December 22, 2017.
    - This transition rule does not apply for purposes of computing foreign-derived intangible income ("**FDII**").
- **Depreciation Method Changes:** Treasury intends to publish a revenue procedure expanding the availability of automatic consent for depreciation changes and updating the terms and conditions of Rev. Proc. 2015-13 (related to the source, separate limitation classification, and character of section 481(a) adjustments).

Qualified Business Asset Investment

Treas. Reg. Section 1.951A-3

- **Dual Use Ratio:** For purposes of determining the portion of property used in the production of tested income, taxpayers should apply the rules under section 861 for allocating a depreciation or amortization deduction to categories of income.

- **FDII QBAI Rules:** These revisions to QBAI rules for GILTI purposes do not impact the calculation of QBAI for FDII purposes. However, Treasury anticipates making similar adjustments (excluding for the ADS transition rule) in the section 250 regulations.

- **Temporary Ownership Rule:** The 2018 Proposed GILTI Regulations included a rule disregarding (for QBAI purposes) property held temporarily over a quarter close. Several modifications to the rule were made including:

  - Applicable only if holding the property over the quarter close would increase the deemed tangible income return ("**DTIR**") of a U.S. shareholder.

  - The provision is now a rebuttable presumption (as opposed to a per se rule) that may be rebutted if the facts and circumstances clearly establish that the subsequent transfer of the property was not contemplated when the property was acquired and that a principal purpose of the acquisition of the property was not to increase the DTIR of the applicable.

  - A safe harbor exception is provided for certain CFCs under common ownership.

Tested Interest Expense and Tested Interest Income

Treas. Reg. Section 1.951A-4

- **Definition of Interest:** For purposes of section 951A, “interest expense” and “interest income” are defined by reference to section 163(j).

- **Related Party Receivables:** Revisions made to ensure related party receivables are not effectively double-counted.

- **Qualified Interest Expense Support:** A CFC’s qualified interest expense is taken into account only to the extent established by the CFC, and if not established, the taxpayer can assume that none of the CFC’s interest expense is qualified.

- **Tested Loss Interest Expense:** A tested loss CFC’s tested interest expense is reduced by an amount equal to 10 percent of the QBAI that the tested loss CFC would have had if it were instead a tested income CFC.

Adjustments to E&P and Basis of Tested Loss CFCs

Treas. Reg. Section 1.951A-6

- **2018 Proposed GILTI Regulations**
  - Provided rules requiring downward adjustments to the adjusted basis in stock of a tested loss CFC to the extent its tested loss was used to offset tested income of another CFC.
  - These adjustments were generally to be made at the time of a direct or indirect disposition of stock of the tested loss CFC.

- **Final GILTI regulations**
  - Reserves on these provisions, noting that Treasury will consider these rules in a separate guidance project.
  - Any future rules would apply only with respect to tested losses incurred in taxable years of CFCs and their U.S. shareholders ending after the date of publication of future guidance.