September 11, 2019

Hon. Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on Temporary Regulations under Section 245A, Proposed Regulations under Sections 951A and 958, and Final Regulations under Section 951A

Dear Commissioner Rettig:

Enclosed please find comments on the Temporary Regulations under section 245A, Proposed Regulations under sections 951A and 958, and Final Regulations under section 951A of the Internal Revenue Code. These comments are submitted on behalf of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss these comments with you or your staff.

Sincerely,

Tom Callahan
Chair, Section of Taxation

Enclosure

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These comments (“Comments”) are submitted on behalf of the American Bar Association (the “ABA”) Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the ABA. Accordingly, they should not be construed as representing the position of the ABA.

Principal responsibility for preparing these Comments was exercised by Scott M. Levine, Devon M. Bodoh, Ari Berk, Blake Bitter, Brett Bloom, Joseph Calianno, Brian Davis, Alden Dilanni-Morton, Sean Dokko, Matthew J. Donnelly, Alfonso J. Dulcey, Morgan Hann, Lukas Kutilek, Natan J. Leyva, Christina McLeod, Po-Ting Peng, Michael Plowgian, Joshua Ruland, and William R. Skinner. Helpful comments were provided by Amie Colwell Breslow, Michael J. Caballero, Christopher Hanfling, and Timothy S. Shuman. They were reviewed by Edward Tanenbaum of the Committee on Government Submissions and Eric B. Sloan, Vice Chair – Government Relations for the Tax Section.

Although members of the Section may have clients who might be affected by the federal tax principles addressed by these Comments, no member who has been engaged by a client (or who is a member of a firm or other organization that has been engaged by a client) to make a government submission with respect to, or otherwise to influence the development or outcome of one or more specific issues addressed by, these Comments has participated in the preparation of the portion (or portions) of these Comments addressing those issues. Additionally, while the Section’s diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

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Date: September 11, 2019
I. Executive Summary

Section 951, as part of subpart F of the Code, provides rules for when a U.S. shareholder (within the meaning of section 951(b) (a “U.S. Shareholder”)) of a controlled foreign corporation (within the meaning of section 957(a) (a “CFC”)) is required to include in U.S. taxable income on a current basis the income of the CFC. Section 951 was amended as part of Public Law 115-97 (the “Act”), enacted on December 22, 2017.

In addition, sections 951A, 250, and 245A were enacted as part of the Act. Similar to section 951, section 951A requires certain U.S. persons to include in U.S. taxable income a portion of the income of CFCs on a current basis. Section 951A requires a U.S. Shareholder of a CFC to include global intangible low-taxed income (“GILTI”) in a manner similar to subpart F income for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. Shareholders in which or with which such taxable years of foreign corporations end. Further, section 245A provides a domestic corporation with a 100% dividends received deduction (the “Section 245A DRD”) for the “foreign sourced portion” (within the meaning of section 245A(c)) of dividends received from specified ten-percent owned foreign corporations (as defined in section 245A(b)(1), “SFCs”), provided certain other requirements are met.

On October 10, 2018, the Department of Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) published Proposed Regulations under sections 951, 951A, 1502, and 6038 (the “2018 Proposed Regulations”). On June 21, 2019, Treasury and the Service issued final Regulations, which adopt the 2018 Proposed Regulations, as well as the proposed foreign tax credit Regulations issued in December 2018 (the “2019 Final Regulations”). The 2019 Final Regulations retain the basic framework of the 2018 Proposed Regulations with some changes, and are effective from June 21, 2019.

1 References to a “section” or “I.R.C. §” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), and regulation references are to the Regulations promulgated under the Code (the “Regulations” or “Reg. §”), unless otherwise indicated.
2 Subpart F consists of sections 951 through 959.
3 A U.S. person is a U.S. shareholder if it owns ten-percent or more of the stock of a CFC, by vote or value, directly, indirectly or through attribution. I.R.C. § 957.
7 Preamble to Final and Temporary Regulations, 84 Fed. Reg. at 29,288 (the “Final Regulations, Preamble”).
In June 2019, Treasury and the Service also issued Temporary Regulations under section 245A (the “2019 Temporary Regulations”), and Proposed Regulations under sections 951A and 958 (the “2019 Proposed Regulations”).

We applaud Treasury and the Service’s continued efforts to provide taxpayers with guidance relating to the Act. In our view, there are certain portions of the Temporary Regulations and Proposed Regulations that we recommend be reconsidered, and there are areas in which clarification would be helpful. To provide context for our recommendations, we provide a detailed summary of section 951A and other relevant Code sections, as well as the Final Regulations, Temporary Regulations, and Proposed Regulations, in Part II.A of this letter.

Our recommendations are summarized below and discussed in more detail in Part II.B of these Comments.

1. Extraordinary Disposition Rules – Mechanics and Related Issues
   a) We recommend that Treasury and the Service amend the extraordinary disposition account rules to provide that the extraordinary disposition account is reduced by 200% of the amount included in income by the section 245A shareholder under section 951(a)(1)(B) by reason of the application of Temporary Regulation section 1.245A-5T(b) to the hypothetical distribution under Regulation section 1.956-1(a)(2).

   b) We recommend that the Treasury and the Service amend the per se rule in Temporary Regulation section 1.245A-5T(c)(3)(ii)(C) to exclude property described in section 1221(a)(1).

   c) We recommend that the per se rule of Temporary Regulation section 1.245A-5T(c)(3)(ii)(C) be amended to provide an exception for transfers of intangible property from a CFC to a related CFC or a related U.S. person that are deemed to occur as a result of a platform contribution transaction as described in Regulation section 1.482-7.

   d) We recommend that the definition of extraordinary disposition in Temporary Regulation section 1.245A-5T(c)(3)(ii) be amended to provide an exception for an SFC’s transfer of specified property that occurs within 12 months after the acquisition of that SFC from a person that is not related (within the meaning of section 267(b) or 707(b)) to the acquirer of that SFC.

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8 Final Temporary Regulations, Limitation on Deduction for Dividends Received From Certain Foreign Corporations and Amounts Eligible for Section 954 Look-Through Exception, 84 Fed. Reg. 28,398 (June 18, 2019).

9 Notice of Proposed Rulemaking, Guidance Under Section 958 (Rules for Determining Stock Ownership) and Section 951A (Global Intangible Low-Taxed Income), 84 Fed. Reg. 29,114 (June 21, 2019).
2. **Extraordinary Disposition Rules – Losses**  
a) We recommend that Treasury and the Service revise the first sentence of Temporary Regulation section 1.245A-5T(c)(3)(iv) to confirm that losses arising from disqualified period dispositions of property that would otherwise not give rise to income described in section 951A(c)(2)(a)(i)(I) through (V), had the basis of such property instead been less than its fair market value, will be taken into account in determining extraordinary disposition earnings and profits.

b) We recommend that Treasury and the Service augment the language of Temporary Regulation section 1.245A-5T(c)(2) to provide greater specificity regarding the calculation of “non-extraordinary disposition earnings and profits” and the sourcing of dividends from the section 245A shareholder’s extraordinary disposition account, including in a nimble dividend situation. Further, we recommend that Treasury and the Service assign extraordinary disposition accounts a finite life, beyond which they cease to exist or no longer have continued applicability.

3. **Extraordinary Disposition Rules – Successor Rules for Section 355 Distributions**  
We recommend that, to the extent that under existing law the earnings and profits of the controlled corporation is allocated, the rule of Temporary Regulation section 1.245A-5T(c)(4)(iii) should apply (i.e., the extraordinary disposition account should be allocated between the distributing SFC and the controlled SFC in the same manner as the earnings and profits are allocated under Regulation section 1.312-10).

4. **Extraordinary Disposition Rules – Alternative Approaches for Tiered Extraordinary Dispositions**  
We recommend that the Temporary Regulations be amended to adopt a tracking system with respect to distributions of extraordinary disposition earnings and profits from a lower-tier CFC. If this recommendation is not adopted, we recommend that Treasury and the Service consider adopting a tracking-system-type of approach with respect to lower-tier CFC dividends occurring before June 18, 2019.

5. **Extraordinary Disposition Rules – Coordination Issues**  
We recommend that the final Regulations provide different alternatives, as discussed in Part II.B.1.f, to correct the duplicative effect of the rules under Regulation section 1.951A-2(c)(5) and Temporary Regulation section 1.245A-5T(d).

6. **Extraordinary Reduction Rules**  
a) We recommend that final Regulations provide that, if a controlling section 245A shareholder makes a closing-of-the-year election, subpart F income and tested income throughout the CFC’s tax year ending on the date it would have otherwise ended had there been no closing-of-the-year
election(s) made with respect to that CFC should be allocated under the “Section 1248 Proration Approach” discussed in Part II.B.2.b(i).

b) We recommend that final Regulations provide that, in reliance on existing IRS Form 5471 reporting, a U.S. Shareholder that is a controlling section 245A shareholder prior to an extraordinary reduction may request, and the CFC may provide, a form promulgated by the Service that sets forth, on an aggregate basis, the pro rata shares of U.S. residents that are U.S. Shareholders of the CFC.

c) We recommend that the final Regulations clarify that only the U.S. residents that are U.S. Shareholders before the extraordinary reduction be required to enter into a binding agreement in order for the controlling section 245A shareholder(s) to make the closing-of-the-year election. We also recommend that final Regulations clarify that the parties to the binding agreement required to make the closing-of-the-year election include only the controlling section 245A shareholder and all other U.S. residents that are U.S. Shareholders before the extraordinary reduction with respect to a CFC.

d) We recommend that final Regulations under section 961 provide that adjustments made under section 961(c) should be taken into account for purposes of determining tested income under section 951A, consistent with section 951A and prior recommendations of the Section.

7. Extraordinary Disposition and Extraordinary Reduction Anti-Abuse Rule
   a) We recommend that the final Regulations narrow the scope of the anti-abuse rule found in Temporary Regulation section 1.245A-5T(h)(1) consistent with the approach adopted by Treasury and the Service in finalizing Regulation section 1.951-1(e)(6). In this regard, we recommend that Treasury and the Service include specific examples describing the types of abuses in both the extraordinary disposition and extraordinary reduction contexts to which the anti-abuse provision would relate, and that the preamble contain a robust comparison discussion regarding Treasury and the Service’s concerns that resulted in the promulgation of the anti-abuse rule.

   b) We further recommend that the final Regulations shift the burden under the anti-abuse rule under Temporary Regulation section 1.245A-5T(h)(1) to the government by providing that the rule will only be applicable if the predominant purpose for a transaction is the avoidance of the purposes of the provisions of the final Regulations (which purposes should be described more clearly in the preamble discussion regarding the anti-abuse rule).
8. **GILTI-Partnership Issues in the Final Regulations**
   a) We recommend that the final Regulations allow a tested income CFC partner of a noncontrolled partnership to use a reasonable alternative method to determine the CFC’s partnership qualified business asset investment with respect to the partnership.

   b) We recommend that Treasury and the Service adopt a rule providing that both foreign and domestic partnerships may increase their basis in their CFC stock to the extent that their partners are entitled to a basis increase in their partnership interests pursuant to section 961(a), effective for purposes of both section 951 and 951A. We further recommend that Treasury and the Service provide that increases to a partnership’s basis in CFC stock under section 961 be made for the benefit of the U.S. Shareholder partner(s) that have inclusions under sections 951(a) and 951A.

   c) We recommend that, in the forthcoming guidance addressing previously taxed earnings and profits, Treasury and the Service provide a framework for characterizing and reporting previously taxed earnings and profits (“PTEP”) distributions at the partnership level.

9. **GILTI-Partnership Issues in the Proposed Regulations**
   a) We recommend that, in promulgating rules to apply aggregate principles to partnerships for provisions that apply by reference to subpart F, Treasury and the Service consider adopting a rule providing that, if a U.S. person sells or exchanges an interest in a partnership that owns (directly or indirectly) stock in a foreign corporation, the amount that the U.S. person treats as ordinary income under section 751(a) be treated as a divided paid by the foreign corporation to the U.S. person under section 1248(a) to the extent the amount treated as ordinary income under section 751(a) is attributable to stock of the foreign corporation that is treated as an unrealized receivable under section 751(c).

   b) We recommend that Treasury and the Service adopt a rule that permits partnerships that have not previously made an upward basis adjustment in CFC stock to make a one-time upward adjustment in such stock to the extent of the partnership’s share of historical PTEP in the CFC.

   c) We recommend that Treasury and the Service adopt a “partnership-first PTEP rule,” as described in Part II.B.3.b(ii), as a transition rule to the treatment of domestic partnerships for purposes of section 959.

10. **GILTI High-Tax Exclusion**
    a) We recommend that the effective date of the proposed GILTI high-tax exclusion be revised to allow taxpayers to choose to apply the 2019
Proposed Regulations in their entirety to all open tax years as if the 2019 Proposed Regulations were finalized, provided that the taxpayers apply the 2019 Proposed Regulations consistently.

b) We recommend that the five-year limitations described in Proposed Regulation section 951A-2(c)(6)(v)(D)(2) be changed to an annual limitation.

c) We recommend that Treasury and the Service adopt special rules for determining high-taxed income that take into account a fiscal unity or similar group.

11. GILTI-QBAI Related Issues

a) In consideration of our recommendation at 7(a) above, we recommend that the final Regulations allow a U.S. shareholder of a noncontrolled tested income CFC to use a reasonable alternative method to determine the CFC’s qualified business asset investment.

b) We recommend that the text of Regulations section 1.951A-3(h)(2)(ii)(B)(2)(ii) be revised in a manner similar to the rule in Regulation section 1.197-2(g)(2)(iii) to resolve an ambiguity in Regulation section 1.951A-3(h)(2)(ii)(B)(2)(ii) as it applies to exchanges of loss property in nonrecognitions transactions with boot and to clarify that the rule does not apply to an increase in basis resulting from gain recognized in nonrecognition transactions.

12. Interaction of the High-Tax Exclusion and the Full Inclusion Test

We request clarification as to whether Regulation section 1.951A-2(c)(4)(iii)(C) is intended to include in gross tested income all full inclusion foreign base company income regardless of whether such full inclusion foreign base company income is subject to a high effective foreign tax rate.

13. Deductibility of Deemed Royalties under Section 367(d)

We recommend that Temporary Regulation section 1.367(d)-1T(c)(2)(ii) be revised provide that deemed royalties under section 367(d) are treated as expenses properly allocated and apportioned to tested income.
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II. Detailed Discussion

A. Background

1. Section 951A

Section 951A requires a U.S. Shareholder of a CFC to include GILTI in a manner similar to subpart F income for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. Shareholders in which or with which such taxable years of foreign corporations end.\(^\text{10}\)

Section 951A(b)(1) defines GILTI as any U.S. Shareholder’s net CFC tested income within the meaning of section 951A(c) (“Net CFC Tested Income”) over such shareholder’s net deemed tangible income return within the meaning of section 951A(b) (“NDTIR”) for the taxable year.

Net CFC Tested Income is, with respect to any U.S. Shareholder for any taxable year of such U.S. Shareholder, the excess (if any) of (A) the aggregate of such shareholder’s pro rata share of the tested income (as defined in the next paragraph, “Tested Income”) of each CFC with respect to which such shareholder is a U.S. Shareholder for the shareholder’s taxable year, over (B) the aggregate of such shareholder’s pro rata share of the tested loss (as defined in the next paragraph, “Tested Loss”) of each CFC with respect to which such shareholder is a U.S. Shareholder for the shareholder’s taxable year.\(^\text{11}\)

Tested Income with respect to any CFC is the excess (if any) of (A) its gross income determined without regard to (i) effectively connected income, (ii) any income taken into account in determining its subpart F income, (iii) any gross income excluded from its foreign base company income (as defined by reason of section 954) and insurance income (within the meaning of section 954(b)(4)), (iv) any dividend received from a related person,\(^\text{12}\) and (v) its foreign oil and gas extraction income (within the meaning of section 907(c)(1)) over (B) the deductions (including taxes) properly allocable to such gross income under rules similar to the rules of section 954(b)(5) (or to which such deductions would be allocable if there were such gross income).\(^\text{13}\) Similarly, a Tested Loss with respect to any CFC is the excess of the amount described in (B) above over the amounts described in (A) above.\(^\text{14}\)

\(^\text{10}\) For a discussion of tax reform and subpart F generally, including Sections 951A, 250, 245A, 904(d)(1)(A), 960(d)(1)(A), and other subpart F provisions amended by the Act, please see the ABA Section of Taxation Comments on the Proposed Regulations Concerning Section 951A, dated November 21, 2018 and available at https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/112118comments.pdf (the “2018 ABA GILTI Comment Letter”).

\(^\text{11}\) I.R.C. § 951A(c)(1).

\(^\text{12}\) For these purposes, a related person is as defined in section 954(d)(3).

\(^\text{13}\) I.R.C. § 951A(c)(2)(A).

the extent that a CFC has a Tested Loss, section 952(c)(1)(A) is applied by increasing the earnings and profits (“E&P”) of the CFC by the Tested Loss of such corporation.15

A U.S. Shareholder’s NDTIR is the excess of (A) ten-percent of the aggregate of its pro rata share of the qualified business asset investment (“QBAI”) of each CFC with respect to which such shareholder is a U.S. Shareholder for such taxable year over (B) the amount of interest expense taken into account in computing Net CFC Tested Income for the taxable year.16

QBAI is defined as the average of a CFC’s aggregate adjusted bases, as of the close of each quarter of such taxable year, in tangible property used in the production of Tested Income (“Specified Tangible Property”) that is depreciable and used in a trade or business of the CFC.17

A U.S. Shareholder’s pro rata share of QBAI, Tested Income, and Tested Loss are determined under the rules of section 951(a)(2) in the same manner as subpart F income.18 In addition, a person is treated as a U.S. Shareholder of a CFC required to include GILTI amounts in income only if such person owns (within the meaning of section 958(a)) stock in such corporation on the last day in the taxable year of such foreign corporation on which such foreign corporation is a CFC.19 Section 951A(e)(3) provides that a foreign corporation is a CFC for any taxable year if such foreign corporation is a CFC at any time during such taxable year.

Except as otherwise provided by Regulations, GILTI included in gross income is treated in the same manner as subpart F inclusions under section 951(a)(1)(A) for purposes of applying sections 168(h)(2)(B), 535(b)(10), 851(b), 904(h)(1), 959, 961, 962, 993(a)(1)(E), 996(f)(1), 1248(b)(1), 1248(d)(1), 6501(e)(1)(C), 6654(d)(2)(D), and 6655(e)(4).20 For purposes of these sections, if a CFC has no Tested Income, its portion of a U.S. Shareholder’s GILTI is zero. If a CFC has Tested Income, its portion of a U.S. Shareholder’s GILTI is the amount of GILTI that bears the same ratio as such U.S. Shareholder’s pro rata amount of the Tested Income bears to the aggregate Tested Income of all Tested Income CFCs.21

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16. I.R.C. § 951A(b)(2). Interest expense is not included in computing NDTIR to the extent the interest income attributable to such expense is taken into account in determining such shareholder’s Net CFC Tested Income. I.R.C. § 951A(b)(2)(B).

17. I.R.C. § 951A(d)(1). See also I.R.C. § 951A(d)(2) (Specified Tangible Property). Property used in the production of both Tested Income and other income is treated as Specified Tangible Property in the same proportion that the Tested Income bears to total gross income produced by the property. I.R.C. § 951A(d)(2)(B). Adjusted basis for purpose of section 951A is determined under section 168(g) (i.e., the alternative depreciation system) and by allocating the depreciation deduction with respect to such property ratably to each day during the taxable year. I.R.C. § 951A(d)(3).

18. I.R.C. § 951A(e)(1). Such amounts are taken into account in the taxable year of the U.S. Shareholder in which or with which the taxable year of the CFC ends. I.R.C. § 951A(e)(1).


2. The Final Regulations

On June 21, 2019, Treasury and the Service issued the 2019 Final Regulations, which adopt the proposed GILTI Regulations issued in October 2018 (i.e., the 2018 Proposed Regulations), as well as the proposed foreign tax credit Regulations issued in December 2018. The 2019 Final Regulations retain the basic framework of the 2018 Proposed Regulations with some changes, and are effective from June 21, 2019.

a. Regulation Section 1.951-1

The 2019 Final Regulations are responsive to comments and include revisions to the amounts included in the gross income of U.S. Shareholders under Regulation section 1.951-1. First, the 2019 Final Regulations replace the term “current earnings and profits” with the term “allocable earnings and profits” for purposes of the hypothetical distribution described in Regulation section 1.951-1(e)(1)(i). Treasury and the Service made this change in response to a comment that the term “current earnings and profits” was confusing because it differed significantly from the definition of “earnings and profits” in section 964(e).

Second, the 2019 Final Regulations clarify the scope of the pro rata share anti-abuse rule to apply only to require appropriate adjustments to the allocation of allocable earnings and profits that would be distributed under the hypothetical distribution with respect to any share outstanding as of the date of the hypothetical distribution. The 2019 Final Regulations do not adopt certain suggested approaches, including limiting the scope of the pro rata share anti-abuse rule to arrangements that lack economic substance or transactions between related parties, and do not include a “small business exception.”

Third, the 2019 Final Regulations retain the facts and circumstances approach for allocating current earnings and profits in a hypothetical distribution by a CFC with more than one class of stock with discretionary distribution rights; commentators had requested the Regulations, when finalized, adopt the fair market value approach of the former Regulations. Fourth, the 2019 Final Regulations clarify Regulation section 1.951-1(e)(7)(v), Example 4, which some commentators believed was confusing based on the definition of “current earnings and profits” in the 2018 Proposed Regulations. The preamble to the 2019 Final Regulations (the “Final Preamble”) states that Example 4 is not intended to refer to the consequences of the hypothetical distribution, but rather to provide examples of terms for stock or related agreements that would not be taken into account for purposes of the hypothetical distribution.

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22 Final Regulations, Preamble at 29,288.
23 Id. at 29,289.
24 Id.
25 Id.
26 Id. at 29,289-29,290.
27 Id. at 29,290.
28 Id.
The 2019 Final Regulations include revised rules under section 951(a)(2)(B), which provide that a dividend received by a person other than the U.S. Shareholder during the taxable year reduces the U.S. Shareholder’s pro rata share of subpart F and Tested Income in the same proportion as that U.S. Shareholder’s pro rata share of each amount bears to the aggregated pro rata share of both amounts; Treasury and the Service was concerned that the 2018 Proposed Regulations could be read to provide an inappropriate double benefit with a dollar-for-dollar reduction in the U.S. Shareholder’s pro rata share of subpart F income and Tested Income.  

The 2019 Final Regulations also revise the rules regarding cumulative preferred stock and the amount of current earnings and profits allocable to such stock to provide that, in cases in which the preferred dividend is based on the applicable Federal rate (“AFR”) as of such stock’s issue date, the current-year E&P allocable to the stock cannot exceed the amount of dividends actually paid during the taxable year with respect to such stock plus the present value of the unpaid dividends with respect to the stock determined by using the AFR applicable on the stock’s issue date.  

Finally, in response to a comment, the 2019 Final Regulations revise the definition of “controlled domestic partnership” such that a domestic partnership is treated as a foreign partnership as to all partners, not just as to a specific U.S. Shareholder that is a partner in the controlled partnership.

b. Regulation Section 1.951A-1

The 2019 Final Regulations also revise certain provisions of Regulation section 1.951A-1. First, the term “U.S. shareholder inclusion year” is modified to provide that a U.S. Shareholder takes into account its pro rata share of a CFC’s Tested Income in the U.S. Shareholder inclusion year that includes the last day of the CFC’s inclusion year.

Second, although the 2019 Final Regulations generally adopt the QBAI allocation rules unchanged from the 2018 Proposed Regulations, they revise the rules regarding excess QBAI to provide that, in instances in which the Tested Income of a CFC is less than ten percent of its QBAI (the “Hypothetical Tangible Return”), the shareholder’s pro rata share of QBAI is determined based on the shareholder’s pro rata share of the Hypothetical Tangible Return, without any limitation based on whether the shareholder owns common or preferred stock.

c. Regulation Section 1.951A-2

Treasury and the Service received several comments regarding the application of Regulation section 1.952-2 to the GILTI rules, including the application of such rules to sections 250 and 245A; however, Treasury and the Service intend to address those comments in future

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29 Id. The relevant examples in the 2019 Final Regulations are also modified to illustrate the application of the revised rules.

30 Id. at 29,291.

31 Id.

32 Reg. § 1.951A-1(d)(1); Final Regulations, Preamble at 29,291.

33 See Reg. § 1.951A-1(d)(3); Final Regulations, Preamble at 29,292.
guidance. The 2019 Final Regulations also adopt the 2018 Proposed Regulations approach to the GILTI high-tax exclusion (“GILTI HTE”) without modification, but, as discussed below, the 2019 Proposed Regulations include rules that would expand the GILTI HTE to other types of income earned by the CFC.

The 2019 Final Regulations also include certain clarifications and revisions related to the coordination rules for subpart F income and Tested Income, including rules for (i) determining gross income included in foreign base company income (“FBCI”), (ii) coordinating with the de minimis, full inclusion, and high-tax exclusion rules of section 954(b), (iii) the application of the rules to items of income described in section 952(a)(3) through (5) (e.g., international boycott income), (iv) the amount of subpart F income under the limitation and recapture rules of section 952(c), (v) the reduction for qualified deficits under section 952(c)(1)(B), and (vi) the election to apply section 953(a) found in section 952(c)(1)(B)(vi)(I).

The 2019 Final Regulations also clarify and revise the rules regarding deductions and losses attributable to disqualified basis in depreciable or amortizable property resulting from a disqualified transfer of property.

d. Regulation Section 1.951A-3

The 2019 Final Regulations generally adopt the approach of the 2018 Proposed Regulations for purposes of determining QBAI. Treasury and the Service did not adopt comments requesting that the Regulations, when finalized, remove the “Tested Loss QBAI Exclusion” and comments requesting changes in how depreciable tangible property is determined for purposes of measuring QBAI. However, the 2019 Final Regulations revise the definition of tangible property in Regulation section 1.951A-3(c)(2) to exclude intangible property described in section 168(k)(2)(A).

Treasury and the Service also did not adopt comments asking that the alternative depreciation system under section 168(g) (“ADS”) not be required under section 951A(d), but the 2019 Final Regulations provide a transition rule for CFCs that are not required to use ADS for purposes of computing income and earnings and profits, allowing them to use their non-ADS method purposes of calculating QBAI. The 2019 Final Regulations also clarify further rules relating to ADS, including rules governing the interaction between the daily proration of the depreciation rule under section 951A(d)(3) and the ADS method. The Final Preamble also states

34 Final Regulations, Preamble at 29,293.
35 Final Regulations, Preamble at 29,293-29,294.
36 See generally Reg. § 1.951A-2; Final Regulations, Preamble at 29,295-29,297.
37 See Reg. § 1.951A-2(c)(5); Final Regulations, Preamble at 29,298-29,301. We note that these Comments do not address the extent to which Regulation section 1.951A-2(c)(5) or the 2019 Temporary Regulations are valid exercises of the Secretary’s regulatory authority.
38 Final Regulations, Preamble at 29,302.
39 Reg. § 1.951A-3(e)(3)(ii) (the rule applies to tangible property placed in service before the first taxable year beginning after December 22, 2017, and applies for purposes of determining QBAI only).
the intent of Treasury and the Service to publish a revenue procedure explaining the availability of automatic consent for depreciation changes.\footnote{Reg. § 1.951A-3(e)(1); Final Regulations, Preamble at 29,304.}

The 2019 Final Regulations also clarify and revise the rules for “dual use property,” including the method for calculating the dual-use ratio.\footnote{Reg. § 1.951A-3(d)(3).} The 2019 Final Regulations also make revisions to the rules regarding partnership QBAI, including \textit{inter alia} rules introducing a new method of calculating QBAI through the use of two ratios (\textit{i.e.}, the proportionate share ratio in cases where the partnership has single-use property, and a combination of the proportionate share and dual-use ratios if the partnership has dual use property).\footnote{See Reg. § 1.951A-3(d) and (g).} Finally, the 2019 Final Regulations include revisions that narrow the anti-abuse rule that disregards basis in Specified Tangible Property held temporarily.\footnote{Reg. § 1.951A-3(h); Final Regulations, Preamble at 29,307-29,308.}

e. \hspace{0.5cm} \textbf{Regulation Section 1.951A-4}

In order to achieve consistency and reduce complexity, the 2019 Final Regulations now define “interest expense” and “interest income” by reference to section 163(j).\footnote{Reg. § 1.951A-4(b)(1)(ii) and (2)(ii). The Final Preamble states that final Regulations under section 163(j) will address comments concerning the validity of the definitions of those terms for purposes of section 163(j), and by extension, the validity of the definitions under the 2019 Final Regulations. Final Regulations, Preamble at 29,310-29,311.} The 2019 Final Regulations also revise the rules for determining qualified interest expense and qualified interest income in order to (i) avoid double counting of related party receivables, (ii) allow interest income excluded under section 954(c)(2)(C) to be included in the numerator for the calculation of qualified interest expense, (iii) require taxpayers take into account a CFC’s qualified interest expense only to the extent established by the CFC, and (iv) treat a CFC that owns 25\% or more of the capital or profits interest in a partnership as owning its attributable share of any property held by the partnership.\footnote{See Reg. § 1.951A-4(b); Final Regulations, Preamble at 29,311.}

The 2019 Final Regulations also introduce a rule that reduces the interest income of a CFC with a Tested Loss (a “Tested Loss CFC”) by its Tested Loss QBAI amount, which is an amount equal to ten percent of the QBAI that the Tested Loss CFC would have had if it were instead a Tested Income CFC.\footnote{Reg. § 1.951A-4(b)(1).}

f. \hspace{0.5cm} \textbf{Regulation Section 1.951A-5}

The 2019 Final Regulations generally do away with the hybrid aggregate-entity approach to domestic partnerships proposed in the 2018 Proposed Regulations in favor of a full aggregate approach, such that the partners of the domestic partnership are for purposes of section 951A treated as owning their proportionate shares of stock in CFCs held by the partnership...
(“Aggregate Approach”). However, the Aggregate Approach is not applicable for purposes of determining U.S. Shareholder or CFC status, or for purposes of determining a controlling domestic shareholder of a CFC, as defined under Regulation section 1.964-1(c)(5). Treasury and the Service continue to study the application of section 1373(a) with respect to section 951A.

**g. Regulation Section 1.951A-6**

The 2019 Final Regulations reserve on rules related to basis adjustments made with regard to stock of Tested Loss CFCs due to concerns of Treasury and the Service that, absent such adjustments, economic or duplicative losses can be created. Any rules issued under Regulation section 1.951A-6(c) will apply only with respect to Tested Losses incurred in taxable years ending after the date of publication of future guidance.

**h. Consolidated Group Rules**

The 2019 Final Regulations adopt the aggregation approach of the 2018 Proposed Regulations without substantial changes. The 2019 Final Regulations reserve regarding basis adjustment to stock of members of the consolidated group, and new rules are expected to form part of the same regulatory project as the basis adjustment rules under Regulation 1.951A-6. Finally, the 2019 Final Regulations do not adopt the rules regarding the “F adjustment” under Proposed Regulation section 1.1502-32(b)(3)(ii)(F).

**3. The 2019 Temporary and Proposed Regulations**

In June 2019, Treasury and the Service also issued Temporary Regulations under section 245A (i.e., the 2019 Temporary Regulations) and Proposed Regulations under sections 951A and 958 (i.e., the 2019 Proposed Regulations).

**a. Temporary Regulations**

The 2019 Temporary Regulations limit the Section 245A DRD in cases in which its application would reverse the intended effect of the subpart F and GILTI regimes. In particular, the 2019 Temporary Regulations limit the Section 245A DRD for certain dividends received from a current or former CFC where (i) a related-party transaction, subject to certain

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47 See generally, Reg. § 1.951A-5; Reg. § 1.951A-1(e).
48 Final Regulations, Preamble at 29,316.
49 Id. at 29,316-29,317.
50 Id. at 29,317-29,316-29,318.
51 Id.
52 Id. at 29,318-29,319.
53 Id. at 29,319.
54 Id.
55 See Preamble to Final Temporary Regulations, 84 Fed. Reg. at 28,400 (the “Temporary Regulations, Preamble”).
limitations, was executed by the CFC on or after January 1, 2018, in a tax year to which GILTI did not apply to such CFC (an “Extraordinary Disposition”), or (ii) a transfer or issuance of stock on or after January 1, 2018, resulted in a reduction of a U.S. Shareholder’s ownership of the CFC (an “Extraordinary Reduction”).

b. Proposed Partnership Regulations

The 2019 Proposed Regulations, among other things, affect the computations of subpart F and GILTI inclusions by expanding the Aggregate Approach with respect to domestic partnerships for purposes of section 951 and any other provisions that apply by reference to section 951.

c. Proposed GILTI HTE Regulations

The 2019 Proposed Regulations also expand the GILTI HTE by generally allowing taxpayers to elect to apply the section 954(b)(4) to non-FBCI or insurance income (i.e., active business income) to the extent such income is taxed at a rate greater than 90% of the U.S. tax rate. For purposes of the GILTI HTE, gross income is measured on a QBU-by-QBU basis, with the election effective for commonly-controlled CFCs. Once made, the GILTI HTE election is binding on future taxable years and, if revoked, cannot be made for any CFC inclusion year that begins within 60 months after the close of the CFC inclusion year for which the election was revoked.

B. Comments

1. The Extraordinary Disposition Rules

a. Background

The 2019 Temporary Regulations provide rules that limit the amount of the Section 245A DRD to the portion of the dividend that is not an “ineligible amount.” For this purpose, an

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56 With respect to an SFC, an Extraordinary Disposition is defined as “any disposition of specified property by the SFC on a date on which it was a CFC and during the SFC’s disqualified period to a related party if the disposition occurs outside of the ordinary course of the SFC’s activities.” Temp. Reg. § 1.245A-5T(c)(3)(iii)(A). The term “specified property” means “any property if gain recognized with respect to such property during the disqualified period is not described in section 951A(c)(2)(A)(i)(I) through (V)” (“Specified Property”). Temp. Reg. § 1.245A-5T(c)(3)(iv). The term “disqualified period” means, “with respect to an SFC that is a CFC on any day during the taxable year that includes January 1, 2018, the period beginning on January 1, 2018, and ending as of the close of the taxable year of the SFC, if any, that begins before January 1, 2018, and ends after December 31, 2017.” Temp. Reg. § 1.245A-5T(c)(3)(iii).

57 Temp. Reg. § 1.245A-5T.

58 Prop. Reg. § 1.958-1(d).


60 Id.

61 Id.

62 Temp. Reg. § 1.245A-5T.
ineligible amount is defined as 50% of the portion of a dividend attributable to E&P that resulted from transactions between related parties during the period after the section 965 measurement date and the date before section 951A applied to the CFC (the “Disqualified Period”).

According to the preamble to the 2019 Temporary Regulations (the “Temporary Preamble”), the Extraordinary Disposition rules under the 2019 Temporary Regulations are a response to CFCs that engaged in related party transactions during the Disqualified Period with a goal of creating stepped-up basis for the buyer and E&P for the seller CFC that was not subject to any current tax and may be eligible for the section 245A deduction. The Temporary Preamble explains that, in the view of Treasury and the Service the E&P resulting from these transactions should not be eligible for the section 245A deduction because such a result “would be inconsistent with the closely interdependent set of international tax rules implemented by [the Act], specifically the transition tax, the GILTI regime, and the participation exemption.”

The 2019 Temporary Regulations attempt to curtail these related party transactions during the Disqualified Period by limiting the section 245A deduction to 50% of the Extraordinary Disposition amount, which is the portion of a dividend received by a section 245A shareholder from an SFC that is paid out of the section 245A shareholder’s Extraordinary Disposition account (the “ED Account”). The account represents the shareholder’s pro rata share of the SFC’s Extraordinary Disposition E&P (“EDEP”), which equals the E&P of the SFC arising from gain recognized by reason of one or more Extraordinary Dispositions.

b. Mechanics and Related Issues

(i) Interaction of the Temporary Regulations with Section 956 Inclusions

We are concerned that the ED Account rules may not be fully coordinated with section 956. Section 951(a)(1)(B) requires a United States Shareholder to include in its gross income the amount determined under section 956 with respect to a CFC. The amount determined under section 956 is the lesser of: (1) the U.S. Shareholder’s pro rata share of the average amounts of U.S. property as defined in section 956(c) held (directly or indirectly) by the CFC at the end of each quarter during the taxable year, less the U.S. Shareholder’s E&P described in section 959(c)(1)(A); or (2) the U.S. Shareholder’s pro rata share of the CFC’s applicable earnings as defined in section 956(b)(1). Recently finalized regulations under section 956 (the “Section 956 Regulations”), however, reduce the amount otherwise determined under section 956 (the “tentative section 956 amount”) with respect to a U.S. Shareholder to the extent that the U.S. Shareholder would be allowed a deduction under section 245A if the U.S. Shareholder had

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63 Temporary Regulations, Preamble at 28,400. An ineligible amount may also result from an Extraordinary Reduction amount, which is discussed in Part II.B.2, below.

64 Temporary Regulations, Preamble at 28,401.

65 Id.

66 Temp. Reg. § 1.245A-5T(b)(2), (c)(1).

received a distribution from the CFC of the tentative section 956 amount.\textsuperscript{68} The Section 956 Regulations extend this treatment to lower-tier CFCs by: (1) treating the lower-tier CFC as being held directly by the U.S. Shareholder for purposes of satisfying the requirements in section 245A(a) through (d); and (2) permitting indirect ownership to satisfy the holding period requirements in section 246(c).\textsuperscript{69}

Temporary Regulation section 1.245A-5T(b) reduces the amount of the deduction allowed under section 245A to a section 245A shareholder (as defined in Temporary Regulation section 1.245A-5T(i)(21), a “section 245A shareholder”) from 100% to 50% for dividends paid out of the ED Account with respect to the section 245A shareholder. Thus, if a specified ten-percent owned foreign corporation (as defined in section 245A(b)(1) \(i.e.,\) an SFC) has an ED Account with respect to a U.S. Shareholder and the U.S. Shareholder also has a tentative section 956 amount, Temporary Regulation section 1.245A-5T(b) would reduce the deduction allowable under section 245A on the hypothetical distribution by the SFC, thereby increasing the amount of the tentative section 956 amount that the U.S. Shareholder would be required to include in income. The 2019 Temporary Regulations do not appear to contemplate this interaction with the Section 956 Regulations and lack guidance related to maintenance of ED accounts to address these situations.

In particular, Temporary Regulation section 1.245A-5T(c)(3)(A) allows a section 245A shareholder to reduce its ED Account only by the “prior Extraordinary Disposition amount” (as adjusted by the successor rules discussed in Part II.B.1.d in this letter). The prior Extraordinary Disposition amount is defined in Temporary Regulation section 1.245A-5T(c)(3)(D) to include only—

1) For ED Accounts of first-tier SFCs—
   a) the Extraordinary Disposition amounts with respect to prior dividends received by the section 245A shareholder from the SFC under the Extraordinary Disposition rules, or
   b) a prior dividend received by the section 245A shareholder from the SFC to the extent that the dividend would otherwise have been treated as an Extraordinary Disposition amount, but that did not qualify for section 245A either because it was a hybrid dividend under section 245A(e) or the section 245A shareholder did not satisfy the holding period requirements in section 246(e),\textsuperscript{70} and

2) For ED Accounts of lower-tier SFCs (and first-tier SFCs that are successors to the ED Account of a lower-tier SFC)—

\textsuperscript{68} Reg. § 1.956-1(a)(2)(i).
\textsuperscript{69} Reg. § 1.956-1(a)(2)(ii).
\textsuperscript{70} Presumably, the rationale for these amounts to be included in the prior Extraordinary Disposition amount is that these amounts are included in the 245A shareholder’s income and therefore the related EDEP do not escape U.S. federal income tax.
a) 200% of the section 245A shareholder’s inclusion under section 951(a) with respect to a tiered Extraordinary Disposition amount,

b) the portion of a prior dividend received by an upper-tier CFC from the SFC that would otherwise be treated as a tiered Extraordinary Disposition amount, but that was a hybrid dividend under section 245A(e), and

c) the qualified portion of a prior dividend received by an upper-tier CFC from a lower-tier CFC that gives rise to a tiered Extraordinary Disposition amount.

An amount determined under section 956 and included in income under section 951(a)(1)(B) is not a dividend received by the U.S. Shareholder, nor is it a tiered Extraordinary Disposition amount (which involves a dividend between a lower-tier CFC and an upper-tier CFC). 71 An amount determined under section 956 and included in income under section 951(a)(1)(B) thus does not fit within any of the categories that comprise the definition of the prior Extraordinary Disposition amount, and therefore it appears that the section 245A shareholder’s ED Account would not be reduced by a section 956 inclusion. As a result, the same earnings of an SFC could be included in the U.S. Shareholder’s income twice—once under section 951(a)(1)(B) as a section 956 amount and again when the SFC distributes the earnings to the U.S. Shareholder. Consider the following example:

**Example 1:** USP, a domestic corporation, owns all of the outstanding stock of CFC1, a CFC with a taxable year end of June 30. USP has an ED Account with respect to CFC1 of $200. 72 During Year 1, CFC1 holds an average amount of $200 of U.S. property as defined in section 956(c) (i.e., its average basis in the U.S. property is $200). At the end of Year 1, CFC1 has no E&P described in section 959(c)(1) or (c)(2), and has $200 of E&P described in section 959(c)(3).

As a result of CFC1’s investment in U.S. property, the tentative section 956 amount with respect to USP is $200. If CFC1 distributed the $200 tentative section 956 amount to USP, Temporary Regulation section 1.245A-5T(b) would limit the deduction allowed under section 245A to $100, because the distribution would consist solely of an Extraordinary Disposition amount, and Temporary Regulation section 1.245A-5T(b) limits the deduction under section 245A to 50% of the Extraordinary Disposition amount. Therefore, USP is required under section 951(a)(1)(B) to include in its gross income an amount equal to $100. The 2019 Temporary Regulations do not appear to allow USP to reduce its ED Account for the amount of the Year 1 section 951(a)(1)(B) inclusion.

In Year 2, CFC1 earns $100 of additional income that is not Tested Income or subpart F income (i.e., it does not give rise to PTEP) and distributes $300 to USP at the end of Year 2. The $300 distribution is considered first a distribution of $100 of PTEP described in

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71 See, e.g., Rodriguez v. Commissioner, 137 T.C. 174 (2011), aff’d, 722 F.3d 306, 309 (5th Cir. 2013) (holding that an income inclusion under section 951(a)(1)(B) was not a “dividend” to the CFC’s U.S. Shareholders, as that term is defined in section 316(a)); see also SIH Partners LLLP v. Commissioner, 150 T.C. 28 (2019), aff’d, 923 F.3d 296, 30608 (3d Cir. 2019) (same).

72 Assume that the de minimis exception under Temporary Regulation section 1.245A-5T(c)(3)(ii)(E) does not apply to this Example 1.
section 959(c)(1), and then as a $200 dividend. All of the $200 dividend is an Extraordinary Disposition amount with respect to USP because the ED Account is still $200, unreduced by the inclusion, and Temporary Regulation section 1.245A-5T(b) limits the deduction allowed under section 245A to $100, resulting in a net $100 of the distribution being taxed as dividend income to USP. The ED Account with respect to USP is reduced by the $200 dividend that is an Extraordinary Disposition amount. If the Extraordinary Disposition amount were reduced by 200% of the amount included by USP in Year 1 under section 951(a)(1)(B) (or, put another way, by the amount of the hypothetical distribution under Regulation section 1.956-1(a)(2)(i)), then none of the actual distribution in Year 2 would be taxed, and the underlying EDEP would only have been taxed once.

As demonstrated in Example 1, the lack of coordination between the ED Account rules and the Section 956 Regulations effectively denies the allowance of the deduction under section 245A with respect to the same Extraordinary Reduction E&P multiple times. We do not believe that such a result is appropriate. Accordingly, we recommend that Treasury and the Service amend the ED Account rules to provide that the ED Account is reduced by 200% of the amount included in income by the section 245A shareholder under section 951(a)(1)(B) by reason of the application of Temporary Regulation section 1.245A-5T(b) to the hypothetical distribution under Regulation section 1.956-1(a)(2). We considered whether the Section 956 Regulations should be amended to provide that Temporary Regulation section 1.245A-5T(b) does not apply to the hypothetical distribution in Regulation section 1.956-1(a)(2)(i); however, we believe that such a change would reintroduce disparate treatment between distributions and investments in U.S. property by CFCs, and we do not believe that such disparate treatment is appropriate.

(ii) Application of the Per Se Rule to Intangible Property

An Extraordinary Disposition requires, among other things, a disposition of specified property that occurs outside of the ordinary course of the SFC’s activities. The 2019 Temporary Regulations generally adopt a facts and circumstances approach for determining whether a sale occurs outside of the ordinary course of an SFC’s activities. Nevertheless, the 2019 Temporary Regulations adopt a per se rule in the case of a disposition of intangible property as defined in section 367(d)(4).

The Temporary Preamble provides the following context for the treatment of a disposition of intangible property as per se outside of the ordinary course of an SFC’s activities:

The temporary regulations include this [per se] rule because the disposition of intangible property is not an ordinary course transaction (relative to, for example, a routine sale of

73 The $100 of PTEP relates to the $100 subpart F inclusion resulting from the application of Temporary Regulation section 1.245-5T(b) in Year 1.


76 Temp. Reg. § 1.245A-5T(c)(3)(ii)(C). We note that the per se rule also applies “if the disposition is undertaken with a principal purpose of generating earnings and profits during the disqualified period[.]” Temp. Reg. § 1.245A-5T(c)(3)(ii)(C).
raw materials from one SFC to another for manufacturing); moreover, during the
disqualified period taxpayers may have had a particularly strong incentive to dispose of
intangible property (which often has low basis) to generate significant amounts of
earnings and profits to the seller (without being subject to current tax) that may be
eligible for the section 245A deduction.\textsuperscript{77}

Thus, unless the \textit{de minimis} exception in Temporary Regulation section 1.245A-
5T(c)(3)(ii)(E) applies, a disposition of intangible property will generally be considered outside
of the ordinary course of an SFC’s activities and constitute an Extraordinary Disposition to the
extent the sale is to a related party during the Disqualified Period.

Although we appreciate the administrative desirability of a \textit{per se} rule, we believe that
the adoption of a \textit{per se} rule for intangible property is overly broad and does not consider certain
businesses that an SFC may conduct in which a sale of intangible property is within the ordinary
course of its activities. Further, even if a transfer of intangible property is outside of the ordinary
course of an SFC’s activities relative to a routine sale of raw materials from one SFC to another,
we believe that there may be circumstances in which the treatment of a transfer of intangible
property as an Extraordinary Disposition may be inappropriate. We discuss each of these
instances below.

\begin{enumerate}
\item \textbf{Transfers of Intangible Property That Is Properly Treated as Inventory}

Temporary Regulation section 1.245A-5T(c)(2)(iv) generally defines specified property
as property that results in gain that would constitute Tested Income. This broad definition
generally would include inventory as defined in section 1221(a)(1), if that inventory is intangible
property.\textsuperscript{78} By contrast, the disqualified basis rules of Regulation section 1.951A-2 (which also
address transactions during the Disqualified Period) exclude from the impact of those rules
property that is described in section 1221(a)(1).\textsuperscript{79}

It is not clear why the Extraordinary Disposition rules do not exclude inventory from the
\textit{per se} rule for intangible property. Under the Extraordinary Disposition rules, a transfer of
inventory described in section 1221(a)(1) generally would not be subject to the Extraordinary
Disposition rules provided that (1) the inventory is not intangible property as defined in section
367(d)(4), and (2) based on all the facts and circumstances, the transfer of the inventory is not
outside of the ordinary course of the SFC’s activities. However, if the inventory sold constituted
intangible property, the sale would be treated as \textit{per se} outside of ordinary course of the SFC’s

\end{enumerate}

\textsuperscript{77} \textit{See} Temporary Regulations, Preamble at 28,401.

\textsuperscript{78} Property described in section 1221(a) includes “stock in trade of the taxpayer or other property of a kind which
would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property
held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.”

\textsuperscript{79} Reg. § 1.951A-2(h)(2)(ii).
activities and would constitute an Extraordinary Disposition if the sale was to a related party during the Disqualified Period. 80

The definition of intangible property in section 367(d)(4) is extraordinarily broad and includes any:

(A) patent, invention, formula, process, design, pattern, or know-how,
(B) copyright, literary, musical, or artistic composition,
(C) trademark, trade name, or brand name,
(D) franchise, license, or contract,
(E) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data,
(F) goodwill, going concern value, or workforce in place (including its composition and terms and conditions (contractual or otherwise) of its employment), or
(G) other item the value or potential value of which is not attributable to tangible property or the services of any individual.

Based on the catch-all definition in section 367(d)(4)(G), transfers of property that are not physically delivered, but instead are transmitted electronically, may be treated as a transfer of intangible property and subject to the per se rule. This treatment could apply, for example, to sales of copies of: (i) software; (ii) music, video, and other media; and (iii) crypto assets.

Consider the following example:

Example 2: USP, a domestic corporation, owns all of the outstanding stock of CFC1 and CFC2, each a CFC with a taxable year end of June 30. CFC1 is engaged in the software development business, and CFC2 is engaged in the software distribution business. During the Disqualified Period, CFC1 transfers copies of software that it develops to CFC2 through two methods: (1) physical delivery of disks on which the software was copied, and (2) a digital download of the software from CFC1’s servers. In either case, CFC1 does not transfer the copyrights to the software to CFC2. CFC2 sells the software acquired from CFC1 to unrelated customers using the same means of delivery as CFC1.

The software sold by CFC1 to CFC2 would be considered inventory as described in section 1221(a)(1) because it is property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business. The software that is physically delivered and is attributable to disks may constitute intangible property, although that result is unclear. However, the software delivered by digital download would be

intangible property as defined in section 367(d)(4)(G), because it is not attributable to tangible property or the services of any individual. As a result of this characterization, the transfer of the software by digital download during the Disqualified Period would be considered *per se* outside of the ordinary course of CFC1’s activities and would constitute an Extraordinary Disposition to the extent the sales exceed the threshold for the *de minimis* exception. In contrast, the transfer of the software by physical delivery may not constitute an Extraordinary Disposition provided, if tangible, and, if based on all the facts and circumstances, the transfer of the software was not outside of the ordinary course of CFC1’s activities.

This Example 2 demonstrates that the *per se* rule related to transfers of intangible property in Temporary Regulation section 1.245A-5T(c)(3)(ii)(C) may be overly broad and may produce disparate results with respect to taxpayers that transferred different types of inventory during the Disqualified Period. Inventory is by definition property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.81 Thus, in our view, if property sold is inventory as defined in section 1221(a)(1), it should not be treated as transferred outside of the ordinary course of an SFC’s activities regardless of whether it is tangible or intangible property.

To address this concern, we recommend that the Treasury and the Service amend the *per se* rule in Temporary Regulation section 1.245A-5T(c)(3)(ii)(C) to exclude property described in section 1221(a)(1). We believe that the facts and circumstances test in Temporary Regulation section 1.245A-5T(c)(3)(ii)(B) is sufficient to address any concerns of abuse in these circumstances.

(2) Transfers of Intangible Property Pursuant to a Platform Contribution Transaction

Regulation section 1.482-7 provides taxpayers with the ability to enter into qualified cost sharing arrangements with their foreign subsidiaries, pursuant to which the parties agree to share the costs of developing future intangible property (“cost shared intangibles”) based on the reasonably anticipated benefits to which each party will be entitled with respect to those cost shared intangibles.

In many cases, a cost sharing participant will own intangible property that is reasonably anticipated to contribute to the development of the cost shared intangibles (a “platform contribution”).82 As a condition of entering into a cost sharing arrangement, a cost sharing participant must commit to make arm’s length payments to another cost sharing participant to the extent of the latter’s platform contributions (a “platform contribution transaction” or “PCT”).83

To determine the arm’s length payments required pursuant to the PCT, the cost sharing participants must identify the PCT as a particular type of transaction and document the

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81 See I.R.C. § 1221(a)(1).

82 Reg. § 1.482-7(c)(1).

83 Reg. § 1.482-7(b)(1)(ii).
transaction as such within their written cost sharing arrangement. This designation must be consistent with the actual conduct of the controlled participants. Depending on the cost sharing participants’ designation of the transaction, the PCT payments will be treated as either consideration for a transfer of an interest in intangible property or for services.

Because the rules in Temporary Regulation section 1.245A-5T(c)(2)(ii)(C) treat all transfers of intangible property as per se outside of the ordinary course of an SFC’s activities, a PCT that is required to be entered into as a condition of a cost sharing arrangement in which one of the cost sharing participants is a fiscal year SFC may be treated as an Extraordinary Disposition. Consider the following example:

Example 3: USCo, a domestic corporation, plans to manufacture and distribute Product X. USCo owns all of the outstanding stock of ForCo, a CFC with a taxable year end of November 30. ForCo owns the patent rights to Product X, as well as proprietary software that was critical to the research and development of Product X.

On January 31, 2018, USCo and ForCo agree to enter into a cost sharing arrangement pursuant to which USCo and ForCo will share the costs related to the research and development of Product Y in a manner consistent with the reasonably anticipated benefits to which USCo and ForCo will be entitled with respect to Product Y. The parties anticipate that both the patent rights for Product X and the related software will contribute to the development of Product Y, and, therefore, such intangible property is treated as a platform contribution for which arm’s length payments are due from USCo to ForCo.

If the parties designate the PCT as a transfer of a portion of the patent rights for Product X and the software to USCo in exchange for PCT payments that is characterized as a taxable sale for U.S. federal income tax purposes, ForCo will be treated as having sold a portion of its patent rights for Product X and software to USCo in exchange for PCT payments during the Disqualified Period. Because the sale involves intangible property, it is treated as per se outside of the ordinary course of ForCo’s activities. USCo is a related party of ForCo as defined in Temporary Regulation section 1.245A-5T(i)(19). Thus, ForCo is deemed to have engaged in an Extraordinary Disposition.

There is no indication in the Temporary Preamble that this fact pattern was considered, and we do not believe that such a result was contemplated by Congress in the legislative history of the Act to apply the Extraordinary Disposition rules in the 2019 Temporary Regulations to SFC-to-U.S. Shareholder transfers of intangible property that occur in a PCT seems to contemplate just the opposite, explaining the reasons for the changes made by the Act as follows:

The Committee believes that the current U.S. system of worldwide taxation (with deferral), and its 35% corporate tax rate, encourages U.S. corporations to locate intangible income abroad, particularly in low- or zero-tax jurisdictions. The location of intangible income in those jurisdictions may require, or be facilitated by, the location of valuable economic activity in those jurisdictions. One of the Committee’s goals in tax

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84 Reg. § 1.482-7(c)(3), (k)(1)(ii)(J).
85 Id.
86 Reg. § 1.482-7(j)(3)(ii).
reform is to remove the tax incentive to locate intangible income abroad and encourage U.S. taxpayers to locate intangible income, and potentially valuable economic activity, in the United States.87

Stated differently, cost sharing arrangements in which intangible property is transferred by a CFC to a U.S. Shareholder are consistent with Congressional intent. In particular, the effect of the PCT is that intangible property is deemed to be transferred into the United States, where the future profits related to that intangible property will be subject to U.S. federal income tax. In some cases, the future profits related to the intangible property will be subject to U.S. federal income tax at the statutory rate of 21%, in comparison to a potential U.S. effective rate of 10.5% that may apply to GILTI inclusions, if the intangible property remained with the CFC.

Furthermore, PCTs can result from subsequent developments that are not driven by U.S. federal income tax considerations. Consider the following example:

**Example 4:** USCo, a domestic corporation, and ForCo, a CFC wholly owned by USCo with a taxable year end of November 30, entered into a cost sharing arrangement in 2015 to develop Product Y. On February 15, 2018, USCo acquired all of the stock of Foreign Target, a corporation which owned both tangible and intangible property, as part of a strategic acquisition to further the development of Product Y. Foreign Target was unrelated to USCo prior to its acquisition on February 15, 2018. The intangible property of Foreign Target is reasonably anticipated to contribute to the development of Product Y. To integrate Foreign Target’s intangible property into the cost sharing arrangement, Foreign Target became a party to USCo’s and ForCo’s existing cost sharing arrangement and Foreign Target’s intangible property is treated as a platform contribution for which arm’s length payments are due from USCo and ForCo to Foreign Target.88

If the parties designate the PCT as a transfer of the intangible property held by Foreign Target in exchange for PCT payments as a taxable sale for U.S. federal income tax purposes, Foreign Target will be treated as having sold a portion of its intangible property to USCo and ForCo (now related parties of Foreign Target) in exchange for PCT payments during the Disqualified Period. Because the sale involves intangible property, it is treated as *per se* outside of the ordinary course of Foreign Target’s business. Thus, Foreign Target is deemed to have engaged in an Extraordinary Disposition.

As illustrated in the example above, the addition of a foreign target to an existing cost sharing arrangement following a strategic acquisition, can result in a PCT that is treated as an Extraordinary Disposition. We do not believe that these are the types of transactions that should be subject to the Extraordinary Disposition rules in the 2019 Temporary Regulations. Taxpayers should not be penalized for transfers occurring during the Disqualified Period pursuant to the cost sharing regulations as a result of entering into cost sharing arrangements or modifying those cost sharing arrangements due to ordinary course post-acquisition integration of intangible property.

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88 Alternatively, Foreign Target could transfer its intangible property to USCo, and USCo could contribute the intangible property in a PCT. We address that type of post-acquisition transfer in Part II.B.1.b(ii)(3), below.
Taking these factors into account, we recommend that the *per se* rule of Temporary Regulation section 1.245A-5T(c)(3)(ii)(C) be amended to provide an exception for transfers of intangible property from an SFC to its U.S. Shareholder that are deemed to occur as a result of a PCT.

(3) Post-Acquisition Transfers

As discussed above, the definition of Extraordinary Disposition in Temporary Regulation section 1.245A-5T(c)(3)(ii) targets transactions that are undertaken outside of the ordinary course of an SFC’s activities—generally, a facts and circumstances test except in the case of intangible property transfers and transfers engaged in to increase E&P in which case there is a presumption that the transaction was undertaken outside of the ordinary course of the SFC’s activities. While mergers, acquisitions, and post-acquisition integration are not typically viewed as ordinary course activities,\(^8^9\) we believe that the 2019 Temporary Regulations should be modified to provide that certain post-acquisition integration transactions be treated as ordinary course activities for purposes of Temporary Regulation section 1.245A-5T(c)(3)(ii).

After an acquisition, the acquiring group almost invariably engages in certain intra-group transactions to consolidate ownership of key assets such as intangibles, realize synergies from the combination, align various business segments, or combine legal entities. These transactions generally take place within a short period of time after, and as a direct result of, the acquisition, and generally is viewed as being undertaken in the “ordinary course” of an acquisition. Applying the Extraordinary Disposition rules seems overly burdensome in the case in which a domestic corporation acquired a foreign corporation from an unrelated seller during or prior to the Disqualified Period and engaged in post-acquisition restructuring transactions for valid business reasons during the Disqualified Period.

Consider the following example:

**Example 5:** USP, a domestic corporation, is engaged in the franchising business in the United States and abroad. USP owns all of the stock of CFC, a foreign corporation with a November 30 taxable year end. CFC owns valuable non-U.S. rights in certain intellectual property that it licenses to third-party franchisees in the ordinary course of its business.

On October 31, 2017, USP acquires the foreign operations of UST, a domestic corporation that is engaged in a business similar to that of USP. As part of the acquisition, USP acquires all of the stock of Foreign IPCo, a foreign corporation with a November 30 taxable year end, historically owned by UST. Foreign IPCo owns valuable non-U.S. rights in intellectual property that it licenses to third-party franchisees in the ordinary course of its business to produce income that is not Subpart F income. USP does not make a section 338(g) election in connection with the acquisition of Foreign IPCo.

During the Disqualified Period and within 12 months of the acquisition, Foreign IPCo transfers its non-U.S. intellectual property rights to CFC in exchange for non-stock

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\(^8^9\) See, e.g., *Indopco, Inc. v. Comm'r*, 503 U.S. 79, 90 n.8 (citing *Motion Picture Capital Corp. v. Commissioner*, 80 F.2d 872, 873-874 (2d Cir. 1936) for the position that a merger is not part of “ordinary and necessary business activities”").
consideration (e.g., cash or a note). The transfer is undertaken for valid business reasons that include significant cost savings related to synergies gained in the integration of the two non-U.S. licensing businesses.

In the example above, because Foreign IPCo’s sale involves a taxable transfer of intangible property during the Disqualified Period it would be treated as an Extraordinary Disposition. Although the example describes a taxable transfer of intangible property, the Extraordinary Disposition rules could similarly apply to post-acquisition transfers of tangible property to the extent the transfer is not determined to be within the ordinary course of Foreign IPCo’s activities. One purpose of the Act was to spur investment, and mergers and acquisitions are an important part of that. Taxpayers engaging in post-acquisition integration transactions should not be penalized for relying on the provisions of the Code, as well as final and Proposed Regulations, in existence at the time of a post-acquisition integration transaction.

Consequently, we recommend that the definition of Extraordinary Disposition in Temporary Regulation section 1.245A-5T(c)(3)(ii) be amended to provide an exception for an SFC’s transfer of specified property that occurs within 12 months after the acquisition of SFC stock from a seller that is not related (within the meaning of section 267(b) or 707(b)) because these types of activities should be viewed as ordinary course as they are in connection with third-party transactions.

c. Losses

(i) Recognized Built-in Losses for Purposes of Establishing ED Account

For purposes of establishing a section 245A shareholder’s ED Account, the EDEP of the relevant SFC must be determined. Temporary Regulation section 1.245A-5T(c)(3)(i)(C) provides that the EDEP of an SFC equals the sum of “the net gain recognized by the SFC with respect to specified property in each extraordinary disposition.” Further, Temporary Regulation section 1.245A-5T(c)(3)(iv) provides that “specified property” means “any property if gain recognized with respect to such property during the disqualified period is not described in section 951A(c)(2)(A)(i)(I) through (V)” (“BIG Specified Property”). The Temporary Regulations were subsequently corrected to expand the definition of BIG Specified Property to include any “property with respect to which a loss was recognized during the disqualified period if the loss is properly allocable to income not described in section 951A(c)(2)(A)(i)(I) through (V)” (a “Specified Loss” and collectively with BIG Specified Property, “Specified Property”) (this correction, the “Technical Correction”). We believe that

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90 See, e.g., House Report to Accompany H.R. 1, H.R. Rept. 409, 115th Cong., 1st Sess. (Nov. 13, 2017), at 112. (“H.R. 1, as reported by the Committee on Ways and Means, makes comprehensive reforms to the Internal Revenue Code of 1986 to . . . to provide tax relief to businesses of all sizes so that they can create jobs, increase paychecks, and invest in the American economy . . . .”); see also Senate Report at 136 (“The Committee believes that providing full expensing for certain business assets will accelerate purchases of equipment and other assets, and promote capital investment, modernization, and growth.”).


92 Limitation on Deduction for Dividends Received From Certain Foreign Corporations and Amounts Eligible for Section 954 Look-Through Exception; Correcting Amendment, 84 Fed. Reg. 38,866 (Aug. 8, 2019).
the Technical Correction is correct and applaud Treasury and the Service for swiftly addressing the issue. We believe that the reference to “net gain” and the prior reference limiting the definition of Specified Property solely to BIG Specified Property would have created uncertainties when an SFC disposed of an item of property at a loss during the Disqualified Period. Although the phrase “net gain” in the definition of EDEP implies that losses and gains arising from relevant items may be offset, the reference to “gain recognized” in the definition of BIG Specified Property could have been interpreted more restrictively. In other words, the reference to “net gain” could have been read such that only property transfers that result in gain recognition are to be included in the definition of Specified Property.

Example 6: USP, a domestic corporation, owns all the outstanding stock of CFC1, and CFC1 in turn owns all the outstanding stock of CFC2. CFC1 and CFC2 are operating companies and have tax year ends of June 30. During the Disqualified Period, CFC1 sells to CFC2 at fair market value the following items: Asset 1 (a manufacturing intangible), Asset 2 (general business property), and Asset 3 (property that does not otherwise give rise to Tested Income under section 951A(c)(2)(A)(i)). At the time of the disposition, there is a built-in gain of $10 in Asset 1, a built-in loss of $6 in Asset 2, and a built-in gain of $7 in Asset 3. The disposal of such properties does not generate net FBCI, CFC1 has no accumulated E&P, and during the relevant year CFC1 generates no other E&P (i.e., its E&P relates solely to these items disposed of during the Disqualified Period) and makes no distributions. For U.S. federal income tax purposes, on June 30, CFC1’s current year E&P is anticipated to be $11. In addition, CFC1’s EDEP (and thus USP’s ED Account) is $4 if the loss from Asset 2 is considered in determining “net gain,” or $10 if it is not.

As Example 6 illustrates, a failure to account for the Asset 2 loss in determining EDEP would have, in our view, resulted in inappropriately increasing USP’s ED Account.

In addition, the expansion of the definition of Specified Property in the Technical Correction is consistent with the Temporary Preamble’s acknowledgement of an anticipated narrow-scope application of Temporary Regulation sections 1.245A-5T(d) and (f) (the “ED

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We note that such losses may be subject to deferral under section 267(f) because the disposition is between members of the same controlled group. We also note that deferred losses are generally subject to Regulation section 1.267(f)-1(g) which generally provides that losses deferred pursuant to section 267(f) do not reduce E&P until such losses are taken into account. However, Temporary Regulation section 1.245A-5T(c)(3)(ii)(C) defines EDEP as “an amount of [E&P] of an SFC equal to the sum of the net gain recognized by the SFC with respect to [S]pecified [P]roperty in each [E]xtraordinary [D]isposition.” (Emphasis added). As the Regulation refers to “recognized” net gain rather than net gain “taken into account,” the Regulation, as written, appears to include losses recognized during the Disqualified Period but not yet taken into account. We also note that such treatment is consistent with Temporary Regulation section 1.951A-2(c)(5)(iv), Example 3. In Example 3, Treasury and the Service conclude that a loss recognized during the Disqualified Period is allocated to the residual CFC gross income category even though the loss has not yet been taken into account. In other words, the loss has been crystalized because it was recognized during the Disqualified Period. Pursuant to the same line of reasoning, those losses also should be crystalized for purposes of calculating EDEP. We acknowledge that a regime could be created whereby the section 245A shareholder’s ED Account could be reduced when the loss is later taken into account. However, we believe that such a regime would be inappropriate because it would result in (i) additional complexity and compliance requirements and (ii) potentially punitive treatment when the loss is taken into account after the ED Account has been eliminated through prior distributions subject to Temporary Regulation sections 1.245A-5T(d) and (f).
Rules”) and a need to limit compliance and administrative burdens for taxpayers that, in our view, augured in favor of expanding the types of losses that may be taken into account in determining EDEP. We also believe, consistent with both the definition of EDEP and the expansion of the term Specified Property pursuant to the Technical Correction, that netting losses for EDEP purposes is consistent with the statutory language of section 245A (which focuses on “undistributed earnings” without regard to how such earnings arose) and aligns with Treasury and the Service’s stated objective of ensuring the reach of the 2019 Temporary Regulations is appropriately circumscribed.

Example 7: The facts are the same as in Example 6, except that Asset 3 has a built-in loss of $7. Further assume that Treasury and the Service have made the clarifying change to Temporary Regulation section 1.245A-5T(c)(3)(iv) described above in footnote 93 and its related text. For U.S. federal income tax purposes, on June 30, CFC1’s current year E&P is anticipated to show a deficit of $3. In addition, CFC1’s EDED (and thus USP’s ED Account) is $0 if the loss from Asset 3 is considered in determining “net gain,” or $4 if it is not.

As Example 7 illustrates, a failure to account for the Asset 3 loss in determining EDEP would have penalized USP for engaging in a restructuring transaction during the Disqualified Period notwithstanding the fact that the restructuring did not generate net E&P to support a later recast of gain as a section 245A qualified dividend. Consistent with the Technical Correction, we believe that it is more appropriate to eliminate the need for USP to maintain an ED Account with respect to CFC1. Such an approach is reasonable given the limited opportunity for taxpayers to manipulate relevant results (e.g., the Disqualified Period has passed and there is no high tax exception for losses) and the strong likelihood that such a restructuring was done for business rather than tax-planning purposes.

(ii) Losses Arising After Establishment of ED Account

If a section 245A shareholder with an ED Account receives a dividend from the CFC, the availability of the section 245A deduction turns on the extent to which the dividend is sourced from the ED Account.95 For this purpose, dividends are first sourced from “non-Extraordinary Disposition E&P” (“NEDEP”), to the extent thereof.96 NEDEP is defined as the amount of the CFC’s section 959(c)(3) E&P (i.e., non-PTEP earnings), determined at the end of its tax year and without reduction for distributions during the year, that exceeds the balance of the ED Account immediately prior to the relevant distribution.97 Given this formulation, the mere fact that a CFC

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94 The Temporary Preamble notes that the 2019 Temporary Regulations are intended to provide a “limited denial” in respect of the section 245A deduction, and in the context of the ED Rules the concern generally is that Disqualified Period dispositions may generate E&P which could be used to “reduce taxable gain that would otherwise be recognized on the subsequent disposition of the stock of the CFC, thus potentially allowing the CFC and its future earnings to be removed from the U.S. tax system without imposition of tax.” The Temporary Preamble also identifies compliance and administrative burdens as important concerns in the context of the ED Rules. See Temporary Regulations, Preamble at 28,400 – 28,401.

95 Temp. Reg. § 1.245A-5T(b)(1).


has net positive section 959(c)(3) E&P (i.e., accumulated and current) does not ensure that a dividend from the CFC will avoid being sourced to the ED Account (i.e., a dividend will avoid being sourced to the ED Account only to the extent that NEDEP exceeds the dividend amount).

To add clarity regarding the proper application of the ED Rules, we recommend that Treasury and the Service augment the language of Temporary Regulation section 1.245A-5T(c)(2) to provide greater specificity regarding the calculation of NEDEP and the sourcing of dividends from the ED Account, including in circumstances giving rise to nimble dividends.

The following examples illustrate the application of the current rule and, in our view, the need for clarity.

**Example 8:** USP, a domestic corporation, owns all the outstanding stock of CFC1 and has an ED Account of $6 associated with CFC1. Prior to the current year, CFC1 had accumulated section 959(c)(3) E&P of $10. During the current year, CFC1’s economic performance deteriorates, and it generates a current year section 959(c)(3) deficit of $2. Accordingly, at the end of the current year, CFC1’s section 959(c)(3) E&P is $8, and the NEDEP amount is $2 (i.e., $8 less an ED Account of $6). If CFC1 were to distribute cash at the end of the current year, up to $8 of the distribution may qualify as a dividend but only the first $2 would avoid being sourced from the ED Account.

**Example 9:** The facts are the same as Example 8, except that CFC1 generates a current year section 959(c)(3) deficit of $8. Accordingly, at the end of the current year, CFC1’s section 959(c)(3) E&P is $2, and the NEDEP amount is $0 (i.e., the section 959(c)(3) E&P balance does not exceed the ED Account). If CFC1 were to distribute cash at the end of the current year, up to $2 of the distribution may qualify as a dividend, but the entire dividend would be sourced from the ED Account.

**Example 10:** The facts are the same as Example 8, except that CFC1 instead generates a current year section 959(c)(3) deficit of $16. Accordingly, at the end of the current year, CFC1’s section 959(c)(3) E&P is a deficit of $6, and the NEDEP amount is $0 (i.e., the section 959(c)(3) E&P balance does not exceed the ED Account). If CFC1 were to distribute cash at the end of the current year, the distribution would not constitute a dividend and thus neither the issue of sourcing to the ED Account nor application of section 245A more-generally appears to be relevant.

**Example 11:** The facts are the same as Example 10, except that CFC1 instead generates a current year section 959(c)(3) deficit of $18. Further, during the following year (i.e., Year 3) CFC1 generates current year section 959(c)(3) E&P of $7. Thus, at the end of Year 3, CFC1’s section 959(c)(3) E&P is a deficit of $1. If CFC1 were to distribute cash at the end of the current year, then up to $7 of the distribution will qualify as a dividend under the nimble dividend principle of section 316(a)(2). In this instance the NEDEP amount appears to be unclear: it may be $1 if the nimble principle prevails (i.e., $7 less and ED Account of $6) or it may be $0 (i.e., the section 959(c)(3) E&P balance of negative $1 does not exceed the ED Account of $6). If CFC1 were to distribute $5 of cash at the end of Year 3, the entire distribution presumably will qualify as a dividend but only the first $1 (or possibly no amount) would avoid being sourced to the ED Account.
As Examples 8 through 11 illustrate, CFC losses may materially impact how section 245A applies to distributions from CFCs to which an ED Account relates. Moreover, Example 11 draws attention to uncertainty regarding the determination of NEDEP (and thus how dividends may be sourced from an ED Account) in the context of a nimble dividend.98

d. Successor Rules for Section 355 Distributions

Temporary Regulation section 1.245A-5T(c)(4) provides adjustments to a section 245A shareholder’s ED Account with respect to certain direct or indirect transfers of its stock in an SFC, specifically transfers of shares of an SFC,99 certain section 381 transactions, transfers of lower-tier CFCs by upper-tier CFCs, and section 355 distributions pursuant to a plan of reorganization. The 2019 Temporary Regulations, do not, however, include a specific rule with respect to section 355 distributions that are not pursuant to a plan of reorganization.

In particular, Temporary Regulation section 1.245A-5T(c)(4)(iii) requires that an ED Account be allocated between the distributing SFC and the controlled SFC in a reorganization under sections 368(a)(1)(D) and 355 (i.e., a divisive D reorganization) in the same manner as the E&P is allocated in the transaction. There is, however, no rule in the 2019 Temporary Regulations for allocating an ED Account in a section 355 distribution that does not involve a reorganization (i.e., a standalone section 355 distribution). The Temporary Preamble does not address this issue, making it unclear whether this distinction was intended.

In the absence of a specific rule, the result of a standalone section 355 distribution appears to be that the ED Accounts of foreign distributing corporation and foreign controlled corporation, if any, remain the same post-distribution as pre-distribution. We believe that this result has the potential to separate ED Accounts from the related E&P, and we do not believe that this should be the result. The existing guidance regarding carryover or separation of a foreign corporations’ E&P in a standalone section 355 distribution is limited in Regulation section 1.312-10.100 To the extent that, under existing law, the E&P of the controlled corporation is increased in such a transaction, we believe that the rule of Temporary Regulation section 1.245A-5T(c)(4)(iii) should apply (i.e., the ED Account should be allocated between the distributing SFC and the controlled SFC in the same manner as the E&P is allocated under

98 Example 11 also demonstrates that an ED Account may lie dormant for a period of economic malaise (e.g., Year 2 in the example) only to resuscitate years later when fortunes start to improve, resulting in what some have referred to as “zombie E&P.”

99 We note that Temporary Regulation section 1.245A-5T(c)(4)(i)(B)(1) bases a transferee’s ED Account on the transferor’s ED Account, reduced “by reason of dividends” pursuant to Temporary Regulation section 1.245A-5T(c)(3). Temporary Regulation section 1.245A-5T(c)(3)(i)(D) reduces the ED Account by the Extraordinary Disposition amount of any “prior dividend received by the section 245A shareholder.” While we believe the intent is clear, it may be helpful to clarify that any amount treated as a dividend under section 1248 as a result of the transfer of the share of the SFC is a “prior dividend” for Temporary Regulation section 1.245A-5T(c)(4)(i)(B)(1).

100 See Prop. Reg. § 1.367(b)-8. See also T.D. 8862 (“[C]urrent rules regarding the carryover or separation of foreign corporations’ earnings and profits do not adequately consider the international aspects of the Code. . . . Forthcoming proposed regulations will consider these issues. Until Treasury and the Service promulgate such regulations, taxpayers should use a reasonable method (consistent with existing law and taking proper account of the purposes of the foreign tax credit regime) to determine the carryover and separation of earnings and profits and related foreign taxes.”). 65 Fed. Reg. 3589, 3591 (Jan. 24, 2000).
Regulation section 1.312-10). Treasury and the Service also may consider clarifying the
treatment of any deemed dividend recognized by a section 245A shareholder due to a section 355
distribution under Regulation section 1.367(b)-5. We also note that the possibility for engaging
in a transaction to favorably manipulate an ED Account would be policed by both the strong
business purpose requirement under Regulation section 1.355-2(b) and the anti-abuse rule under
Temporary Regulation section 1.245A-5T(h).

e. Alternative Approaches for Tiered Extraordinary Distributions

Temporary Regulation section 1.245A-5T(d) limits the availability of the look-through
exception in section 954(c)(6) for certain dividends made by lower-tier CFCs to upper-tier CFCs
that are attributable to EDEP at the lower-tier CFC level. The consequence of this rule is that
dividends paid by a lower-tier CFC out of its ED Account to an upper-tier CFC are immediately
included in the subpart F income of the U.S. Shareholder. The Temporary Preamble explains the
rationale for the tiered Extraordinary Disposition rules as follows:

[T]he temporary regulations limit the section 954(c)(6) exception in these cases [of tiered
extraordinary dispositions], rather than limiting the application of section 245A only
when the lower-tier CFC earnings and profits are distributed through intervening CFCs to
a section 245A shareholder. This approach prevents deferral of tax with respect to the
applicable subpart F income or tested income and minimizes the administrative and
compliance burdens that would be created by continuing to track the relevant earnings at
the upper-tier CFC.101

We do not believe that the limitation of the look through exception in section 954(c)(6)
for tiered Extraordinary Dispositions necessarily achieves the objectives of preventing deferral of
tax and minimizing administrative and compliance burdens as stated in the Temporary Preamble.
The EDEP is not taxed at the time the underlying income is recognized, so the rules create
deferral. Moreover, the rules do not address deferral created by the same country exception of
section 95(c)(3). Temporary Regulation section 1.245A-5T(d) also applies to distributions made
prior to its issuance, reversing taxpayers’ long-established expectations of the treatment of such
distributions. We believe that these considerations argue for prospective application of tiered
Extraordinary Disposition amounts, along with adjustments to address transactions that may have
occurred during the Disqualified Period.

As an initial matter, the tiered Extraordinary Disposition rules create an incentive for
deferral. To be subject to the rules, a lower-tier CFC must make a distribution. Thus, a lower-
tier CFC is incentivized not to make a distribution in order to avoid triggering the application of
the rules.

Furthermore, the tiered Extraordinary Disposition rules do not address the availability of
the exception in section 954(c)(3) for dividends paid between CFCs that are organized in the
same country (the “same country exception”).102 If the same country exception applies, a lower-

101 See Temporary Regulations, Preamble at 28,404.
102 In general, the same country exception applies to exclude dividends from foreign personal holding company
income if the dividend is received from a related person that: (1) is a corporation created or organized under the
The tier CFC can pay a dividend to an upper-tier CFC out of its ED Account that would not constitute subpart F income. We further note that there does not appear to be any provision (including the successor rules in Temporary Regulation section 1.245A-5T(c)(4)) that would move the ED Account of the lower-tier CFC to the upper-tier CFC in these circumstances. The absence of such a provision is consistent with the statement in the Temporary Preamble regarding the complexity that would be entailed by such a rule. Because the ED Account of the lower-tier CFC does not move to the upper-tier CFC when the same country exception applies, the earnings associated with an Extraordinary Disposition of a lower-tier CFC may be separated from an ED Account. We do not believe that this result was intended, and it could be addressed by providing a mechanism for the ED Account to move with the distributed E&P. If such a tracking mechanism is provided for distributions that qualify under section 954(c)(3), the same mechanism could be used for distributions that qualify under section 954(c)(6).

Moreover, we do not believe that a tracking approach would create material incremental administrative or compliance burdens. In this regard, U.S. Shareholders will already be required to track their ED Accounts and NEDEP to determine the consequences of a lower-tier CFC dividend under the 2019 Temporary Regulations. The additional step of moving the ED Account to the upper-tier CFC should not significantly increase a U.S. Shareholder’s administrative or compliance burden. Moreover, U.S. Shareholders will already be required to maintain a number of accounts with respect to the E&P of their CFCs, including PTEP accounts and hybrid deduction accounts. The addition of an account for EDEP should not materially increase the administrative or compliance burdens of U.S. Shareholders.

Finally, lower-tier CFCs may have made dividend distributions to their upper-tier CFCs in advance of the issuance of the 2019 Temporary Regulations. Section 954(c)(6) significantly pre-dates section 245A, and taxpayers were not provided notice that dividends that qualify for section 954(c)(6) but for the 2019 Temporary Regulations could create subpart F income. We believe that these considerations argue strongly for prospective application of tiered Extraordinary Disposition amounts, along with adjustments to address transactions that may have occurred during the Disqualified Period.

In consideration of the points above, we recommend that the 2019 Temporary Regulations be amended to adopt a tracking system with respect to distributions of EDEP from a lower-tier CFC. In particular, the amended approach would: (1) continue to apply the laws of the same foreign country under the laws of which the CFC is created or organized; and (2) has a substantial part of its assets used in its trade or business located in such same foreign country. We note that there is no grant of regulatory authority under section 954(c)(3) that is similar to the grant of regulatory authority under section 954(c)(6)(A), and perhaps Treasury and the Service did not believe that they had authority to override the same country exception. However, we are not aware why Treasury and the Service did not address CFC distributions out of ED Accounts where those distributions were excluded from subpart F under section 954(c)(6) through tracking the distributed E&P. However, we are not aware why Treasury and the Service did not address CFC distributions out of ED Accounts where those distributions were excluded from subpart F under section 954(c)(3).

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103 See Temporary Regulations, Preamble at 28,404.

104 See Notice 2019-01, 2019-3 I.R.B. 1 (setting forth up to 16 separate categories of PTEP that a taxpayer will be required to track going forward); see also Prop. Reg. § 1.245A(e)-1(d) (establishing a “hybrid deduction account” that a U.S. Shareholder must track with respect to each share of its CFC stock to determine whether a dividend is a hybrid dividend as defined in section 245A(e)(4)).
through exception in section 954(c)(6) and same country exception in section 954(c)(3) for lower-tier CFC dividends paid out of EDEP; (2) require an upper-tier CFC to increase its ED Account with respect to a U.S. Shareholder to the extent the upper-tier CFC receives a dividend from a lower-tier CFC out of the lower-tier CFC’s EDEP and the U.S. Shareholder does not have an inclusion under section 951(a) with respect to such amount; and (3) reduce the lower-tier CFC’s ED Account with respect to the U.S. Shareholder by the amount of the increase to the upper-tier CFC’s increase in its ED Account with respect to the U.S. Shareholder. We note that a similar rule already exists in Temporary Regulation section 1.245A-5T(c)(4)(iv). In particular, under this rule, if an upper-tier CFC disposes of its lower-tier CFC stock, the upper-tier CFC is required to increase its ED Account by the amount of the lower-tier CFC’s ED Account. This recommendation would cause the EDEP to be taxed when distributed to the U.S. Shareholder, similar to the rules for first-tier CFCs.

If this recommendation is not adopted, we recommend that Treasury and the Service consider adopting the approach above at least with respect to lower-tier CFC dividends occurring prior to June 18, 2019. This approach would provide limited relief to U.S. Shareholders that held the stock of lower-tier CFCs that paid dividends that would have otherwise qualified for the look-through exception in section 954(c)(6) prior to the issuance of the 2019 Temporary Regulations.

f. Coordination Issues

(i) Background

Proposed Regulation section 1.951A-2(c)(5) (the “Proposed Tested Income Anti-Abuse Rule”) included a rule that disallowed the taxpayer’s use of “disqualified basis” in determining Tested Income or Tested Loss. “Disqualified basis,” as discussed below, was basis created by transfers of property among related persons when, as a result of the effective date of section 951A, the gain giving rise to the basis was not taken into account in computing the seller’s GILTI.105 In the case of such a transfer (as defined below, a “Disqualified Transfer”) of property, the Proposed Tested Income Anti-Abuse Rule would have prevented a taxpayer from using the basis created in the acquisition of the property for purposes of reducing GILTI, except to the extent that the transferring CFC’s gain on the sale was subject to U.S. tax as effectively connected income or was taken into account in determining subpart F income.106

The possibility for a Disqualified Transfer to occur without U.S. tax to the shareholder under the GILTI regime or section 965 is a product of the statutory effective dates. Regardless of a CFC’s taxable year, section 965 measures deferred foreign income as of either November 2, 2017, or December 31, 2017.107 By contrast, the GILTI rules are generally effective for the taxable years of CFCs beginning after December 31, 2017, and the taxable years of U.S. Shareholders in which or with which such taxable years end.108 Thus, in the case of a fiscal year

107 I.R.C. § 965(a)(1), (a)(2).
CFC, a portion of its last taxable year beginning before December 31, 2017, is subject to neither GILTI nor section 965 (i.e., the Disqualified Period). A CFC with a calendar year as its taxable year, by contrast, has no Disqualified Period because the first day after December 31, 2017, is in a year to which section 951A applies. The legislative history is silent as to why Congress staggered the effective dates of GILTI and section 965 in this manner; however, it may have been to avoid the complexity of coordinating GILTI and section 965 in a taxable year that straddles the old and the new rules. Such a rationale is consistent with the Congressional intention to accelerate the repatriation of foreign earnings back to the United States for domestic investment.

The Proposed Tested Income Anti-Abuse Rule operated based on terms defined in Proposed Regulation section 1.951A-3(h), the section addressing QBAI. In that section, “Disqualified Basis” was defined as the excess of adjusted basis of property after a Disqualified Transfer over the “qualified gain amount” with respect to the transfer. The Proposed Tested Income Anti-Abuse Rule provided that Disqualified Basis in the property may be reduced or eliminated through events such as depreciation or amortization of the property, as well as sales, exchanges, or other transactions that resulted in recovery or elimination of basis.

“Disqualified Transfer” is defined broadly to mean any disposition by a CFC during the Disqualified Period to any related person. Indirect transfers, such as a sale of a partnership interest with a section 754 election, were also included in the definition of a Disqualified Transfer. Although described in the preamble to the Proposed Tested Income Anti-Abuse Rule as an “anti-abuse provision,” the Proposed Tested Income Anti-Abuse Rule rules operated mechanically without regard to the taxpayer’s intent.

Where a CFC had Disqualified Basis in property, any deduction or loss attributable to Disqualified Basis of any Specified Property that was to be allocated and apportioned against Gross Tested Income would have been disregarded for determining Tested Income or Tested Loss. As illustrated by the Example in Proposed Regulation section 1.951A-2(c)(5), the rule would have disregarded for Tested Income purposes the amortization of a step up in basis of an intangible sold from CFC1 to CFC2 during the Disqualified Period, except to the extent that CFC1’s gain recognized was subject to U.S. tax as income effectively connected with a U.S. trade or business or subpart F income (“ECI”).

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110 Prop. Reg. § 1.951A-3(h)(2)(ii)(A). The “Qualified Gain Amount” in turn means (i) the amount of gain subject to U.S. federal income tax under section 882 as effectively connected income (after taking into account treaty reductions) and (ii) any U.S. Shareholder’s pro rata share of the gain recognized by the transferor that is taken into account in determining the shareholder’s subpart F income inclusion. See Prop. Reg. § 1.951A-3(h)(2)(ii)(B).
112 Id.
115 If the transferring CFC has a calendar year as its taxable period, there is no Disqualified Period and the Disqualified Transfer rules would not apply. See Prop. Reg. § 1.951A-2(h)(2)(iii), Ex. (2).
The 2019 Final Regulations made several changes to the Proposed Tested Income Anti-Abuse Rule. In particular, apparently as a result of questions as to Treasury’s authority to promulgate a deduction-disallowance rule in this context,116 the 2019 Final Regulations treat any deduction or loss attributable to Disqualified Basis as not “properly allocable” to gross Tested Income, subpart F income, or ECI of the CFC that received the Specified Property (referred to as “residual CFC gross income”).117 As a result, those deductions are to be allocated to the residual CFC gross income category.118 According to the Temporary Preamble, Treasury and the Service reached this conclusion because:

This rule symmetry between the category of income generated by reason of a transfer during the [D]isqualified [P]eriod and the category of income to which any deduction or loss attributable to the resulting basis is allocated. That is, a [D]isqualified [T]ransfer, by definition, generates residual CFC gross income… and the rule in [Regulation section] 1.951A-2(c)(5) allocates the deduction or loss attributable to the [D]isqualified [B]asis to the same category of income.119

(ii) Coordination Between the Temporary Regulations and Regulation Section 1.951A-2(c)(5)

As stated in the Final Preamble, Disqualified Basis Rules serves to prevent the taxpayer from obtaining a tax benefit from depreciation or amortization of “costless” tax basis created through a transfer during the Disqualified Period.120 At the same time, the 2019 Temporary Regulations ensure that the taxpayer will, in fact, incur the tax cost of creating Disqualified Basis when the relevant earnings are repatriated. Absent coordination, the Extraordinary Disposition rules under Temporary Regulation section 1.245A-5T(d) and (f) (i.e., the ED Rules) and the Disqualified Basis Rules would impose a duplicative penalty of disallowing recovery of basis that the taxpayer has incurred a cost to create. In our view, the application of both the Disqualified Basis Rules and ED Rules goes beyond the stated policy objective of the Disqualified Basis Rules.

Moreover, given the structure of the Disqualified Basis Rules as finalized, the application of both the Disqualified Basis Rules and ED Rules raises a serious concern of imposing taxation twice on the same item of gross income. Specifically, as Disqualified Basis is depreciated or

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116 Final Regulations, Preamble at 29,298-29,299.
117 Reg. § 1.951A-2(c)(5)(i) (the “Disqualified Basis Rules”).
118 Reg. § 1.951A-2(c)(5)(i).
119 Temporary Regulations, Preamble at 29,299. We note that Treasury and the Service believe that “[w]ith respect to the determination of tested income or tested loss, whether an item of deduction or loss is disregarded (under the [Proposed Tested Income Anti-Abuse Rule]) or allocated to income other than gross tested income (under the [F]inal [R]egulations) does not provide a different result.” Final Regulations, Preamble at 29,299-29,300. In at least one significant instance, this does not appear to be the case. As discussed below, upon a future sale of the Specified Property by the transferee CFC, the allocation of amortization or depreciation deductions to the residual CFC gross income category may result in that CFC’s U.S. Shareholder recognizing gain on the same appreciation twice without the economic use of any offsetting deductions.
120 Temporary Regulations, Preamble at 29,298.
amortized by the transferee, it is allocated and apportioned to the residual category of the transferee CFC’s E&P. Further, as the 2019 Final Regulations make clear, as those depreciation or amortization deductions are taken, the transferee CFC’s basis in the Specified Property is reduced.121 As those amortization or depreciation deductions are allocated to the residual category, the transferee CFC’s gain on a resale of the property will increase, despite the fact that the same gain has already been included in the transferor CFC’s E&P that will be treated as taxable under the ED Rules. This result appears to tax the same item of gross income twice in a way that extends beyond preventing the stated abuse of creating “costless” basis during the Disqualified Period. Further, to the extent that both the ED Rules and Disqualified Basis Rules apply, the stated rationale for the allocation and apportionment of deduction or loss to the residual category of creating symmetry between the category of income and expense from the Disqualified Transfer, in our view, becomes more tenuous.122 Rather, the stated policy rationale for the allocation and apportionment (i.e., symmetry between income and deduction) would seem to require some form of coordination between the treatment of the E&P created in the transferor CFC with the expense created in the related transferee. Simply put, in our view, the pivot to a rule that allocates depreciation and amortization expense of Disqualified Property to the residual category to match the tax-exempt E&P created by the transfer is troublesome where those E&P, pursuant to the ED Rules, are or will be subject to U.S. federal corporate income taxation.

We recognize the complexity of coordinating the two rules in an administrable manner, and also recognize that taxpayers that underwent transfers subject to the Disqualified Basis Rules are not all similarly situated. Therefore, we recommend that the final Regulations provide optional alternatives to correct the duplicative effect of the two rules. Provided taxpayers are not claiming a U.S. tax benefit from “costless” tax basis created during the Disqualified Period, we believe the final Regulations should be agnostic as to the manner in which the rules are coordinated.

We believe there are two main approaches that could be taken to coordinate the Disqualified Basis Rules and ED Rules. First, we recommend that the final Regulations permit taxpayers to effectively unwind the tax effect of a Disqualified Transfer through the Basis Elimination Election by providing that, where the taxpayer makes that election, the corresponding ED Account is eliminated with respect to that Disqualified Transfer provided the transferee is a related CFC and remains a CFC for the five-year period beginning on the date of the Disqualified Transfer. Second, if the taxpayer does not make the Basis Elimination Election, we recommend that the Regulations include a set of matching rules that: (a) permits amortization or depreciation of Disqualified Basis to the extent the Extraordinary Disposition has

121 See Reg. § 1.951A-2(c)(5)(iv), Example 2. By contrast, other analogous rules to prevent a tax benefit from a related transfer, such as the anti-churning rules of section 197(f), provide only that the transferee’s basis in the asset is non-amortizable, and thus do not create this double taxation issue.

122 See Temporary Regulations, Preamble at 29,299. We also note that under general income tax principles where Treasury and the Service have been entrusted to promulgate rules to “properly allocate” income with deductions, when an asset gives rise to amortization or depreciation deductions, those deductions are traditionally matched with the “factually related” income the asset generates (e.g., a royalty-generating patent that gives rise to amortization deductions would be matched against those royalties) and not the gain recognized when the asset is sold. Further, section 951A(c)(2)(A)(ii) provides that gross Tested Income is reduced by “deductions (including taxes) properly allocable to such gross income under rules similar to the rules of section 954(b)(5)[.]” We know of no similar rule under section 954(b)(5) or the Regulations thereunder.
been subject to U.S. corporate income tax, (b) reduces the ED Account to the extent that the taxpayer has allocated expense or loss with respect to Disqualified Basis to the residual CFC gross income category, or (c) provides a combination of (a) and (b). For the reasons discussed below, we believe that adopting a matching rule that provides for a combination of (a) and (b) is the best approach to ensure that the Disqualified Basis Rules and the ED Rules are narrowly tailored to achieve their stated goals.

First, we recommend that the final Regulations allow Taxpayers to elect to unwind a Disqualified Transfer within a reasonable period of time after additional Regulations or other guidance is finalized. The 2019 Final Regulations permit taxpayers to elect to eliminate the Disqualified Basis arising from the Disqualified Transfer within 180 days of the their publication.123 As discussed below, with regard to matching of income and expense, we recommend that allocations of deduction or loss attributable to Disqualified Basis and, thus, to the residual CFC gross income category should cause the ED Account of the related transferor to be reduced. Similarly, the final Regulations could provide that where a transferee CFC makes the Basis Elimination Election, the ED Account would be eliminated. Since the costless basis is eliminated by this election, it is unnecessary to treat any of the related E&P as EDEP that is taxable notwithstanding section 245A.124

We note that the reduction of the CFC transferor’s ED Account, but not the E&P, would result in the transferor CFC retaining section 245A-eligible E&P. With one exception (discussed below), the retention of such E&P does not appear to result in any significant tax benefits to the transferor CFC’s U.S. shareholders. Further, one could argue that the Basis Elimination Election should result in a corresponding reduction of the transferor CFC’s E&P as it is somewhat analogous to a non-deductible loss that reduces E&P.125 Such an E&P reduction may address Treasury and the Service’s concern that such E&P could be used to enable the U.S. shareholder to engage in “out-from-under” planning—effectively removing the CFC from the U.S. tax net without paying an additional U.S. tax.

If, however, the transferor CFC sells an appreciated Disqualified Asset to a related foreign transferee that is not a CFC (for example, where a foreign multinational owns the CFC directly or indirectly through a chain of foreign corporations) and the transferor CFC’s U.S. shareholder later sells, directly or indirectly, the stock of the transferor CFC, some or all of the gain on that stock would be recharacterized as a dividend on which the U.S. shareholder may be eligible for the Section 245A DRD.126 Further, the Disqualified Asset would no longer be owned by a person subject to U.S. federal income tax. As a result, neither the income generated

124 In effect, this should result in approximately the same U.S. federal income tax consequences as Approach B discussed below.
125 See Reg. § 1.312-7 (E&P reduced when loss is recognized even though the loss is disallowed, for example, under section 267(a)).
126 Id.
from the Disqualified Asset nor any gain on its subsequent sale to a third party would be subject to U.S. tax.\textsuperscript{127}

In the circumstance immediately above, the elimination of the ED Account would not result in a duplicative penalty and the apparent concerns of Treasury and the Service would not be allayed. Thus, we recommend that when a Basis Elimination Election is made with respect to a related transferee CFC, the corresponding ED Account should be eliminated provided the transferee CFC remains a CFC for the five-year period beginning on the date of the corresponding Disqualified Transfer. The five-year requirement would ensure that the allocation of amortization and depreciation deductions to the residual CFC gross income category has relevance and approximates the position the taxpayer would have been in had it not entered into a Disqualified Transfer in the first instance.\textsuperscript{128}

In addition to providing taxpayers an option to effectively unwind a Disqualified Transfer through the Basis Elimination Election, we also recommend that the Regulations coordinate the Disqualified Basis Rules and ED Rules through a matching principle. We can foresee two approaches to purge Disqualified Basis or ED Accounts, as well as a hybrid of the two approaches. We recommend that the Regulations provide taxpayers with the hybrid approach, discussed as “Alternative C” below, which provides for the closest degree of matching and symmetry between the tax costs of, and the tax benefits of the basis created by, a Disqualified Transfer.

(iii) Alternative A: Treat Dividend out of Extraordinary Disposition E&P as a Qualified Gain Amount

The first alternative to match the two sets of rules would be to treat any dividend paid to the section 245A shareholder out of an ED Account as a Qualified Gain Amount that allows the related basis to be usable beginning with the period in which such dividend was taxed to that shareholder.\textsuperscript{129} In our view, to the extent that a taxpayer has included the Extraordinary

\textsuperscript{127} We note that such a concern with the section 245A benefit from the related E&P should not exist on sales to related U.S. persons where the basis elimination election is made. If the transferor CFC sells an appreciated Disqualified Asset to a related U.S. transferee and a U.S. shareholder of the transferor CFC later sells, directly or indirectly, stock of the transferor CFC, some or all of the gain on that stock would be recharacterized as a dividend with regard to which, absent the ED Rules, the U.S. shareholder would be eligible for the Section 245A DRD. See I.R.C. §§ 1248(j), 964(e)(4). However, the U.S. transferee would, by making the basis elimination election, be giving up the potential tax benefit from amortization or depreciation deductions with respect to the stepped-up basis in the Disqualified Asset that would otherwise be available to the U.S. transferee to offset income that would otherwise be subject to a 21\% (or possibly 13.125\%) corporate tax rate. However, if the taxpayer were permitted to make, and made, a Basis Elimination Election, the ability to depreciate or amortize that basis would not be available to the U.S. transferee, and there would be the same concerns as to double taxation if the ED Rules also applied to deny the U.S. shareholder the Section 245A DRD on a future sale of the transferor CFC stock.

\textsuperscript{128} We note such a rule could be applied by immediately eliminating the ED Account subject to a recapture rule in the event the CFC loses its CFC status within the five-year period or simply reduced after the expiration of the five-year period. We also note that the five-year requirement should be treated as violated even if the CFC retains its status as a CFC to the extent that one or more U.S. shareholders have capital gain recharacterized as a dividend eligible for the section 245A DRD as a result of EDEP during that five-year period.

\textsuperscript{129} Reg. § 1.951A-3(h)(2)(ii)(C)(3).
Disposition amount in income, the taxpayer has incurred the tax cost of creating the Disqualified Basis and should be permitted to amortize or depreciate the related basis step-up.

We recommend that Alternative A be applied retroactively to re-determine the transferee CFC’s Disqualified Basis as of the year in which the dividend out of the ED Account occurs. In our view, this would be administrable to both taxpayers and the Service. At the same time, however, it results in an imperfect matching of expense and income, in that intervening deductions or loss attributable to Disqualified Basis would have been allocated to residual CFC gross income and permanently unavailable to reduce gross Tested Income.

(iv) **Alternative B: Reduce Extraordinary Disposition Amount to the Extent Disqualified Basis is Allocated and Apportioned to Residual CFC Gross Income**

Conversely, we recommend that the 2019 Temporary Regulations reduce the ED Account to the extent that a section 245A shareholder’s CFC has eliminated the Disqualified Basis through the Basis Elimination Election (as discussed above) or has allocated and apportioned deduction or loss to residual CFC gross income under the Disqualified Basis Rules. In this case, the GILTI rules would be applied to eliminate the tax benefit from the costless basis, and, as a result, the section 245A shareholder’s ED Account with respect to the transferor CFC would be commensurately reduced. The reduction of the ED Account would be limited to cases in which the Disqualified Basis is recovered through depreciation, amortization, or other recognition of loss that is allocated to residual CFC gross income of a CFC related to the transferor.130 To the extent that the transferee CFC recovers Disqualified Basis to reduce gain on the sale of the specified property to a person other than an related party that is a CFC,131 we recommend that the ED Account remain intact because the taxpayer has obtained a tax benefit from the Disqualified Basis.

(v) **Alternative C: Hybrid Approach Where Both Alternative A and Alternative B Apply to the Same Property**

Each of Alternative A and Alternative B achieves some degree of symmetry between the expense and income side of the Disqualified Transfer. However, standing alone, each of the above alternatives leave significant gaps and potential for a duplicative application of the Disqualified Basis Rule and ED Rule. Therefore, we recommend a hybrid approach in which both Alternative A and Alternative B apply to a CFC in the case of a Disqualified Transfer.

The need for, and application of, a hybrid approach can best be illustrated with an example.

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130 We believe that this adjustment should include cases where the disqualified basis is excluded from cost of goods sold under Regulation section 1.951A-2(c)(5)(i).

131 See Reg. § 1.951A-3(h)(2)(ii)(B)(1)(ii). Where the related party CFC inherits the taint of the disqualified basis under this section, the transferee CFC’s recovery of Disqualified Basis has not produced a tax benefit.
Example 12: USP, a domestic corporation, owns all of CFC1 and CFC2, each a CFC. In 2018, CFC1 sold disqualified property to CFC2, producing $90 of Disqualified Basis in a section 197 intangible in CFC2’s hands and $90 of related EDEP in CFC1. During 2019, 2020, and 2021, CFC2 amortizes a total of $18 of disqualified basis that is allocated to residual CFC gross income, thus producing no U.S. tax benefit. In 2022, CFC1 pays a $90 dividend to USP, all of which is out of E&P generated by the Disqualified Transfer.

Consequences under Alternative A. Standing alone, the inclusion by CFC1 of $90 of E&P as a taxable dividend under the ED Rules would permit CFC2 to begin to take a tax benefit for amortization of the remaining $72 of otherwise Disqualified Basis. However, without any adjustment to CFC2’s Tested Income in prior years (which may be closed due to the statute of limitations), USP would permanently lose the $18 of amortization deductions previously allocated to residual CFC gross income, despite having paid tax on the full $90 dividend.

Consequences under Alternative B. Standing alone, the allocation of the $18 of amortization deductions to residual CFC gross income would reduce the ED Account subject to tax from $90 to $72. However, without any additional adjustment to the remainder of CFC2’s $72 of Disqualified Basis, the taxpayer would still be unduly penalized by permanently losing any tax benefit from this $72 of basis despite having paid U.S. corporate income tax on the Disqualified Basis pursuant to the ED Rules.

Consequences under Alternative C (i.e., the Hybrid Approach). Under the hybrid approach, the taxable dividend would be reduced to the $72 of E&P that resulted in basis that is still available to CFC2, and would also allow CFC2 to begin to amortize the $72 against Tested Income after the tax paid by USP on the related ED Account. This hybrid approach would achieve a matching of expense and income, and would create a result as to CFC2’s remaining basis similar to what would have been the result had the Disqualified Transfer occurred after the GILTI rules had become effective. The hybrid approach of Alternative C, as well as Alternative A and Alternative B, also safeguard the fisc from taxpayers obtaining any tax benefit from the creation of otherwise “costless” Disqualified Basis.

2. The Extraordinary Reduction Rules

a. Background and Purpose of Regulations

The 2019 Temporary Regulations deny the Section 245A DRD for all or a portion of certain dividends paid to a “controlling section 245A shareholder” by a CFC in a taxable year in which an “Extraordinary Reduction” occurs with respect to that controlling section 245A shareholder.132 For this purpose, an Extraordinary Reduction occurs if either: (1) a controlling

132 Temp. Reg. § 1.245A-5T(b)(2), (e)(1). A controlling section 245A shareholder is any section 245A shareholder that owns, directly or indirectly, more than 50% (by vote or value) of the stock of the CFC. In addition to direct and indirect ownership, the 2019 Temporary Regulations apply broad aggregation rules that treat a section 245A shareholder as owning stock of a CFC owned by a related party. Furthermore, section 245A shareholders are treated as owning all stock of a CFC owned by persons acting in concert with the section 245A shareholder to undertake an Extraordinary Reduction. The term “acting in concert” is not defined in the 2019 Temporary Regulations, but section 245A shareholders are per se treated as acting in concert with (1) all other U.S. Shareholders of a lower-tier
section 245A shareholder transfers directly or indirectly more than ten percent (by value) of its stock in the CFC (and at least five percent of the total CFC stock outstanding as of the beginning of the CFC’s taxable year); or (2) a controlling section 245A shareholder’s direct or indirect interest in the stock of a CFC is reduced to less than 90% of its prior interest (and is reduced by at least five percentage points).\footnote{133}

The Extraordinary Reduction amount is equal to the lesser of (1) the sum of the controlling section 245A shareholder’s pre-reduction pro rata share of the CFC’s subpart F income\footnote{134} and Tested Income\footnote{135} for the CFC’s taxable year reduced by the prior Extraordinary Reduction amount and (2) the amount of certain dividends received by a controlling section 245A shareholder during a CFC’s taxable year.

(i) Pre-reduction Pro Rata Share

As a starting point, a controlling section 245A shareholder’s pre-reduction pro rata share of subpart F income is such shareholder’s pro rata share of subpart F income determined based on the controlling section 245A shareholder’s direct or indirect ownership of stock of the CFC immediately before the Extraordinary Reduction.\footnote{136} Similar rules apply for purposes of the controlling section 245A shareholder’s pre-reduction pro rata share of Tested Income.\footnote{137} Pro rata share is determined under section 951(4)(a) and Regulation section 1.951-1(b) in the case of subpart F income and section 951A(e)(1) and Regulation section 1.951A-1(d)(1) in the case of Tested Income.\footnote{138} With respect to both subpart F income and Tested Income, however, the controlling section 245A shareholder’s pre-reduction pro rata share is determined without regard to section 951(a)(2)(B) and Regulation section 1.951-1(b)(1)(ii), which provisions have the effect of reducing a shareholder’s pro rata share on account of dividends (including dividends arising by reason of section 1248(a) or 964(e)) paid to another shareholder.\footnote{139}

A controlling section 245A shareholder’s pre-reduction pro rata share of subpart F income or Tested Income is reduced to account for actual inclusions of such amounts by the controlling section 245A shareholder or other U.S. tax residents. First, it does not include subpart F income or Tested Income actually included in gross income by the controlling section 245A shareholder.\footnote{140} For example, if a controlling section 245A shareholder owns 100% of the stock of a CFC at the beginning of the CFC’s taxable year, transfers 40% of that stock during the year and therefore includes 60% of the CFC’s subpart F income and Tested Income for that year.
taxable year, its pre-reduction pro rata share is only equal to 40% of the sum of the amounts of the CFC’s subpart F income and Tested Income.

Second, a controlling section 245A shareholder’s pre-reduction pro rata share is reduced to the extent that another U.S. tax resident’s pro rata share of subpart F income or Tested Income is increased as a result of a direct or indirect transfer of stock by the controlling section 245A shareholder or by the issuance of stock in the CFC during the taxable year in which the Extraordinary Reduction occurs.141

As noted above, the Extraordinary Reduction amount of a dividend received by a controlling section 245A shareholder of a CFC is equal to the pre-reduction pro rata share of the sum of the CFC’s subpart F income and Tested Income reduced by the prior Extraordinary Reduction amount.142 In general, this reduction avoids double counting. To the extent that an amount has been previously included in subpart F income or Tested Income by the controlling section 245A shareholder, such income inclusions reduce the Extraordinary Reduction amount.

(ii) Tiered-Extraordinary Reductions

Because an Extraordinary Reduction can occur with respect to a lower-tier CFC held by an upper-tier CFC, the 2019 Temporary Regulations extend the Extraordinary Reduction regime to certain dividends received by an upper-tier CFC from a lower-tier CFC by denying the application of section 954(c)(6) to such dividends (including certain stock gain recharacterized as a dividend under section 964(e)) (the “tiered Extraordinary Reduction rule”).143

Specifically, the 2019 Temporary Regulations provide that section 954(c)(6) applies only to a portion of a dividend paid by a lower-tier CFC to an upper-tier CFC only to the extent that the dividend exceeds the “tiered Extraordinary Reduction amount.”144 This provision applies if (1) an Extraordinary Reduction occurs with respect to a lower-tier CFC (a “lower-tier Extraordinary Reduction”) and (2) an upper-tier CFC receives a dividend from the lower-tier CFC during the taxable year of the lower-tier CFC in which the lower-tier Extraordinary Reduction occurred.145

The tiered Extraordinary Reduction amount is different from an Extraordinary Reduction amount. Specifically, the tiered Extraordinary Reduction amount of a dividend received by an upper-tier CFC from a lower-tier CFC is equal to the upper-tier CFC’s proportionate interest in the subpart F income and Tested Income of the lower-tier CFC reduced by certain amounts. For this purpose, the upper-tier CFC’s proportionate interest in the subpart F income and Tested Income in the lower-tier CFC is equal to its percentage interest (by value) in the stock of the

141 Temp. Reg. § 1.245A-5T(e)(2)(ii)(B). Special rules are provided to account for transfers made by multiple controlling section 245A shareholders.
144 Id.
145 Id.
lower-tier CFC immediately before the Extraordinary Reduction multiplied by the lower-tier CFC’s subpart F income and Tested Income for the lower-tier CFC’s taxable year.\(^ {146} \)

Similar to how a controlled section 245A shareholder’s pre-reduction pro rata share is reduced by the prior Extraordinary Reduction amount, the tiered Extraordinary Reduction amount is reduced to the extent of certain items that would give rise to double counting of the same income.

(iii) Election to Close the CFC’s Taxable Year

The 2019 Temporary Regulations provide that, for a taxable year of a CFC in which an Extraordinary Reduction occurs, a controlling section 245A shareholder of that CFC may elect to close the relevant CFC’s taxable year for all purposes of the Code and with respect to all shareholders of the CFC as of the end of the date on which the Extraordinary Reduction occurs. If this election is made, the Extraordinary Reduction amount with respect to a dividend paid by the relevant CFC in the taxable year in which an Extraordinary Reduction occurs is zero.\(^ {147} \) If the Extraordinary Reduction occurs pursuant to multiple transactions, the CFC’s U.S. taxable year for U.S. federal income tax purposes closes as of the end of each date on which a transaction forming a part of the Extraordinary Reduction occurs.\(^ {148} \) A controlling section 245A shareholder that elects to close a CFC’s U.S. taxable year is treated as owning the amount of stock in the CFC it owned prior to the Extraordinary Reduction, and such stock is not treated as owned by any other person.\(^ {149} \)

Although there may be ancillary consequences to closing a CFC’s taxable year (potentially multiple times), for all purposes of the Code, the primary consequence of this election is to convert dividend income that is fully taxable by reason of the rules under Temporary Regulation sections 1.245A-5T(e) and (f) (the “ER Rules”) into Tested Income or subpart F income, thereby allowing foreign tax credits and, with respect to Tested Income, the section 250 deduction, if available for GILTI inclusions.\(^ {150} \)

(1) Allocation of Foreign Taxes

Under generally applicable rules, foreign income taxes that are determined based on the taxable income recognized in a CFC’s tax accounting period for foreign tax purposes, such as a taxable year, do not accrue until the end of that period.\(^ {151} \) As a result, since in most cases the foreign tax accounting period generally will end after the date an Extraordinary Reduction occurs, none of the taxes paid with respect to income earned in the pre-Extraordinary Reduction period will accrue and be deemed paid under section 960 with respect to subpart F income or Tested Income included by a controlling section 245A shareholder as result of a closing-of-the-

\(^ {146} \) Temp. Reg. § 1.245A-5T(f)(2)(i).
\(^ {147} \) Temp. Reg. § 1.245A-5T(e)(3)(A).
\(^ {148} \) Id.
\(^ {149} \) Id.
\(^ {150} \) See Temporary Regulations, Preamble at 28,411.
\(^ {151} \) Prop. Reg. § 1.960-1(b)(4).
year election. In similar circumstances, Regulations under section 901 allocate foreign income taxes to periods before a transaction occurs that would separate income from taxes.152

The 2019 Temporary Regulations, however, contain a special rule when the closing-of-the-year election is made, that allocates foreign taxes paid or accrued by the CFC between the periods before and after the Extraordinary Reduction under the principles of Regulation section 1.1502-76(b).153 As a result, under section 960(a) or (d), a controlling section 245A shareholder may be deemed to pay a portion of the foreign taxes imposed on the income of the CFC that was the subject of the Extraordinary Reduction.154 This rule is consistent with existing Regulations that allocate taxes between two or more technical taxpayers to the extent that a transfer of a foreign disregarded entity does not result in a closing of the entity’s foreign taxable year.155

(2) Treatment of Post-ER Year Short Year

The Temporary Preamble indicates that the closing-of-the-year election was intended to ensure that, to the extent a dividend paid in the year of an Extraordinary Reduction was attributable to a controlling section 245A shareholder’s pro rata share of subpart F income or Tested Income, the dividend be taxed under the subpart F income or GILTI regimes.156 Thus, for example, under the theory of the Temporary Regulations, Tested Income should be included under section 951A and taxed under the GILTI regime, the corresponding E&P should be treated as PTEP and corresponding basis adjustments should be made under section 961 to reduce any gain recognized in the Extraordinary Reduction.157 However, Tested Income is not allocated to pre- and post-Extraordinary Reduction periods in the same way that E&P is allocated for purposes of section 1248. The former is based on items accrued through the date of the deemed taxable year close, but the latter is determined for the entire period and then pro-rated on a daily basis.158

(3) Comparison of Consequences of a Closing-of-the-Year Election with Consequences of an Inclusion by Reason of an Extraordinary Disposition

The 2019 Temporary Regulations treat dividends subject to the ER Rules differently from those subject to the Extraordinary Disposition rules. As described above, only 50% of an

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152 See Reg. § 1.901-2(f)(4)(ii).
154 I.R.C. § 960(a), (d).
156 See Temporary Regulations, Preamble at 28,402-28,403.
157 Alternatively, to the extent that the controlling section 245A shareholder (or its consolidated group) otherwise had QBAI or Tested Losses, the section 951A inclusion would be reduced and a portion of the actual or section 1248(a) dividend should be eligible for the section 245A or 1248(j) deduction.
158 Cf. Reg. § 1.951A-2(c) (defining tested income of a CFC for a CFC inclusion year) with Reg. § 1.1248-3(c) (allocating earnings and profits to a person’s shares based on day-count proration).
Extraordinary Disposition amount is ineligible for a Section 245A DRD. Conversely, the entire Extraordinary Reduction amount is ineligible for a Section 245A DRD. Significantly, the closing-of-the-year election is available only for Extraordinary Reductions, which has the effect of converting (in certain cases) dividends ineligible for the Section 245A DRD into GILTI inclusions and distributions of PTEP.

The results under the Extraordinary Disposition rules are, in some circumstances, equivalent to the 50% section 250 deduction that may apply to a GILTI inclusion. The section 250 deduction, however, is subject to a taxable income limitation. As a result, the section 250 deduction might not be available, in whole or in part, to controlling section 245A shareholders that make closing-of-the-year elections. As a consequence, the closing-of-the-year election may result in a higher effective U.S. federal income tax rate than the denial of only 50% of the Section 245A DRD.

On the other hand, with respect to its other CFCs, a controlling section 245A shareholder (or its consolidated group) may have an overall net Tested Loss or may have deemed tangible income return in excess of its net Tested Income. If the closing-of-the-year election is made, the shareholder would increase its pro rata share of Tested Income, which may or may not result in overall net Tested Income and a GILTI inclusion. Either way, the amount of the inclusion (net of the 50% section 250 deduction) would be less than 50% of the amount of the dividend (because at least a portion of it would be absorbed by the net Tested Loss or deemed tangible income return in respect of the shareholder’s other CFCs). As a result, the election may result in a lower effective U.S. federal tax rate than the denial of 50% of the Section 245A DRD.

Tested Income resulting from the closing-of-the-year election generally will increase the controlling section 245A shareholder’s (or its consolidated group’s) section 951A category income under section 904(d)(1)(A). If a controlling section 245A shareholder (or its consolidated group) has excess foreign tax credits attributable to that category, that would otherwise expire unused, the election may result in a lower effective U.S. federal tax rate than the denial of only 50% of the Section 245A DRD.

(4) Making the Closing-of-the-Year Election

To make the closing-of-the-year election, (1) each controlling section 245A shareholder must attach a statement to its original U.S. tax return for the taxable year in which the Extraordinary Reduction occurs; and (2) a controlling section 245A shareholder must also enter into a binding agreement (the “Binding Agreement”) not only with the other controlling section 245A shareholders, but also with respect to each U.S. tax resident that, on the end of each date on which a transaction forming a part of the Extraordinary Reduction occurs, owns directly or indirectly stock in the CFC and is a U.S. Shareholder with respect to that CFC. In the

161 I.R.C. § 250(a)(2); Prop. Reg. § 1.250(a)-1(b)(2).
163 Id.
Binding Agreement, these shareholders must agree that each controlling section 245A shareholders will elect to close the taxable year of the CFC. If a controlling section 245A shareholder is a member of a consolidated group and participates in the Extraordinary Reduction, the agent for such group must file this election.164

b. Discussion

(i) The Closing-of-the-Year Election and Allocation Issues

As described above, the 2019 Temporary Regulations are targeted at transactions that, under the plain language of the Code, convert a controlling section 245A shareholder’s built-in gain in CFC stock into a dividend eligible for the Section 245A DRD. This conversion occurs because a CFC recognizes the built-in gain in its assets (which corresponds to the shareholder’s built-in gain in its stock), but the gain is not included under section 951(a) or section 951A in the gross income of the controlling section 245A shareholder or another U.S. tax resident because (1) section 951(a)(2)(B) reduces the transferee’s pro rata share, or (2) there is no U.S. Shareholder after the Extraordinary Reduction. The closing-of-the-year election, in certain circumstances, has the effect of converting that dividend back into the subpart F income or Tested Income that is included in the gross income of the controlling section 245A shareholder.

However, as illustrated in the example below, the consequences of the closing-of-the-year election can be very different depending on the order in which an Extraordinary Reduction occurs and Tested Income is recognized.

Example 13: US Seller, a domestic corporation, owns 100% of the sole class of CFC Target stock. US Seller has a $100 built-in gain in its CFC Target stock, which in turn has a $100 built-in gain in its assets for purposes of both Tested Income and E&P. CFC Target has no E&P. US Buyer owns CFC1, and CFC1 owns CFC2. On Day 99 of Year 1, US Seller sells 50% of the shares of CFC Target to CFC1 and the other 50% of the shares of CFC Target to CFC2. Two days after the transaction closes, CFC Target elects to be classified as a partnership for U.S. federal income tax purposes. As a result, at the end of Day 100, Year 1, CFC Target is treated as distributing all of its assets to CFC1 and CFC2 in a taxable liquidation described in sections 331 and 336.

Consequences in the Absence of the 2019 Temporary Regulations. US Seller would recognize $100 of gain on the sale of CFC Target. With respect to the $100 of gain, $99 would be treated as a section 1248(a) dividend, computed as follows: due to the subsequent taxable liquidation, CFC Target generates $100 of E&P. Of this E&P, $99 is attributable to US Seller and $1 is attributable to the US Buyer, respectively, under Reg. 1.1248-3. Assuming the holding period and other requirements are satisfied, and that US Seller did not have a hybrid deduction account with respect to the shares of CFC Target, US Seller would qualify for a $99 Section 245A DRD. Further, US Buyer’s pro rata share of CFC Target’s Tested Income would be $1, taking into account the reduction under section 951(a)(2)(B) for the $99 section 1248(a) dividend received by the US Seller.

164 Id.
Result if the Closing-of-the-Year Election is not Made. The same consequences as above, except that, due to the fact that an Extraordinary Reduction occurred on Day 99, US Seller would be denied the entire $99 Section 245A DRD.

Result if the Closing-of-the-Year Election is Made. CFC Target’s U.S. taxable year would close at the end of Day 99. As a result, CFC Target has no E&P in Year 1. Furthermore, because CFC Target would not have recognized any Tested Income in Year 1, US Seller would not have a GILTI inclusion with respect to the CFC Target and did not increase the adjusted basis in its CFC Target stock under section 961(a). Therefore, US Seller would recognize $100 of capital gain on the stock sale, none of which would be treated as a section 1248(a) dividend. In addition, US Buyer would recognize a $100 GILTI inclusion with respect to CFC Target under section 951A, because no distribution described in section 951(a)(2)(B) would occur during the year it acquired the CFC Target stock (that would consist solely of Day 100).

The differences between the result obtained when the CFC recognizes gain prior to the Extraordinary Reduction and when it recognizes gain after the Extraordinary Reduction are inconsistent and we believe that Treasury and the Service should modify the closing-of-the-year election to reduce such inconsistency. We considered several possible approaches, each discussed below.

(1) The Section 1248 Proration Approach

One approach would apply the principles in Regulation section 1.1248-3 to allocate the subpart F income and Tested Income of a CFC to the short year before an Extraordinary Reduction (the “Pre-ER Short Year”) and the short year after the Extraordinary Reduction (the “Post-ER Short Year” and, together with the Pre-ER Short Year, the “Entire Tax Year”). As a general matter, Regulation section 1.1248-3 provides that E&P for a year are attributable to stock based on daily proration. Under these principles, in Example 13, Tested Income recognized after the Extraordinary Reduction would be allocated to the Pre-ER Short Year based on the number of days in that short year (and similarly, Tested Income would be allocated to the Post-ER Short Year). Under this approach, in the example above, US Seller would (i) include $99 of tested income in its GILTI computation, (ii) to the extent it was treated as recognizing a GILTI inclusion in respect of CFC would increase its basis under section 961(a), (iii) would treat as a section 1248(a) dividend potentially eligible for the section 245A DRD any amount treated as tested income but not included as GILTI (due to tested losses or net deemed tangible income return, for example) and (iv) would recognize $1 of capital gain. Correspondingly, US Buyer would include $1 of tested income in its GILTI computation. We recommend that final Regulations adopt this approach, which we refer to as the “Section 1248 Proration Approach.”

(2) The -76(b) Approach

A second approach would apply the principles in Regulation section 1.1502-76(b) to allocate the subpart F income and Tested Income of a CFC to the Pre-ER Short Year and the Post-ER Short Year (the “-76(b) Approach”). As a general matter, Regulation section 1.1502-76(b) allocates items to different short periods within a year ratably based on day count, except that “extraordinary items” are treated as recognized in the short period in which they occur. Among other things, extraordinary items include gain from the disposition of capital assets,
section 1231 assets and from the assets disposed of in an applicable asset acquisition described in section 1060. Given that the very nature of an Extraordinary Reduction transaction implies an extraordinary item will arise in one short period or the other, applying the approach in Regulation section 1.1502-76 would provide unwarranted planning opportunities for the well advised and traps for the unwary. While we do not recommend the -76(b) Approach as a general rule, it is administratively more convenient than the full closing-of-the-books method adopted by the 2019 Temporary Regulations.

(3) The 50 Percent Approach

A third approach would deny only 50% of the Section 245A DRD, rather than 100% (the “50 Percent Approach”), which is consistent with the treatment of Extraordinary Dispositions. As described above, there are significant differences between the denial of only 50% of the Section 245A DRD and the closing-of-the-year election, which effectively converts all or part of a dividend into a GILTI inclusion.\(^{165}\) Given that the purpose of the closing-of-the-year election, as described in the Temporary Preamble, is to include Tested Income recognized during the taxable year of a CFC in which there is an Extraordinary Reduction in a U.S. shareholder’s GILTI computation, and given the significant differences between a denial of only 50% of the Section 245A DRD and a GILTI inclusion, we do not recommend the 50 Percent Approach over the Section 1248 Proration Approach.

(4) The Closing-of-the-Books Approach

A fourth approach would apply the closing-of-the-books method required by the 2019 Temporary Regulations (the “Closing-of-the-Books Approach”). This approach has the benefits and shortcomings of the Regulation section 1.1502-76(b) method (that is, while it may provide certainty in some circumstances, it also provides tax planning opportunities for well-advised taxpayers and traps for the unwary). In addition, as compared to the -76(b) Approach, it involves significant administrative complexity. That is, although the -76 Approach would generally pro rata items other than extraordinary items, the closing-of-the-books method required by the 2019 Temporary Regulations would require a CFC to close its books on the date of an Extraordinary Reduction. If that date is not the last day the CFC’s ordinary accounting periods (such as a quarter or month end), the CFC will be required to undergo a separate process to determine the amount of items recognized before or after the Extraordinary Reduction. Furthermore, before the 2019 Temporary Regulations were issued, generally applicable tax law allocated income (1) on the basis of taxable years under sections 951(a) and 951A and (2) to the extent required to allocate within a year on the basis of day-count proration under Regulation section 1.1248-3. Due to the administrative complexity and the fact that it is contrary to the long-standing proration approach under prior law, we do not recommend that the Closing-of-the-Books Approach be retained in the final Regulations.

\(^{165}\) More specifically, the closing-of-the-year election converts a dividend into a GILTI or subpart F income inclusion and a distribution of PTEP (and potentially a Section 245A DRD-eligible dividend, to the extent that all tested income recognized does not give rise to a GILTI inclusion from the CFC). In addition, the section 250 deduction is subject to a taxable income limitation, a GILTI inclusion increases foreign tax credit limitation in the section 951A category under section 904(d), and foreign tax credits may be deemed paid under section 960(d) as a result of a GILTI inclusion.
We recommend that final Regulations provide that, if a controlling section 245A shareholder makes a closing-of-the-year election, subpart F income and Tested Income from the Entire Tax Year should be allocated to the Pre-ER Short Year and the Post-ER Short Year under the Section 1248 Proration Approach. Foreign income taxes paid or accrued during the Entire Tax Year should be allocated pursuant to the principles of Regulation section 1.1502-76(b), taking into account the Section 1248 Proration of subpart F income and Tested Income.

While making this recommendation, we acknowledge that the 2019 Temporary Regulations provide a different rule and taxpayers will rely on that rule to structure transactions for the time being. Changing the allocation rule in future guidance, especially if such a change were retroactive, may result in unfair consequences to taxpayers. For example, under the Section 1248 Proration Approach, if an Extraordinary Reduction occurs at the beginning of a CFC’s taxable year and its taxable year does not terminate shortly after the date of the Extraordinary Reduction, a large amount of any subpart F income or Tested Income may be allocated to the Post-ER Short Year even if the CFC recognized all of its built-in gain in the Pre-ER Short Year. The consequence of this allocation, therefore, may be to treat most of the built-in gain as capital gain, whereas the existing closing-of-the-year election would treat it as Tested Income or subpart F income. Furthermore, on a going-forward basis, the Section 1248 Proration Approach may result in restructuring or delaying significant commercial decisions based on tax planning, due to the fact that a U.S. seller may benefit from a tax year that ends relatively soon after the Extraordinary Reduction occurs.

Therefore, in the alternative, we recommend that final Regulations provide taxpayers with the right to elect to apply either the -76(b) Approach or the Section 1248 Proration Approach. In the further event that this election is not adopted on a going-forward basis because it is too taxpayer favorable, we recommend that this election be made available either (1) if the Section 1248 Proration Approach is not adopted as the general rule, with respect to Extraordinary Reductions that occurred before the 2019 Temporary Regulations were released to mitigate the fact that taxpayers did not have notice at the time of those Extraordinary Reduction transactions, or (2) if the Section 1248 Proration Approach is adopted as the general rule, with respect to Extraordinary Reductions that occurred from the time the 2019 Temporary Regulations were released until the time that relevant final regulations under Section 245A are released.

We note that, to the extent either of these recommendations is adopted in final Regulations, we recommend that the allocation of foreign income taxes provided by the 2019 Temporary Regulations also should be conformed as described below. While the allocation of foreign income taxes to the Pre-ER Short Year and the Post-ER Short Year might still follow Regulation section 1.1502-76(b) principles, those principles should take into account the income allocated to the respective Short Years. For example, if subpart F income and Tested Income is allocated to a Pre-ER Short Year and a Post-ER Short Year under the Section 1248 Proration Approach, then the principles of Regulation section 1.1502-76(b) should be applied by treating the prorated items as arising in the period to which they were allocated.
(ii) Challenges in Obtaining U.S. Resident Information

The 2019 Temporary Regulations do not provide rules to establish whether and to what extent, for purposes of determining a controlling section 245A shareholder’s pre-reduction pro rata share, a U.S. resident’s pro rata share of subpart F income or Tested Income is increased as a result of a transfer by a controlling section 245A shareholder or by an issuance by the CFC during the year of an Extraordinary Reduction. In the absence of guidance, taxpayers must consider both (1) as a technical matter, methods to determine whether a U.S. resident’s pro rata share is increased “as a result” of certain transactions and (2) as a practical matter, how to gather information regarding a transferee’s pro rata share of subpart F income and Tested Income. Furthermore, this issue is particularly challenging in the case of dilution transactions, in which the CFC or an upper-tier CFC issues stock to one or more shareholders after the Extraordinary Reduction (the “Buy-Side Shareholders”), since the shareholders before the Extraordinary Reduction (the “Sell-Side Shareholders”) may not participate in the transaction or otherwise have any opportunity to negotiate information-sharing rights with Buy-Side Shareholders. This issue is likely to be even more challenging if, prior to the date the 2019 Temporary Regulations were released, either (1) there was an Extraordinary Reduction and an unrelated party acquired stock in a CFC with a controlling section 245A shareholder or (2) a controlling section 245A shareholder, a CFC, or an intermediate entity had entered into a binding commitment with an unrelated party to execute an Extraordinary Reduction transaction. While on a going-forward basis, it may theoretically be possible to negotiate for this information, as a practical matter Buy-Side Shareholders may be understandably reticent to share confidential tax information with Sell-Side Shareholders.

To mitigate this administrative and practical burden, and to facilitate compliance with this provision, we recommend that final Regulations provide that in reliance on existing IRS Form 5471 reporting, a U.S. Shareholder that is a controlling section 245A shareholder prior to an Extraordinary Reduction may request, and the CFC may provide, a Form promulgated by the Service that sets forth, on an aggregate and anonymous basis, the pro rata shares of U.S. residents that are U.S. Shareholders of the CFC. This Form should not include identifying information of any U.S. Shareholder (other than the U.S. shareholder to which it is directed) in order to protect taxpayer confidentiality and privacy, but should permit reliance by the controlling section 245A shareholders on such anonymous information.

We note that tracing pro rata shares of U.S. residents at the end of a CFC’s year to the shares formerly held directly or indirectly by the controlling section 245A shareholder is likely to be quite challenging, if not impossible, in all but the simplest capital and ownership structures. We recommend further that Treasury and the Service therefore permit taxpayers to employ any reasonable method for this purpose. If Treasury and the Service wish to provide more concrete guidance, we recommend that they consider ways to approximate the amount of subpart F income and Tested Income included in a U.S. resident’s pro rata shares and permit controlling section 245A shareholders to rely on those approximations. For example, a CFC might compare the percentage of subpart F income and Tested Income included in U.S. residents’ pro rata shares in the year before the Extraordinary Reduction to the same percentage in the year of the Extraordinary Reduction. The CFC might then first treat any decrease in ownership as resulting from Extraordinary Reductions with respect to controlling section 245A shareholders, allocated to such Extraordinary Reductions on a pro rata basis.
To ease administrative and practical burdens, we recommend that final Regulations permit CFCs to provide controlling section 245A shareholders with anonymous information describing the aggregate amount of U.S. tax residents’ pro rata share of subpart F income and Tested Income and also permit controlling section 245A shareholders to rely on that information unless they have actual knowledge that the information is inaccurate, thereby facilitating compliance with the provision while protecting the confidentiality and privacy of other U.S. residents.

(iii) Is the Closing-of-the-Year Election Unilateral or Bilateral?

As noted above, the 2019 Temporary Regulations provide that the closing-of-the-year election is made and effective if (1) “each controlling section 245A shareholder making the election” attaches the required statement to its timely-filed tax return and (2) “each controlling section 245A shareholder and each U.S. tax resident that on the end of the date on which the extraordinary reduction occurs . . . owns directly or indirectly stock of the CFC and is a United States shareholder with respect to the CFC” to enter into a binding commitment to close the taxable year of the CFC.\textsuperscript{166} The 2019 Temporary Regulations are not entirely clear, however, as to whether each of these requirements applies only to the shareholders before the Extraordinary Reduction (\textit{i.e.}, the Sell-Side Shareholders) or both before and after the Extraordinary Reduction (\textit{i.e.}, both the Sell-Side Shareholders and the Buy-Side Shareholders). On the one hand, the 2019 Temporary Regulations provide that for purposes of applying the closing-of-the-year election, a controlling section 245A shareholder that has an Extraordinary Reduction with respect to a CFC is treated as owning the same amount of stock it owned immediately before the Extraordinary Reduction.\textsuperscript{167} Furthermore, such stock is treated as not being owned by any other person as of the close of the CFC’s taxable year.\textsuperscript{168} As a result, the 2019 Temporary Regulations could be read to permit only Sell-Side Shareholders to make the closing-of-the-year election and to require only the Sell-Side Shareholders to enter into the Binding Agreement. On the other hand, in the Temporary Regulation section 1.245A-5T(j)(4)(iii), Ex. 3, both the Sell-Side Shareholder and the Buy-Side Shareholder enter into a binding agreement to close the year.\textsuperscript{169}

We recommend that the final Regulations clarify that the closing-of-the-year election is made only by the controlling section 245A shareholders that are Sell-Side Shareholders and that only Sell-Side Shareholders be required to enter into the Binding Agreement.

It should be noted that the closing-of-the-year election might affect both Sell-Side Shareholders and Buy-Side Shareholders. For example, a transferee controlling section 245A shareholder’s pro rata share might, in the absence of a closing-of-the-year election, be reduced pursuant to section 951(a)(2)(B) by a distribution to the transferor controlling section 245A shareholder. Furthermore, the allocation of items between the Pre-ER Short Year and the Post-

\textsuperscript{166} Id. (emphasis added).


\textsuperscript{168} Id.

\textsuperscript{169} Temp. Reg. § 1.245A-5T(j)(4)(iii) (Example 3; Alternative facts).
ER Short Year might change U.S. tax liability of transferor U.S. residents that are U.S. shareholders with respect to the CFC.

These concerns are not persuasive, however. Due to section 951(a)(2)(B), the consequences to Buy-Side Shareholders are generally the same whether or not the closing-of-the-year election is made. In addition, an election made by both Sell-Side Shareholders and Buy-Side Shareholders would be difficult for Sell-Side Shareholders to monitor, confirm and enforce since the 2019 Temporary Regulations require the election to be filed with the tax return (unlike a section 338 election, which is made by filing I.R.S. Form 8023 by itself). Furthermore, if Buy-Side Shareholders are adversely affected by a closing-of-the-year election, they would be required to negotiate contractual protections that require Sell-Side Shareholders to not make the election. Such a provision is consistent with market practice and is well understood by participants in mergers and acquisitions transactions and their advisors. For example, elections under section 338(g) are unilateral as they may be made only by Buy-Side Shareholders. A market practice has developed whereby interested sellers negotiate conditions on these elections, but indifferent sellers do not.

We also recommend that, consistent with an election made only by Sell-Side Shareholders, final Regulations clarify that the parties to the Binding Agreement required to make the closing-of-the-year election include only Sell-Side Shareholders.

(iv) Easing the Administrative Burden Associated with Making the Closing-of-the-Year Election

In certain cases, obtaining the consent of each U.S. resident that is a U.S. shareholder may be administratively and practically difficult, if not impossible. For example, after the repeal of section 958(b)(4) pursuant to the Act, U.S. residents may be treated as either controlling section 245A shareholders or U.S. shareholders of a CFC as a result of constructive ownership, even if they indirectly own a very small interest in the CFC. Locating these small owners, some of which may not even be aware that they “own” (within the meaning of section 958(b)) an interest in the CFC, may be impossible.

The definition of “controlling section 245A shareholder” includes broad attribution rules that treat a shareholder as owning stock that is actually owned (directly or indirectly) by related parties. For this purpose, “related party” means, with respect to a person, another person bearing a relationship described in section 267(b) or 707(b) to the person.170 The attribution rules in sections 267(b) and 707(b) are quite broad, including among other things the partner attribution rule in section 267(c)(3), which provides that an individual that owns stock in a corporation is treated as owning the stock owned, directly or indirectly, by his partner. In the context of private investment funds in particular, this rule can result in a significant number of small shareholders that are controlling section 245A shareholders.

Furthermore, existing contractual arrangements in private investment funds, foreign corporate charter documents and otherwise may not contemplate the type of collective action

necessary to expeditiously make the closing-of-the-year election or enter into a Binding Agreement with each of these shareholders.

To ease administrative and practical burdens, we recommend that final Regulations permit certain foreign corporations or partnerships to enter into the Binding Agreement required to make the closing-of-the-year election with respect to their shareholders or the partnerships themselves, respectively, that indirectly own less than five percent of a CFC subject to an Extraordinary Reduction.

c. The Extraordinary Disposition and Extraordinary Reduction Anti-Abuse Rule

The Temporary Regulations also include an anti-abuse rule (the “Section 245A Anti-Abuse Rule”) that permits the Service to “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.” 171

We believe that, as drafted, the Section 245A Anti-Abuse Rule is vague and overly-broad. While we appreciate that Treasury and the Service would prefer to use a principles-based approach to backstop what otherwise may be viewed as a mechanical set of rules, we believe that it is not equitable to leave taxpayers without reasonable guidance regarding the parameters of those principles or the potential adjustments one may anticipate if the rule were invoked. Moreover, although the perceived abuses to which the ED Rules and the ER Rules relate may find some unity in policies associated with the Act, the origins of the underlying transactions and the general focus of each of the rules is unique (e.g., the ED Rules relate solely to reform-related gap planning while the the ER Rules relate to operative provisions of law that predate reform). 172 As such, without guidance as to intent and application, taxpayers are left untethered when attempting to ascertain whether an internal restructuring potentially runs afoul of the Section 245A Anti-Abuse Rule. This is not fundamentally different than the situation presented when Proposed Regulation section 1.951-1(e)(6) was originally proposed.

To address these concerns while protecting the legitimate concerns of the government, we recommend that Treasury and the Service provide clarity regarding the “purposes” that the Section 245A Anti-Abuse Rule serves, and included in the final Regulations examples as to the type of “appropriate adjustments” that would be made in the event the rule is invoked. For instance, it is not clear whether a supply chain restructuring that results in the conversion of a profitable CFC (to which an ED Account relates) into a loss-making or marginally-profitable CFC is within the ambit of the rule. Further, even if such a transaction were within the rule, it is not clear whether, under the Section 245A Anti-Abuse Rule, the Service is empowered to adjust ED Accounts, to create or modify Extraordinary Reduction amounts, or to perhaps propose even broader adjustments to reflect perceived subpart F or GILTI avoidance. We believe that this

172 For instance, the Temporary Preamble states that the purpose of the ED Rules is to disallow a section 245A deduction for transactions that raise narrow abuse concerns, but it does not suggest how or when the Section 245A Anti-Abuse Rule might be applied once an ED Account has been established. Arguably, application of the Section 245A Anti-Abuse Rule would be different in an Extraordinary Reduction context.
should be clarified by including Section 245A Anti-Abuse Rule examples in the final Regulations and a robust discussion regarding its applicability in the preamble to the final Regulations. Such an approach would be consistent with the GILTI and Base Erosion and Anti-Abuse Tax regulatory packages that contain anti-abuse rules directed at specific instances of abuse and that provide greater clarity as to their application.  

3. **GILTI and Subpart F – Partnership Issues**

   a. **Application of the Final Regulations to Passthrough Entities and their Owners**

   The 2019 Final Regulations under section 951A include several noteworthy changes to the 2018 Proposed Regulations with regard to the application of section 951A (and related provisions) to partnerships and their partners.174 This section offers comments on the provisions of the 2019 Final Regulations that apply to partnerships and their partners.175

   (i) **Partnership QBAI**

   For purposes of determining QBAI, the adjusted basis in Specified Tangible Property is generally determined by using ADS, and by allocating the depreciation deduction with respect to that property for the CFC inclusion year ratably to each day during the period in the CFC inclusion year to which the depreciation relates.176 In addition, for purposes of determining income and E&P, a CFC is generally required to use ADS for depreciable property used predominantly outside the United States.177 However, a CFC may instead use for this purpose a depreciation method used for its books of account regularly maintained for accounting to shareholders or a method conforming to United States generally accepted accounting principles (“GAAP”) (such method, a “Non-ADS Depreciation Method”) if the differences between ADS and the Non-ADS Depreciation Method are immaterial.178 Consistent with these rules, the 2019 Final Regulations provide that a CFC that is not required to use ADS for purposes of computing income and E&P may elect, for purposes of calculating QBAI, to use its Non-ADS Depreciation Method to determine the adjusted basis in Specified Tangible Property placed in service before the CFC’s first taxable year beginning after December 22, 2017.179

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173 See Reg. § 1.951A-3(h)(1) (general anti-avoidance rule attributable to transferred property); Reg. § 1.951A-2(c)(5) (allocation attributable to disqualified basis); Reg. § 1.951-1(c)(6) (transactions and arrangements changing pro rata share distributions); Prop. Reg. § 1.59A-9(b).


175 Some of the comments in this section also apply to other passthrough entities (such as S corporations) and their owners.

176 I.R.C. § 951A(d)(3) (the Act included two paragraphs designated as section 951A(d)(3); this citation refers to the first such paragraph which is titled “Determination of adjusted basis”); Reg. § 1.951A-3(e)(1).

177 See I.R.C. § 168(g); Reg. § 1.952-2(c)(2)(ii), (iv); Reg. § 1.964-1(a)(2).

178 See Reg. § 1.952-2(c)(2)(ii) and (iv); Reg. § 1.964-1(a)(2).

179 Reg. § 1.951A-3(e)(3)(ii).
A partnership’s basis in property, generally determined using ADS, may be relevant whenever a Tested Income CFC holds an interest in a partnership during the CFC’s inclusion year. The necessity for CFCs that own interests in partnerships to obtain this basis information raises administrative concerns. For instance, a CFC partner of a noncontrolled partnership may have difficulty determining the basis in partnership property under ADS. Similar issues arise regarding the ability of such a partner to access information that would allow the partner to determine the proportionate share ratio and the dual use ratio.

The 2019 Final Regulations generally provide that a Tested Income CFC that holds an interest in a partnership during the CFC’s inclusion year increases its QBAI by the amount of the CFC’s partnership QBAI with respect to the partnership.\(^{180}\) The CFC’s partnership QBAI is the sum of the CFC’s partner adjusted basis in each piece of partnership Specified Tangible Property (“PSTP”) as of the close of the partnership’s taxable year that ends with or within the CFC inclusion year (“Partnership QBAI”).\(^ {181}\) PSTP is classified as either sole use partnership property or dual use partnership property.\(^ {182}\) The CFC’s partner adjusted basis is the sum of (i) the CFC’s proportionate share of the partnership’s adjusted basis in sole use partnership property for the partnership taxable year, (ii) the CFC’s partner-specific QBAI basis in the sole use partnership property for the partnership taxable year, and (iii) with respect to dual use property, the sum of the Tested Income CFC’s proportionate share of the partnership’s adjusted basis in the property for the partnership taxable year and the Tested Income CFC’s partner-specific QBAI basis in the property for the partnership taxable year, multiplied by the Tested Income CFC’s dual use ratio with respect to the property for the partnership taxable year, except that the Tested Income CFC’s dual use ratio is determined by reference to the Tested Income CFC’s distributive share of amounts used in calculating the dual use ratio under Regulation section 1.951A-3(d)(3).\(^ {183}\) These rules essentially require a Tested Income CFC partner to determine, on an asset-by-asset basis, (i) the partnership’s adjusted basis in PSTP, (ii) the CFC’s proportionate share ratio in the property, and (iii) in the case of dual use property, the CFC’s dual use ratio with respect to the property in determining its Partnership QBAI. The principles of Regulation section 1.951A-3(e), which generally require using ADS in determining the adjusted basis in Specified Tangible Property, also apply for purposes of determining the partnership adjusted basis in PSTP and the CFC’s partner-specific QBAI basis.\(^ {184}\)

With respect to the partnership’s adjusted basis in PSTP, the Final Preamble acknowledges that a CFC that is a partner in a foreign partnership may have difficulty determining the basis in partnership property under ADS, particularly when the partnership is not controlled by U.S. persons, and requests comments on methodologies for determining the basis in partnership property owned by a foreign partnership that is not controlled directly or indirectly by U.S. persons.\(^ {185}\) We share these administrative concerns regarding a CFC partner’s ability to

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\(^{180}\) Reg. § 1.951A-3(g)(1).

\(^{181}\) Reg. § 1.951A-3(g)(2).

\(^{182}\) Reg. § 1.951A-3(g)(3)(ii)(B) and (iii)(B).

\(^{183}\) See Reg. § 1.951A-3(g)(3).

\(^{184}\) See Reg. § 1.951A-3(g)(6)-(7).

\(^{185}\) Final Regulations, Preamble at 29,305.
obtain accurate and timely information. In addition, we believe that, in many cases, such a CFC partner could also have difficulty obtaining accurate and timely information that would allow the partner to determine the proportionate share ratio and the dual use ratio (if any) with respect to each separate item of a noncontrolled partnership’s PSTP.

In light of the foregoing, we recommend that the Regulations allow a Tested Income CFC partner of a noncontrolled partnership to use any reasonable method (rather than the ADS method prescribed by Regulation section 1.951A-1(e)(1) and the election provided by Regulation section 1.951A-1(e)(3)(ii)) to determine the CFC’s Partnership QBAI with respect to the partnership. As explained below, a reasonable alternative method may be utilized, in appropriate circumstances, to determine a partnership’s adjusted basis in PSTP. A reasonable alternative method could also be applied to determine a CFC partner’s proportionate share ratio and/or dual use ratio with respect to PSTP of a noncontrolled partnership. Our recommendations are explained in detail below.

(1) Alternative Methods for Determining Partnership QBAI

We considered two approaches to address a situation in which a CFC partner of a noncontrolled partnership has difficulty determining the basis in partnership property under ADS. First, such a partner could use any reasonable method. Because the information a CFC partner may obtain from a noncontrolled partnership may vary, we believe many methods could be reasonable.

As an initial matter, a rule permitting a CFC partner to use a reasonable method to determine the basis of partnership property with respect to a noncontrolled partnership should define what constitutes control of the partnership. One possible definition of control could refer to the definition of control of a foreign partnership under Regulation section 1.6038-3(b)(1), i.e., a Category 1 filer in the instructions for Form 8865. There could be others as well.

We acknowledge that giving taxpayers relatively free reign may invite abuse, particularly if taxpayers refer to certain analogous authorities to adopt a method more favorable to them than ADS. For example, under section 199A(b)(6)(B), each property’s depreciable period would be ten years or more for purposes of calculating a taxpayer’s qualified business income. Other authorities may treat the basis of property as its original cost even though the property is subject

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186 Although the Final Preamble only mentions the administrative concern with respect to a foreign partnership not controlled by U.S. persons, we believe that this concern may be present for any partnership not controlled by the CFC partner, regardless whether the partnership is domestic or foreign.

187 In general, a Category 1 filer of Form 8865 is a U.S. person who owns more than 50% of the interests in a foreign partnership’s capital, profits, deductions, or losses at any time during the partnership’s tax year. See also Reg. § 1.6038-3. For purposes of determining ownership interest under this rule, the constructive ownership rules of section 267(c) (excluding section 267(c)(3)) apply, taking into account that such rules refer to corporations and not to partnerships. Reg. § 1.6038-3(b)(4). In addition, based on the instructions, control of a partnership is ownership of more than 50% interest in capital, profits, deductions, or losses in the partnership. Instructions for Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships.

188 See Prop. Reg. § 1.199A-2(c)(2).
to cost recovery. We think alternative methods, such as these, that a taxpayer knows or has reason to know, even without knowing the partnership’s basis in PSTP using ADS, would inflate the calculated QBAI at least temporarily in comparison to ADS and would not be a reasonable method. On the other hand, methods that would normally recover basis at a rate that is close to or faster than ADS, such as a method based on U.S. or local GAAP or a cost recovery method based on the Modified Accelerated Cost Recovery System (“MACRS”) could be examples of a reasonable method.

The rationale for permitting certain partners to apply a reasonable method to determine the basis of partnership property for purposes of section 951A is also present with regard to the determination of a corporate partner’s QBAI for purposes of section 250. If Treasury and the Service decide to permit a CFC partner of a noncontrolled partnership to determine the basis of partnership property using a reasonable method for purposes of section 951A and also decide to adopt a similar approach for purposes of determining the foreign-derived intangible income (“FDII”) of a U.S. corporation that is a partner of a noncontrolled partnership, one potential guardrail to prevent arbitrage of reasonable methods by taxpayers would be to require taxpayers to apply the same reasonable method to determining partnership QBAI for purposes of sections 951A and 250.

If Treasury and the Service determine that it is not appropriate for CFC partners to be allowed to adopt any reasonable method to calculate its Partnership QBAI with respect to all noncontrolled partnerships, we recommend that Treasury and the Service consider limiting the allowance of a reasonable method to CFC partners that own up to a maximum percentage or value of ownership in a noncontrolled partnership.

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189 See Prop. Reg. § 1.199A-2(c)(3) (defining unadjusted basis immediately after acquisition).
190 I.R.C. § 168(a). See also Publication 946, How to Depreciate Property.
191 Another potential alternative reasonable method is based on the partnership book basis information in Schedule L of Form 1065 or Form 8865, if a CFC partner of a noncontrolled partnership obtains such information from the partnership. We believe this approach is analogous to Regulation section 1.705-1(b), which allows a partner to use the alternative rule to determine the adjusted basis of its interest in a partnership by reference to the partner’s share of the adjusted basis of partnership property which would be distributable upon termination of the partnership in certain cases. The Regulation provides, inter alia, that the alternative rule may be used to determine the adjusted basis of a partner’s interest where circumstances are such that the partner cannot practically apply the general rule under section 705(a) to determine the adjusted basis of its interest in the partnership.
192 The reference in section 250(b)(2)(B) to section 951A(d) for purposes of determining the FDII of a U.S. corporation suggests that rules similar to those found in Regulation section 1.951A-3 may be considered for purposes of section 250. But see Final Regulations, Preamble at 29,304 (providing that that the transition rule in Regulation section 1.951A-3(e)(3)(ii) does not apply for purposes of determining the FDII of a U.S. corporation).
193 For example, a consistency rule could require a U.S. corporation that is both a partner of a noncontrolled partnership (an “FDII Partnership”) and a U.S. Shareholder of a CFC partner of a noncontrolled partnership (a “GILTI Partnership”) to apply the same reasonable method that the CFC partner uses for determining its Partnership QBAI with respect to the GILTI Partnership for purposes of determining the U.S. corporation’s FDII with respect to the FDII Partnership.
194 For this purpose, value might be determined by reference to the partner’s adjusted basis in its partnership interest or by reference to the fair market value of the partnership interest. Because a partner’s access to information with
(2) Asset-By-Asset Determination of Partnership QBAI

As described above, under the 2019 Final Regulations, a Tested Income CFC partner needs to calculate its proportionate share ratio and, in the case of dual use property, its dual use ratio with respect to PSTP on an asset-by-asset basis to calculate its Partnership QBAI.

Similar to a CFC partner’s potential difficulty in determining the partnership’s adjusted basis in PSTP under ADS, we think a CFC partner of a noncontrolled partnership may have difficulty obtaining accurate and timely information that would allow the partner to determine the proportionate share ratio and the dual use ratio (if applicable) with respect to each separate item of a noncontrolled partnership’s PSTP. Therefore, we recommend that Regulations allow a CFC partner of a noncontrolled partnership to determine its proportionate share ratio and dual use ratio of PSTP by reference to the partner’s distributive share of the partnership’s depreciation on all of the partnership’s property for the partnership’s relevant taxable year.

(ii) Partnerships with U.S. Shareholder Partners

The 2019 Final Regulations significantly improve upon the 2018 Proposed Regulations by adopting an aggregate approach to domestic partnerships for purposes of GILTI. This approach generally treats a domestic partnership in the same manner as a foreign partnership for purposes of determining the U.S. persons that own stock of a foreign corporation within the meaning of section 958(a).

Specifically, Regulation section 1.951A-1(e)(1) (the “Domestic Partnership Rule”) provides that:

For purposes of section 951A and the section 951A regulations, and for purposes of any other provision that applies by reference to section 951A or the section 951A regulations, a domestic partnership is not treated as owning stock of a foreign corporation within the meaning of section 958(a). When the preceding sentence applies, a domestic partnership is treated in the same manner as a foreign partnership under section 958(a)(2) for purposes of determining the persons that own stock of the foreign corporation within the meaning of section 958(a).

Under the 2019 Final Regulations, the persons that have inclusions under section 951A with respect to a CFC are those U.S. Shareholders of the CFC that own “section 958(a) stock” of the CFC. Regulation section 1.951A-1(f)(4) provides that the term “section 958(a) stock” means stock of a CFC owned (directly or indirectly) by a U.S. Shareholder within the meaning of section 958(a), as modified by the Domestic Partnership Rule. Thus, under the final Regulations, a domestic partnership will not have an inclusion under section 951A because the Domestic Partnership Rule provides that the domestic partnership does not own section 958(a) stock of any CFC for purposes of section 951A.

respect to a noncontrolled partnership might be limited, the fair market value of a partnership interest (if relevant) could also be determined by reference to a reasonable method.

195 Reg. § 1.951A-1(e).
196 Reg. § 1.951A-1(b).
Under the 2019 Final Regulations, any partner (whether direct or indirect through other partnerships) that is a U.S. Shareholder of a CFC the stock of which is owned by the partnership under section 958(a) (without regard to Regulation section 1.951A-1(e)) and that is treated as owning section 958(a) stock of the CFC by reason of Regulation section 1.951A-1(e) (a “U.S. Shareholder Partner”) may have an inclusion under section 951A with respect to the CFC. The effect of this rule is similar to the manner in which inclusions under section 951 have historically applied to foreign partnerships and their U.S. Shareholder Partners.

While the application of section 951 to foreign partnerships has been consistent for several decades, there are significant uncertainties that many taxpayers encounter. For instance, it is not clear whether a foreign partnership adjusts the basis of its stock in a CFC when a U.S. Shareholder Partner adjusts its basis in its interest in the partnership with regard to a section 951 inclusion attributable to the CFC the stock of which is owned by the U.S. Shareholder Partner through the partnership. There are also uncertainties as to how distributions of PTEP are characterized as distributions are made (1) by a CFC to a foreign partnership and (2) by the foreign partnership to the U.S. Shareholder Partner that included an amount in gross income under section 951 with respect to the CFC.

Because the 2019 Final Regulations effectively apply the subpart F framework for foreign partnerships to all partnerships (domestic and foreign) for purposes of GILTI, many of these issues will be relevant to U.S. Shareholder Partners with inclusions under section 951A. The following recommendations address the application of sections 961 and 959 to partnerships and U.S. Shareholder Partners.

(1) Basis Adjustments under Section 961

Section 961 provides rules for basis adjustments to a U.S. Shareholder’s stock in a CFC and for basis adjustments of other property by reason of which a U.S. Shareholder is considered (under section 958(a)(2)) as owning stock in a CFC. Specifically, section 961(a) provides that a U.S. Shareholder increases its basis in such stock or property by the amount of income that is included in the shareholder’s gross income under section 951(a). When the U.S. Shareholder receives an amount that is excluded from gross income pursuant to section 959(a) as a distribution of PTEP, section 961(b)(1) provides for a basis reduction in that amount. If there is insufficient basis in the stock or other property to cover the amount of reduction under section 961(b)(1), the excess is taxed as gain from the sale or exchange of property pursuant to section 961(b)(2). Section 961(c) provides that, under Regulations, adjustments similar to those provided in sections 961(a) and 961(b) are to be made with respect to the basis of certain lower-tier CFCs, but only for purposes of determining the amount to be included in the U.S. Shareholder’s gross income under section 951.

The objective of the section 961 basis adjustment regime is to prevent double-taxation of income subject to inclusion by a U.S. Shareholder under section 951. Without the upward basis

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197 I.R.C. § 961(a).
198 I.R.C. § 961(b).
199 I.R.C. § 961(c).
adjustments of section 961(a), when a U.S. Shareholder sells its stock in a CFC, the U.S. Shareholder would be taxed on the increased stock value (either in the form of increased gain or decreased loss) attributable to income that was already taxed under section 951.

In addition to basis adjustments with respect to a U.S. Shareholder’s directly held stock in a CFC, section 961 provides for basis adjustments to other property of the U.S. Shareholder “by reason of which he is considered under section 958(a)(2) as owning stock of a [CFC].”200 Under section 958(a)(2), CFC stock that is owned by a foreign corporation, foreign partnership, or foreign estate or trust, within the meaning of section 7701(a)(31), is considered to be owned proportionately by its shareholders, partners, or beneficiaries.201 Consistent with the language of section 961(a), the current section 961 Regulations provide for a basis adjustment in “(i) [s]tock in a foreign corporation; (ii) [a]n interest in a foreign partnership; or (iii) [a] beneficial interest in a foreign estate or trust” through which the U.S. Shareholder owns the CFC stock.202

Specifically with respect to a U.S. Shareholder that holds an indirect interest in CFC stock through a foreign partnership, although it is evident that, under section 961(a) the U.S. Shareholder increases its basis in the partnership interest to the extent of its section 951 inclusion from such CFC because the partnership interest is the property through which the U.S. Shareholder partner holds its interest in the CFC, the express provisions of section 961 do not make clear whether the partnership may (or must) correspondingly increase its basis in the CFC stock. Neither has Treasury or the Service provided guidance on this point.

If a foreign partnership cannot make a section 961(a) upward basis adjustment in CFC stock that it holds directly, there is, as noted above, potential taxation of gain in the CFC stock in the event of a taxable disposition of such stock by the partnership, precisely the result that section 961(a) was enacted to avoid. In the past, that potential for double-taxation could be mitigated by structuring joint venture investments in CFC stock through domestic, rather than foreign, partnerships. Unlike a foreign partnership, under current law, a domestic partnership is itself the U.S. Shareholder for purposes of section 951(a) and, before the issuance of the 2019 Final Regulations, was itself the U.S. Shareholder for purposes of GILTI. Thus, the domestic partnership makes a basis adjustment under section 961(a) with respect to its directly held CFC stock in the case of a subpart F inclusion and would have done so in the case of a GILTI inclusion before the 2019 Final Regulations. Inside-outside basis parity (i.e., parity between the partnership’s basis in its property and the partner’s basis in its partnership interest) could be maintained in the case of a domestic partnership because the partner would make a section 705 upward basis adjustment in its interest in the partnership to the extent of its allocable share of the income of the partnership taken into account under section 951 (and section 951A before the 2019 Final Regulations).203

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200 I.R.C. § 961.
201 I.R.C. § 958(a)(2).
202 Reg. § 1.961-1(b)(1).
203 Section 705(a) provides for an increase in a partner’s basis in the partnership interest to the extent of its distributive share of taxable income of the partnership. Upon the distribution of PTEP by the CFC to the domestic
Under the Proposed Domestic Partnership Rule (defined below in Part II.B.3.6(i)) and under the 2019 Final Regulations, however, domestic partnerships are treated in the same manner as foreign partnerships for section 958 purposes and presumably will be treated in the same manner as foreign partnerships for purposes of section 961. This change in law would, therefore, expand the reach of the section 961 partnership inside basis issue discussed above to domestic partnerships, including existing domestic partnerships that have never had to concern themselves with that issue, and eliminate the opportunity for self-help on this issue through the use of domestic, rather than foreign partnerships. We believe that the promulgation of the Proposed Domestic Partnership Rule in connection with the 2019 Final Regulations is the right opportunity to clarify the question of whether partnerships make inside basis adjustments under section 961.

We recommend, accordingly, that Treasury and the Service adopt a rule providing that, for the purposes of both section 951 and 951A, both foreign and domestic partnerships must increase their basis in their CFC stock to the extent that their partners are entitled to a basis increase in their partnership interests pursuant to section 961(a). In other words, parity of inside and outside basis will be maintained through appropriate matching of (1) U.S. Shareholder partners’ increases to their basis in the partnership interest and (2) increases to the partnership’s basis in its CFC stock.

We further recommend that Treasury and the Service provide that increases to a partnership’s basis in CFC stock under section 961 be made solely for the benefit of the U.S. Shareholder Partner(s) that have inclusions under sections 951(a) and 951A. We believe it would be appropriate to associate the partnership’s adjustment with the U.S. Shareholder Partner that has the inclusion because (1) the U.S. Shareholder Partner is the taxpayer that includes subpart F or GILTI in its gross income with respect to the CFC and should therefore be the person that benefits from the basis adjustment that is intended to protect taxpayers from double taxation of the same income, and (2) the U.S. Shareholder Partner is the person that determines the amount of GILTI included by the U.S. Shareholder Partner with regard to the CFC owned by the partnership.

Authority for an inside basis adjustment derives from the language of section 961(a) considered in the light of aggregate treatment of partnerships for section 961 purposes. If the partnership is to be treated as an aggregate, partners should not suffer a different result with respect to elimination of double-taxation under section 961(a) depending on whether they sell their interest in CFC stock via a sale of their partnership interest or via a sale by the partnership

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204 We are of the view that section 961 should follow the section 951 and section 951A inclusion regimes and, accordingly, believe that aggregate treatment for inclusion purposes should be taken into account for section 961 purposes. See, e.g., Final Regulations, Preamble at 29,315 (identifying sections 959, 960, and 961 as examples of provisions that apply by reference to section 951A).

205 The association of the partnership’s basis adjustment with the U.S. Shareholder Partner is especially important where a partnership has U.S. Shareholder Partners and partners that are not U.S. Shareholder Partners because, if the partnership’s basis adjustment in the CFC stock were “common” basis, then the U.S. Shareholder Partners could be inappropriately burdened by increased gain (or reduced loss) on the taxable disposition of the CFC stock.
of the CFC stock. To create an inside-outside basis disparity under section 961(a), particularly in the context of aggregate treatment of the partnership, results in a trap for the unwary and the need for unnecessary restructuring (and possible planning opportunities for the well-advised) to prevent recognition of uneconomic gain inconsistent with the purposes of section 961. Further, because section 961(a) authorizes adjustments to the basis of a U.S. Shareholder’s stock in a CFC and because the U.S. Shareholder is treated as owning its proportionate share of the stock that the partnership owns under the aggregate approach, it is appropriate to adjust the basis of the CFC stock that the U.S. Shareholder is treated as owning, notwithstanding that such stock is legally held by the partnership.206

The association of the partnership’s basis adjustment in CFC stock with the relevant U.S. Shareholder Partner could be managed via the mechanism of a section 743(b) adjustment, which generally protects inside-outside basis parity.207 Although the conditions for a section 743(b) adjustment are not technically met as a result of an outside basis increase pursuant to section 961(a), the section 743(b) mechanism is particularly useful for the purpose of managing the potential inside-outside basis disparity resulting from the income inclusion occurring at the partner level under sections 951(a) or 951A. There is precedent for this approach in other contexts, such as in the existing section 367(a) Regulations, in which a partner makes a section 743(b) adjustment when there is an outbound transfer of property by a partnership to a foreign corporation and a U.S. partner includes income under section 367(a).208 In such case, a U.S. partner is treated as transferring its proportionate share of the property, requiring an adjustment to the basis in the partner’s interest in the partnership corresponding to any gain recognized under section 367(a). The Regulations permit the partnership to make a corresponding inside basis adjustment pursuant to sections 743(b) and 754 as if the U.S. partner had acquired an interest in the partnership for an amount equal to the gain recognized.209 A similar approach

206 Tellingly, section 961(a) provides for adjustments to the basis of the U.S. Shareholder’s stock in a CFC and the basis of property by which the U.S. Shareholder is considered as owning stock of a CFC, presenting additional statutory support for the making of adjustments to basis at more than a single level of ownership as a consequence of a single inclusion. We do not believe that the fact that Congress did not address CFC stock held through partnerships when it added section 961(c) should be given much weight in determining whether there is sufficient authority to take this action pursuant to section 961(a). The current shift from entity to aggregate treatment for domestic partnerships is not something that Congress likely contemplated. Accordingly, as Treasury and the Service take action to coordinate aggregate treatment for partnerships with regard to inclusions from CFCs, it is important that it clarify the consequences of such aggregate treatment in a manner that is consistent with the overall purposes of section 961 and the avoidance of double taxation of PTEP.

207 We previously recommended the use of the section 743(b) mechanism in our comments on the Proposed Regulations under section 965 and in our comments on the 2018 Proposed Regulations. See ABA Section of Taxation, Comments on the Proposed Regulations Addressing Section 965 (Oct. 29, 2018), available at https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/102918comments1.pdf; ABA Section of Taxation, Comments on the Proposed Regulations under Section 951A in Relation to Passthrough Entities and their Owners (Jan. 16, 2019), available at https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/011619comments.pdf. While final Regulations under section 965 did not adopt this approach, they did provide for “specified basis adjustments,” which were similar to the section 743(b) mechanism. The preamble to the final Regulations under section 965 indicated that Treasury and the Service “will consider these recommendations in connection with future guidance concerning the application of sections 959 and 961 generally.” 84 Fed. Reg. 1,838, at 1,849 (Feb. 5, 2019).


could be taken for purposes of section 961, in which the basis increase in the partnership interest pursuant to section 961(a) is mirrored in the CFC stock (or other property through which the CFC stock is indirectly owned) held by the partnership by an adjustment under section 743(b) as if there had been a purchase of a partnership interest by the partner for an amount equal to the section 961(a) amount. We note that Regulations under section 965 and the Temporary Regulations under section 721(c) use similar mechanisms.\textsuperscript{210} We are of the view that the development of a new basis adjustment regime with respect to any of those provisions is both unnecessary and undesirable, given that section 743 already provides a complete (and well-understood) mechanism for making, tracking, and recovering such basis adjustments, and any new and different basis adjustment regime introduces unnecessary complexity and confusion.

Accordingly, if Treasury and the Service adopt our recommendation to provide a rule for increasing a partnership’s basis in CFC stock (or other property) under section 961(a) with respect to the GILTI (and subpart F) inclusions of U.S. Shareholder Partners, we further recommend that the basis adjustment should be made under section 743(b) in a manner similar to the section 743(b) adjustment provided by Temporary Regulation section 1.367(a)-1T(c)(3)(i)(B). That is, we recommend that (i) a U.S. Shareholder Partner be treated as acquiring a new interest in the partnership with basis equal to the amount by which the U.S. Shareholder Partner increases its basis in the partnership under section 961(a) for a GILTI (or subpart F) inclusion and (ii) to the extent that a section 754 election has not been made by the partnership, a section 754 election would be deemed to have been made solely for the purpose of applying section 743(b) to this deemed acquisition.\textsuperscript{211} A section 743(b) adjustment made under this framework should be treated as a section 743(b) basis adjustment for all federal income tax purposes.

The amount of the section 743(b) adjustment should equal to the amount of the U.S. Shareholder Partner’s increase to the basis of its interest in the partnership under section 961(a) (the “Section 961(a) Amount”) and such adjustment should be made solely to the basis in CFC stock with respect to which the section 961(a) basis increase arose. This result can be achieved either by an express rule that directly mandates the result or by applying the full section 743(b) adjustment mechanisms and section 755 basis allocation mechanisms in the regulations with certain appropriate assumptions. For instance, for purposes of computing the section 743(b) adjustment pursuant to Regulation section 1.743-1, each of (i) the amount of cash that would be deemed to be received by the U.S. Shareholder Partner for purposes of applying Regulation section 1.743-1(d)(1)(i) and (ii) the gain that would be allocated to the U.S. Shareholder Partner as a result of the hypothetical transaction would be deemed to be equal to the Section 961(a) Amount, resulting in the transferee’s share of the adjusted basis to the partnership of partnership property to be zero. This approach would ensure that the amount of the section 743(b) adjustment under Regulation section 1.743-1(b) is equal to Section 961(a) Amount. In addition,

\textsuperscript{210} See Reg. § 1.965-2(e); Temp. Reg. §1.721(c)-3T(d).

\textsuperscript{211} In our view, an actual section 754 election should not be required in order for the partnership to make the inside basis adjustment reflecting the U.S. Shareholder Partner’s inclusions of GILTI (and Subpart F income). Basis adjustments pursuant to section 961 do not relate to an actual acquisition of a partnership interest and, accordingly, we see no reason why the partnership should be required to make a section 754 election, applicable to all actual acquisitions of partnership interests going forward, in order to obtain inside and outside basis parity in the section 961 context.
for purposes of section 755, (i) the amount of gain that would be allocated to the U.S. Shareholder Partner as a result of the hypothetical transaction described in Regulation section 1.755-1(b)(1)(ii) with respect to the stock of the CFC that gave rise to the GILTI (or subpart F) inclusion would be deemed to be equal to the amount of the U.S. Shareholder Partner’s increase to the basis of its interest in the partnership under section 961(a) and (ii) the amount of income, gain, or loss that would be allocated to the U.S. Shareholder Partner as a result of the hypothetical transaction with respect to other partnership property would be deemed to be zero. This coordination rule would ensure that the section 743(b) adjustment is allocated solely to the stock of the CFC with respect to which the U.S. Shareholder Partner had a GILTI (or subpart F) inclusion.

In addition to the recommendations above for making positive section 743(b) adjustments with respect to U.S. Shareholder Partners’ GILTI (or subpart F) inclusions, we also recommend that Treasury and the Service consider adopting special rules to coordinate the application of section 961(b) with the recovery of section 743(b) adjustments. First, we recommend that section 961(b) apply only to the U.S. Shareholder Partner’s interest in the partnership through which the U.S. Shareholder Partner owns section 958(a) stock of the CFC. We believe this approach is appropriate because the application of section 961(b) both at the partnership level and the partner level could result in, or require special rules to avoid, double-taxation. For example, a distribution of PTEP that would result in section 961(b)(2) gain at the partnership level could also trigger section 961(b)(2) gain at the partner level if special rules are not adopted to adjust the partner’s basis in its interest in the partnership for the partner’s distributive share of the partnership’s section 961(b)(2) gain before the partner determines its basis in the partnership for purposes of applying section 961(b) at the partner level. This approach also preserves the potential recognition of gain under section 961(b)(2) in the event that a distribution excluded from income under section 959 exceeds the U.S. Shareholder Partner’s basis in its interest in the partnership. Finally, this approach has the advantage of preserving the application of section 961 at the U.S. shareholder level while utilizing a familiar framework that applies section 743(b) to achieve the intended results of an aggregate approach to partnerships for purposes of section 951A (and section 951).

In conjunction with applying section 961(b) at the U.S. Shareholder Partner level, we also recommend a coordination rule to reduce or eliminate the section 743(b) adjustment made by a partnership with respect to the U.S. Shareholder Partner’s section 961(a) basis increase. To the extent that a U.S. Shareholder Partner reduces its basis in its interest in a partnership under section 961(b)(1), we believe that it would be appropriate for the partnership’s section 743(b) adjustment with respect to the U.S. Shareholder Partner to be redetermined to preserve the parity of the partnership’s basis in its property and the partner’s basis in its partnership interest with respect to the section 961 basis adjustments. For example, a coordination rule could provide that a partnership’s section 743(b) basis adjustment allocated to CFC stock with respect to the U.S. Shareholder Partner is reduced (but not below zero) to the extent that the U.S. Shareholder Partner’s basis in its interest in the partnership is reduced under section 961(b)(1) by reason of a
distribution of PTEP from the CFC.\textsuperscript{212} Thus, the decrease in outside basis pursuant to section 961(b)(1) would be duplicated by a decrease in inside basis pursuant to section 743.

(2) Distributions Subject to Section 959

While the distribution of PTEP that is excluded from the gross income of a distributee U.S. Shareholder Partner under section 959 is treated as a distribution that is not a dividend, a partnership, even a domestic partnership, cannot be a U.S. Shareholder that previously included a distributed PTEP amount in gross income under section 951A.\textsuperscript{213} This raises at least two questions: (1) how is the distribution of PTEP characterized to the partnership, and (2) how does the partnership allocate the income (or amounts excluded from income) among its partners?

An inclusion under section 951A is treated as an inclusion under section 951(a)(1)(A) (i.e., subpart F income) for purposes of section 959.\textsuperscript{214} Moreover, for purposes of applying section 959 to GILTI inclusions, a domestic partnership is treated in the same manner as a foreign partnership for purposes of determining the U.S. persons that own section 958(a) stock of a foreign corporation.\textsuperscript{215} Therefore, if a partnership holds stock of a CFC, a U.S. Shareholder Partner of that partnership is treated—for purposes of section 959—as owning stock of the CFC within the meaning of section 958(a) to the extent of the U.S. Shareholder Partner’s proportionate interest in the partnership.\textsuperscript{216}

Section 959(a) provides, in part, that if an amount of PTEP is distributed to a U.S. Shareholder that had the inclusion giving rise to the PTEP “directly or indirectly through a chain of ownership described under section 958(a),” the amount shall not “again be included in the gross income of” the U.S. Shareholder. If a CFC makes a distribution, indirectly through a partnership, to a U.S. Shareholder Partner that previously included a GILTI inclusion amount with respect to the CFC, the distribution is made through a chain of ownership described under section 958(a). Thus, the distribution to the U.S. Shareholder Partner is excluded from the U.S. Shareholder Partner’s gross income under section 959 to the extent the distribution is made out of the CFC’s PTEP with respect to the U.S. Shareholder Partner. Section 959(d) provides that

\textsuperscript{212} In certain situations, the amount by which the U.S. Shareholder Partner decreases its basis in its interest in the partnership as a result of a PTEP distribution by the CFC could exceed the section 743(b) basis adjustment allocated to the CFC stock with respect to the U.S. Shareholder Partner (such excess, the “Excess Section 961(b)(1) Amount”). In those circumstances, a special rule may be required to maintain basis parity at the partnership level and the partner level. For instance, a special rule for maintaining basis parity could provide for a negative section 743(b) basis adjustment that is allocated to the CFC stock in the amount of the Excess Section 961(b)(1) Amount. There may be other alternatives for accomplishing this objective as well.

\textsuperscript{213} This section does not offer comprehensive comments related to distributions of PTEP. Rather, this section focuses primarily on the interaction of the PTEP rules with the aggregate approach to partnerships under the 2019 Final Regulations.

\textsuperscript{214} I.R.C. § 951A(f)(2); Reg. § 1.951A-5(b)(1).

\textsuperscript{215} Reg. § 1.951A-1(e)(1). See also Final Regulations, Preamble at 29,315 (identifying sections 959, 960, and 961 as examples of provisions that apply by reference to section 951A).

\textsuperscript{216} Generally, Regulation section 1.958-1(b) provides that stock owned by a foreign partnership is considered as being owned proportionately by its partners, and Regulation section 1.958-1(c)(2) provides that a partner’s proportionate interest in a foreign partnership is made on the basis of all the facts and circumstances.
“[a]ny distribution excluded from gross income under subsection (a) shall be treated, for purposes of this chapter, as a distribution which is not a dividend; except that such distributions shall immediately reduce earnings and profits.”

The following example illustrates the difficulties encountered if a partnership has at least one partner that is a U.S. Shareholder Partner and at least one partner that is not a U.S. Shareholder Partner.

**Example 14:** A domestic partnership, PRS, has two partners, US1 and US2, both of which are domestic corporations. US1 owns 95% of the interests in PRS, and US2 owns the remaining five percent of the interests in PRS. PRS owns all of the outstanding stock of FC, a CFC. FC has $100 of Tested Income in Year 1. FC has no Tested Income or Tested Loss in Year 2. US1 does not own section 958(a) stock of any CFC other than FC. In Year 2, FC distributes $100 to PRS, and PRS distributes $95 to US1 and $5 to US2. All entities have the same taxable year.

US1 is a U.S. Shareholder Partner. In Year 1, US1 has a GILTI inclusion of $95 under section 951A (equal to US1’s pro rata share of FC’s Tested Income, or 95% multiplied by $100). Thus, $95 of FC’s E&P is described in section 959(c)(2) with respect to US1. US2 has no inclusion under section 951A in Year 1 because US2 is not a U.S. Shareholder Partner with respect to PRS and FC. Thus, the remaining $5 of FC’s E&P for Year 1 is described in section 959(c)(3).

In Year 2, $95 is distributed to US1 indirectly through PRS. US1 should exclude the entire amount of the distribution from its gross income under section 959(a), because US1 is treated as owning stock of FC by reason of section 958(a)(2), and US1 previously included $95 in its gross income under section 951A with respect to FC.

It is not clear, however, how the distribution of $100 by FC to PRS in Year 2 should be characterized for federal income tax purposes or for purposes of section 704(b). If the treatment of the distribution takes into account US1’s exclusion of the distribution from US1’s gross income, PRS may treat $95 of the distribution as income exempt from tax. If, however, $95 of the distribution is treated as tax-exempt income, the allocation of that tax-exempt item would generally be determined under section 704(b) and there is no mechanism to ensure that PRS would allocate all $95 of the tax-exempt income to US1. Similarly, if $5 of the distribution is treated as a dividend, the allocation of the dividend would generally be determined under section 704(b) and there is no mechanism to ensure that PRS would allocate all $5 of the dividend income to US2. In this situation, if any of the tax-exempt income were allocated to US2 or any of the dividend were allocated to

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217 See also Reg. § 1.959-4 (providing, generally, that “any distribution to a United States person which is excluded from the gross income of such person under section 959(a)(1) and §1.959-1 shall be treated for purposes of chapter 1 (relating to normal taxes and surtaxes) of subtitle A (relating to income taxes) of the Code as a distribution which is not a dividend”).

218 These concerns are applicable to any partnership with U.S. Shareholder Partners, even if all of the partnership’s partners are U.S. Shareholder Partners, because the characterization of the distribution to the partnership affects, among other things, the partnership’s return of partnership income and the partners’ adjustments to their bases in their partnership interests.

219 The principles illustrated by this example would also apply if PRS were a foreign partnership.
US1, the overall taxation of the partners would appear to be distorted relative to the
taxation that would have occurred if the partners directly owned the FC stock.

In addition, because PRS is not the U.S. shareholder that previously included the
distributed amount in gross income under section 951A, it appears that section 959(a)
may not prevent the distribution in Year 2 from being included in the gross income of
PRS. In contrast to the allocation scenario described above, PRS may treat the entire
amount of the distribution (\textit{i.e.}, $100) as a dividend for purposes of section 704(b) and
other federal income tax purposes. If the entire distribution is characterized as a dividend
and PRS allocates $95 of the dividend income to US1 and $5 of the dividend income to
US2, then US1 would presumably exclude its distributive share of the $95 of dividend
income from US1’s gross income under section 959(a). The dividend characterization of
the $5 distribution to US2 is appropriate because US2 did not have an inclusion under
section 951A with respect to the $5 of earnings by FC that were ultimately distributed to
US2.

We believe that partnerships and their partners would benefit from guidance addressing
the characterization of PTEP distributions at the partnership level. We therefore respectfully
request that, in the forthcoming guidance package addressing PTEP,\textsuperscript{220} Treasury and the Service
provide a framework for characterizing and reporting PTEP distributions at the partnership level.
We further request that the framework addressing PTEP distributions through partnerships takes
into account (1) changes in a U.S. Shareholder Partner’s interest in the partnership \textit{(e.g., by}
acquisition, disposition, dilution, or other variation), (2) changes in a partner’s status as a U.S.
Shareholder Partner, (3) PTEP amounts created by actual inclusions under section 951(a) with
respect to which the partnership is the U.S. shareholder that previously included the amount in
gross income, and (4) adjustments to partner outside basis under section 705 resulting from
PTEP distributions.\textsuperscript{221} We will be pleased to submit comments regarding any future proposed
regulations attempting to address these issues.

\textbf{b. Application of the Proposed Regulations to Passthrough
Entities and their Owners}

This section addresses the application of the Proposed Regulations under section 958 (the
“Subpart F Proposed Regulations”\textsuperscript{222}) with regard to partnerships and their partners.

\textbf{(i) Scope of Aggregate Treatment}

The Subpart F Proposed Regulations would apply an aggregate approach to domestic
partnerships that, for purposes of sections 951 and 951A (and certain related provisions), would
treat a domestic partnership in the same manner as a foreign partnership for purposes of

\textsuperscript{220} See Final Regulations, Preamble at 29,298; \textit{see also} Notice 2019-1, 2019-2 I.R.B. 275, section 3.

\textsuperscript{221} These recommendations regarding PTEP distributions in this section relate to GILTI inclusions. Section
II.B.3.b(ii) of these Comments also addresses PTEP distributions with regard to subpart F inclusions and the Subpart
F Proposed Regulations.

\textsuperscript{222} 84 Fed. Reg. 29,114 (June 21, 2019) \textit{(i.e., 2019 Proposed Regulations)}. \textit{See} Prop. Reg. §§ 1.958-1(d), 1.951-1,
1.956-1.
determining the U.S. persons that own stock of a foreign corporation within the meaning of section 958(a) (the “Proposed Domestic Partnership Rule”).

Importantly, however, the Proposed Domestic Partnership Rule would not apply for purposes of determining (1) whether any U.S. person is a U.S. Shareholder, (2) whether any U.S. Shareholder is a controlling domestic shareholder, or (3) whether any foreign corporation is a CFC. The preamble to the Subpart F Proposed Regulations (the “Proposed Preamble”) clarifies that the Proposed Domestic Partnership Rule also would not apply “for any other purposes of the Code, including for purposes of section 1248.” Although the Proposed Domestic Partnership Rule may not apply for purposes of section 1248, we nevertheless believe that rules coordinating the application of sections 1248 and 751(a) with regard domestic partnerships would be appropriate to harmonize the treatment of domestic partnerships and their partners under sections 951 and 951A, as well as other provisions impacted by the Act, such as section 245A.

There may be other provisions that apply by reference to sections 951 or 951A for which application of an aggregate approach or coordination with the Proposed Domestic Partnership Rule would be appropriate. However, we have not attempted to address those provisions. These Comments are therefore limited to our recommendations regarding section 1248 and the aggregate approach taken by the Subpart F Proposed Regulations and the 2019 Final Regulations.

(1) Section 1248

In general, if a U.S. person recognizes gain on the sale or exchange of stock in a foreign corporation and the U.S. person owns ten percent or more of the voting power of the stock of the foreign corporation (under section 958(a) or (b)) at any time during the five-year period ending on the date of the sale or exchange when the foreign corporation is a CFC, section 1248 characterizes the gain as a dividend to the extent of the E&P described in section 1248(a) with respect to the stock that is sold or exchanged. Generally, a domestic partnership is a U.S. person for purposes of section 1248.

Although a foreign partnership is not a U.S. person for purposes of section 1248, a U.S. person may, by reason of the U.S. person’s ownership of an interest in a foreign partnership, own stock of a foreign corporation within the meaning of section 958(a) or be considered to own stock of a foreign corporation under section 958(b). In addition, “if a foreign partnership sells or exchanges stock of a corporation, the partners in such foreign partnership shall be treated” as if

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224 The term “controlling domestic shareholder” is defined in Regulation section 1.964-1(c)(5).
227 Reg. § 1.1248-1(a)(1) (cross-referencing definition of “United States person” to I.R.C. § 7701(a)(30)).
the partners actually sold or exchanged “their proportionate share of the stock of such corporation.”

Thus, a sale of stock of a foreign corporation by a partnership may be subject to section 1248 if either (1) the selling partnership is a domestic partnership that satisfies the ownership requirement of section 1248(a)(2), or (2) the selling partnership is a foreign partnership with one or more partners that are U.S. persons that satisfy the ownership requirement of section 1248(a)(2) and are treated as selling the stock under Regulation section 1.1248-1(a)(4).

(2) Section 751(a)

In general, gain or loss recognized by a partner on a sale or exchange of an interest in a partnership is capital gain or loss. However, under section 751(a), gain or loss recognized by a partner on a sale or exchange of a partnership interest is treated as ordinary income or loss to the extent that income or loss from the partnership’s unrealized receivables and inventory items (collectively, “hot assets”) would be allocated to the partner with respect to the transferred interest if the partnership sold all of its property in a taxable transaction for cash equal to fair market value immediately before the transfer of the partnership interest. The difference between the amount treated as ordinary income or loss under section 751(a) and the partner’s total gain or loss on the sale or exchange of the partnership interest is capital gain or loss.

Section 751(a) is therefore similar in effect to section 1248(a) because both provisions characterize capital gain as ordinary income where there is a sale or exchange of certain property (i.e., an interest in a partnership in the case of section 751(a) and stock in a foreign corporation in the case of section 1248(a)) with respect to which certain conditions are met.

The Regulations under section 751(c) make reference to section 1248 for purposes of determining a partnership’s unrealized receivables. Under Regulation section 1.751-1(c)(4)(iv), the term “unrealized receivables” includes “the amount that would be treated as gain to which section 1248(a) would apply if” a partnership’s stock in a foreign corporation “were sold by the partnership at fair market value.” As described above, a sale of stock of a foreign

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228 Reg. § 1.1248-1(a)(4).
229 I.R.C. § 741.
230 I.R.C. § 751(c); Reg. § 1.751-1(c) (unrealized receivables); I.R.C. § 751(d); Reg. § 1.751-1(d)(2) (inventory items).
231 Reg. § 1.751-1(a).
232 Reg. § 1.751-1(a)(2).
233 The extent to which a taxpayer may recognize ordinary income under each provision is different, however. Under section 1248(a), the amount treated as a dividend is limited to the amount of gain recognized by the taxpayer. In contrast, the amount treated as ordinary income under section 751(a) may exceed the taxpayer’s overall amount of gain on the sale or exchange of its interest in a partnership (with the difference characterized as capital loss). See Reg. § 1.751-1(a)(2). Section 751(a) may also treat the sale of a partnership interest as giving rise to ordinary loss whereas section 1248(a) would not treat any amount of loss recognized on stock as a dividend.
234 See also I.R.C. § 751(c).
235 Reg. § 1.751-1(c)(4)(iv).
corporation by a partnership is subject to section 1248 provided that the ownership requirement of section 1248(a)(2) is satisfied by the partnership (in the case of a domestic partnership) or by a domestic partner in the partnership (in the case of a foreign partnership). Thus, stock of a foreign corporation owned by any partnership (whether domestic or foreign) may be treated as an unrealized receivable of the partnership for purposes of section 751(a) to the extent that section 1248(a) would apply to characterize the partnership’s gain on the sale of the stock as a dividend.

As described above, if a foreign partnership sells stock in a foreign corporation, the partners in the foreign partnership are treated, for purposes of section 1248, as selling or exchanging their proportionate share of the stock under Regulation section 1.1248-1(a)(4). In addition, section 1248(g)(2)(B) provides that section 1248 does not apply to any amount to the extent that such amount is treated as ordinary income under any other provision of the Code. Treasury and the Service addressed comments regarding the interaction of section 1248(g)(2)(B) and Regulation section 1.1248-1(a)(4) in the preamble to the Regulations under section 1248.236

A commentator noted that § 1.1248-1(a)(4) of the proposed regulations could be read to apply to the sale by a partner of its interest in a partnership holding the stock of a corporation. The Treasury Department and the IRS did not intend that interpretation because it would be contrary to section 1248(g)(2)(B). An amount that is received by a partner in exchange for all or part of its partnership interest is treated as ordinary income under section 751(a) and (c) to the extent attributable to stock in a foreign corporation as described in section 1248. Section 1248(g)(2)(B) provides that section 1248 will not apply if any other provision of the Code treats an amount as ordinary income. Accordingly, § 1.1248-1(a)(4) in the final regulations is revised to clarify that a foreign partnership is treated as an aggregate for this purpose only when a foreign partnership sells or exchanges stock of a corporation.237

For the reasons described below, we believe that it would be inappropriate, in the context of the international tax regime most recently updated by the Act, if no portion of any gain is characterized as a dividend on a partner’s sale or exchange of an interest in a partnership through which the partner indirectly owns stock in a foreign corporation that would be subject to section 1248 if the partner had owned and sold such stock directly.

(3) Recommendation

Gain on the disposition of a partnership interest that is treated as ordinary income under section 751(a) generally is treated as ordinary for all purposes of the Code and generally is taxable at rates applicable to ordinary income. However, gain characterized as a dividend under section 1248(a) may be subject to different rates of tax depending on the facts. For example, a section 1248(a) dividend may be eligible for long-term capital gains rates to the extent that the dividend is received by an individual taxpayer and the dividend satisfies the requirements of a qualified dividend income under section 1(h)(11).238 Alternatively, gain recognized by a


238 Very generally, an individual’s net capital gain includes dividends received from qualified foreign corporations defined in section 1(h)(11)(C). I.R.C. § 1(h)(11)(A) and (B).
domestic corporation and treated as a dividend under section 1248(a) may qualify for the 100% dividends received deduction under section 245A, provided the domestic corporation satisfies the requirements of section 245A.\(^{239}\) Dividends may also be subject to tax at rates applicable to ordinary income.

In effect, section 1248(a) dividends may be taxed at reduced rates of tax whereas amounts treated as ordinary income under section 751(a) generally are not subject to reduced rates of tax.\(^{240}\) Thus, an amount that is treated as ordinary income to a partner under section 751(a) by reason of the partner’s interest in the potential section 1248(a) dividend of stock in a foreign corporation held by the partnership would be subject to the rate of tax applicable to the partner’s ordinary income even if the partner would treat an actual amount characterized as a dividend under section 1248 with respect to that stock as qualified dividend income or as a dividend eligible for a dividend received deduction.

Taking into account the framework described above, if an amount is (1) treated as ordinary income to a partner under section 751(a) and (2) attributable to the amount of a potential section 1248(a) dividend with respect to stock in a foreign corporation that is related to the disposed interest in the partnership, we believe that it would be appropriate to characterize the amount, with respect to the partner to whom section 751(a) applies, as a dividend under section 1248(a). We further believe that it would be appropriate to assess tax on the amount characterized as a section 1248(a) dividend under this approach as if the amount were actually gain recognized by the partner on the sale of stock in the foreign corporation and characterized as a dividend under section 1248(a).

We therefore recommend that, in promulgating rules to apply aggregate principles to partnerships for provisions that apply by reference to subpart F, Treasury and the Service consider adopting a rule (a “Deemed Dividend Rule”) providing that, if a U.S. person sells or exchanges an interest in a partnership that owns (directly or indirectly) stock in a foreign corporation, an amount that the U.S. person treats as ordinary income under section 751(a) would be treated as a divided paid by the foreign corporation to the U.S. person under section 1248(a) to the extent the amount is attributable to stock of the foreign corporation that is treated as an unrealized receivable by reason of section 751(c). We believe that the Deemed Dividend Rule, which is essentially a coordination rule between sections 751(a) and 1248(a), would avoid many of the distortions between the taxation of gains under these provisions. Included below are some suggestions as to the recommended application of the Deemed Dividend Rule.

First, the Deemed Dividend Rule would not affect the determination of the amount of ordinary income or loss and capital gain or loss recognized by a partner under section 751(a) and Regulation section 1.751-1. Rather, the Deemed Divided Rule would apply only to the amount, if any, treated as ordinary income to the partner under section 751(a) and the Regulations thereunder (the “Section 751(a) Ordinary Income”).

The amount of the partner’s Section 751(a) Ordinary Income that would be characterized as a section 1248(a) divided under the Deemed Dividend Rule would, with respect to the stock of

\(^{239}\) See I.R.C. § 1248(j).

\(^{240}\) But see, e.g., I.R.C. § 199A(e)(4)(B); Reg. § 1.199A-3(b)(1)(i).
a foreign corporation attributable to the sold or exchanged interest in the partnership, be the amount of the stock treated as an unrealized receivable under section 751(c) (the “Deemed Dividend Amount”).241

The Deemed Dividend Rule would treat the partner’s Deemed Dividend Amount as if the Deemed Dividend Amount were an amount of gain recognized by the partner on an actual disposition of stock in the foreign corporation and characterized as a dividend under section 1248(a).242 Thus, depending on the facts of the partner and the foreign corporation, the Deemed Dividend Amount could be eligible for (1) taxation as an ordinary dividend at ordinary tax rates, (2) taxation as qualified dividend income (if the partner is an individual and the section 1248(a) dividend would satisfy the requirements of section 1(h)(11)), (3) a dividend received deduction under section 245A, and/or (4) subject to other provisions applicable to dividends under section 1248(a).

We believe that the Deemed Dividend Rule would achieve appropriate results for a U.S. person that disposes of an interest in a partnership (whether domestic or foreign) in a taxable transaction where the partnership owns stock in a foreign corporation that is treated, in whole or in part, as an unrealized receivable under section 751(c) by reason of section 1248(a).243

241 For example, in a situation where a partnership would allocate a $50 section 1248(a) dividend and $30 of income from other unrealized receivables (for a sum of $80 of income from section 751 property) to a partner if the partnership had sold all of its property at fair market value, the partner would have $80 Section 751(a) Ordinary Income on the sale of its interest in the partnership. The partner’s the Deemed Dividend Amount would be $50 because $50 of the Section 751(a) Ordinary Income amount is attributable to the section 1248(a) dividend that the partnership would have allocated to the partner as a result of the hypothetical transaction described in Regulation section 1.751-1(a)(2). In certain cases, special rules may be necessary to determine the Deemed Dividend Amount where the Deemed Dividend Amount would otherwise exceed the partner’s Section 751(a) Ordinary Income. For example, in such a circumstance, the Deemed Dividend Amount could be determined to be an amount up to (or in proportion to) the partner’s Section 751(a) Ordinary Income.

242 The Deemed Dividend Rule is recommended to be a characterization rule that treats an amount of a partner’s Section 751(a) Ordinary Income as a dividend under section 1248(a); it is not intended to affect the determination of any amounts under section 1248(a) with regard to stock in a foreign corporation owned by a partnership.

243 We considered alternative approaches to coordinating sections 751(a) and 1248(a) in the context of the international reforms introduced by the Act. For example, we considered whether a U.S. person that sells or exchanges an interest in a partnership that owns stock in a foreign corporation could be treated as directly selling or exchanging its proportionate share of the stock in the foreign corporation for purposes of section 1248 in a manner similar to Regulation section 1.1248-1(a)(4) (a “Deemed Sale Rule”). However, a Deemed Sale Rule would be inconsistent with sections 741 and 751(a) (which treat a partner as selling an interest in a partnership rather than the partner’s share of the partnership’s assets), and section 1248 should not be applied to treat a partner as selling stock in a foreign corporation where the partner actually sells an interest in a partnership. In addition, a Deemed Sale Rule could require ordering rules to coordinate with section 751(a) and could result in inappropriate distortions of amounts treated as ordinary income or loss and capital gain or loss under section 751(a). We recommend the Deemed Dividend Rule because it preserves the application of section 751(a), as well as the general principles of subchapter K, while also reaching an appropriate result regarding the taxation of a U.S. person’s gain in stock of a foreign corporation that is subject to section 1248(a).
(ii) Transition Rules

(1) Basis Adjustments under Section 961

We recommend that Treasury and the Service adopt a rule that permits partnerships that did not make an upward basis increase in CFC stock in the past to make a one-time upward adjustment in such stock to the extent of the partnership’s share of historical PTEP in the CFC.\textsuperscript{244} This alternative would be consistent with treating the inside basis increases as clarifications of prior law, eliminating the double-taxation risk with respect to historical PTEP, as well as future PTEP. We see no reason why, in the absence of prior guidance, and in light of the strong policy reasons for maintaining inside-outside basis parity with respect to section 961 basis adjustments, permitting inside-basis increases should not be treated as a clarification and given retroactive effect with respect to foreign partnerships, rather than being limited to the taxable years of foreign corporations beginning after December 31, 2017 and taxable years of U.S. Shareholders and partnerships in which or with such taxable years of foreign corporations end.

If Treasury and the Service do not choose to adopt the recommendation in the prior paragraph, we alternatively recommend that transition rules be added that coordinate the distribution of historical PTEP (\textit{i.e.}, PTEP that is present at the time the change in domestic partnership treatment from entity to aggregate becomes effective) with prior section 961(a) adjustments, such that section 961(b) basis decreases upon the distribution of PTEP be made consistently with the location of prior basis increases under section 961(a). For example, if a foreign partnership did not increase its basis in CFC stock under section 961(a) at the time that its partner had an inclusion and a basis increase under section 961(a) in its partnership interest, there should be no basis decrease in the partnership’s CFC stock under section 961(b)(1) at the time of the distribution of such PTEP.

Under the Partnership-First PTEP Rule discussed below, historical PTEP will be treated as distributed prior to PTEP generated during the Post-Effective Date Period (as defined below). To coordinate with the Partnership-First PTEP Rule, we believe that, with respect to a distribution of PTEP that arose as a result of an inclusion at the partnership level (\textit{i.e.}, when the domestic partnership was treated as an entity for section 951(a) purposes) and that is excluded from gross income at the partnership level under section 959(a), any section 961(b) basis decrease should also be made at the partnership level. We believe this approach is appropriate, notwithstanding the treatment of a domestic partnership as an aggregate for section 961 purposes at the time of the distribution of PTEP because there should have been no basis increase at the partner level (under section 961(a)) in the case of a domestic partnership that historically had an income inclusion under section 951. This paragraph will be clearer to the reader after reading the next section.

\textsuperscript{244} In the case of foreign partnership, the partnership’s share of historical PTEP in the CFC would be the aggregate amount of PTEP in the CFC that is attributable to the partners of the foreign partnership that included such PTEP in gross income with respect to stock of the CFC treated as owned by the partners through the foreign partnership under section 958(a). In the case of a domestic partnership, the partnership’s share of historical PTEP in the CFC would be the aggregate amount of PTEP in the CFC that is attributable to the partnership’s prior inclusions in gross income under section 951 (to the extent not previously reduced by distributions under section 959).
As described earlier in these Comments, section 959(a) applies to a distribution of PTEP by a CFC to a U.S. Shareholder Partner through a partnership that is included in the chain of ownership between the U.S. Shareholder Partner and the CFC described in section 958(a). Under the rules applicable to domestic partnerships (other than the Proposed Domestic Partnership Rule), a domestic partnership generally includes amounts in its gross income under section 951(a) if the domestic partnership is a U.S. Shareholder that owns stock of a CFC within the meaning of section 958(a) and the CFC has subpart F income or an investment in U.S. property. Thus, a domestic partnership that (1) had an inclusion under section 951(a) prior to any period for which the domestic partnership relies on the Subpart F Proposed Regulations or (2) has an inclusion under section 951(a) with respect to taxable years before the effective date of any final Proposed Domestic Partnership Rule (a “Pre-Effective Date Domestic Partnership”) should be treated as a U.S. Shareholder that previously included an amount in gross income under section 951(a) for purposes of section 959(a). A logical corollary of this conclusion is that a Pre-Effective Date Domestic Partnership should, absent a rule providing otherwise, be entitled to exclude certain distributions of PTEP from gross income under section 959(a).

A domestic partnership will not have any inclusion under section 951(a) and the partnership’s U.S. Shareholder Partners will be subject to potential inclusions under sections 951 and 951A for any taxable year of the domestic partnership (i) in which the domestic partnership relies on the Subpart F Proposed Regulations or (ii) to which any final Proposed Domestic Partnership Rule applies (a “Post-Effective Date Period”). Thus, with respect to any inclusions under sections 951 and 951A for a Post-Effective Date Period, a domestic partnership should not, absent a rule providing otherwise, be entitled to exclude certain distributions of PTEP from gross income under section 959(a). Instead, its U.S. Shareholder Partners may be entitled to exclude certain distributions of PTEP through the partnership from gross income under section 959(a).

In a Post-Effective Date Period, domestic partnerships generally would be expected to provide information to their partners regarding distributions made by CFCs to the partnership. In these situations, we believe that it generally would be appropriate for each U.S. Shareholder Partner of the partnership to determine, at the partnership level, the extent to which the U.S. Shareholder Partner is entitled to exclude an amount of the distributions made by the CFC to the partnership from the U.S. Shareholder Partner’s gross income under section 959(a). We believe this framework is the most administrable option because a domestic partnership may not know the extent to which each of its U.S. Shareholder Partners includes amounts in gross income under sections 951 and 951A, and there is no mechanism to ensure that U.S. Shareholder Partners would provide such information to a domestic partnership on an accurate and timely basis. Moreover, we believe that this framework would be consistent with the historical approach to section 959(a) (with regard to tracing PTEP at the U.S. Shareholder level) and would allow U.S. Shareholder Partners that change their interests in the partnership (e.g., by acquisition or

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245 These Comments previously discussed partnership-level treatment at Section II.B.3.a(ii).

246 See I.R.C. § 959(a) (applying the exclusion from gross income to U.S. Shareholders that own, directly or indirectly through a chain of foreign entities, stock in a foreign corporation with respect to which the U.S. Shareholders previously included income under section 951).
disposition) to share information at the partner level regarding the section 959 attributes of each transferor and transferee partner.

There is, however, an additional degree of complexity applicable to Pre-Effective Date Domestic Partnerships because such partnerships will have had inclusions under section 951 and their U.S. Shareholder Partners may have later inclusions under sections 951 and 951A with respect to the same CFC. Moreover, such partnerships may not know (or have a reason to know) the amount of any inclusion under section 951A recognized by their U.S. Shareholder Partners.247

Thus, there is uncertainty regarding the extent to which the domestic partnership or its U.S. Shareholder Partners may be entitled to exclude amounts from gross income under section 959(a) on a distribution of PTEP by the CFC through the domestic partnership. To facilitate the transition to a state in which no domestic partnership has any amount of a previously included amount under section 951 for which a distribution by the CFC has not yet been excluded under section 959(a), we recommend an affirmative ordering rule that would treat all distributions of PTEP as being made first out of amounts previously included in the gross income of a domestic partnership, and then out of amounts previously included in the gross income of a U.S. Shareholder Partner (a “Partnership-First PTEP Rule”).

A Partnership-First PTEP Rule would allow domestic partnerships to accurately report the amount of distributions by CFCs that are excluded from the domestic partnership’s gross income with respect to the CFC.248 In addition, a Partnership-First PTEP Rule would be consistent with the general ordering rule of section 959(c) (under which PTEP are generally distributed before untaxed earnings) because amounts that have been included by the domestic partnership and allocated to its partners (including its partners that are not U.S. Shareholder Partners) would be excluded from the domestic partnership’s income (and therefore excluded from the distributive share of income of the partners that are not U.S. Shareholder Partners) before any distributions by the CFC are taxable to any of the partners that previously included income with respect to the earnings of the CFC. A Partnership-First PTEP Rule would also have the advantage of eliminating, as quickly as possible, all PTEP balances that are attributable to domestic partnerships because such PTEP balances would be treated as distributed before any other PTEP balances. In other words, a Partnership-First PTEP Rule would be an efficient mechanism to transition domestic partnerships to reach the “end-state” of being subject to sections 951 and 951A, as well as section 959, only at the U.S. Shareholder Partner level and having the domestic partnership serve as a conduit through which the distributions would be made and the information regarding relevant attributes would be reported.

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247 A partnership may not know, for instance, the amount of a U.S. Shareholder Partner’s inclusion under section 951A or the extent to which a U.S. Shareholder Partner’s inclusion under section 951A is allocable to stock of a CFC owned by the partnership. In addition, there is no mechanism that would ensure that a U.S. Shareholder Partner would provide such information to a partnership.

248 A rule that would treat distributions of PTEP as being made proportionately with respect to PTEP attributable to a domestic partnership and its U.S. Shareholder Partners could be distortive in terms of the amounts of distributions excluded from the gross income of each partner of the domestic partnership (including partners that are not U.S. Shareholder Partners) and could lead to unnecessary complexity.
For purposes of implementing a Partnership-First PTEP Rule, the domestic partnership
would generally have priority over its U.S. Shareholder Partners with respect to the share of the
CFC distribution paid to the partnership. In the case of a CFC with PTEP described in section
959(c)(1), the ordering rule would give the domestic partnership priority over its U.S.
Shareholder Partners to PTEP described in section 959(c)(1). Then, the CFC’s distributions
would be considered to be made out of section 959(c)(1) PTEP with respect to U.S. Shareholder
Partners before any distributions are made out of PTEP described in section 959(c)(2). Next,
distributions would be considered to be made out of section 959(c)(2) PTEP with respect to the
domestic partnership before any amounts of section 959(c)(2) PTEP are distributed with respect
to the U.S. Shareholder Partners.

As an alternative to a Partnership-First PTEP Rule, a domestic partnership could be
treated as making a one-time deemed transfer of its interest as a U.S. Shareholder in a CFC to its
partners at the time that the Proposed Domestic Partnership Rule is first applicable to the
domestic partnership (i.e., on the earlier of the effective date of the domestic partnership’s
reliance on the Subpart F Proposed Regulations or the effective date of any final Proposed
Domestic Partnership Rule) (a “Deemed Transfer Rule”). Under a Deemed Transfer Rule, each
domestic partner could be treated, for purposes of section 959(a) as a U.S. person that acquires
from the partnership a portion of the partnership’s interest as a U.S. Shareholder in a foreign
corporation. In general, we expect that a Deemed Transfer Rule would reach appropriate results
in many situations because, for purposes of section 959(a), domestic partners could step into the
shoes of the domestic partnership with respect to their share of the partnership’s prior inclusions
under section 951. However, a Deemed Transfer Rule would require several special rules to
reach appropriate results in all cases and we therefore do not recommend this approach.249

For the reasons outlined above, if the Proposed Domestic Partnership Rule is finalized,
we recommend that Treasury and the Service adopt a Partnership-First PTEP Rule as a transition
rule to the treatment of domestic partnerships for purposes of section 959.

4. The GILTI High-Tax Exclusion

a. Background

Section 951A(c)(2)(A)(III) excludes from the definition of Tested Income any gross
income excluded from FBCI and insurance income by reason of the high-tax exception of section
954(b)(4). The 2019 Final Regulations adopted the GILTI HTE of the 2018 Proposed
Regulations and clarified the scope of the exclusion by providing that high-taxed income is

249 For example, if a domestic partnership with prior inclusions under section 951 had partners whose interests
changed over time (or even year-by-year, as is the case for many partnerships with complex capital structures), a
Deemed Transfer Rule would need to take into account the extent to which each partner would be treated as having
previously included income under section 951 (by reason of the partner’s distributive share of such income) in prior
years and the extent to which each partner has already been treated as excluding amounts from gross income under
section 959(a) with respect to those distributive shares of inclusions under section 951. This partner-by-partner
tracing rule would also have taken into account successors in interest and other partnership and partner-level equity
transactions (such as contributions or transfers of partnership interests). As another example, coordination of a
Deemed Transfer Rule with section 959(b) for CFC partners would need to be considered to avoid the potential
double-counting of inclusions in the income of the CFC’s U.S. Shareholder(s). There may be other instances in
which a Deemed Transfer Rule would require the development of special rules to avoid inappropriate results.
excluded from Tested Income only if such income is excluded from FBCI or insurance income solely by reason of an election made under section 954(b)(4) and Regulation section 1.954-1(d)(5). In response to comments received by Treasury and the Service, the 2019 Proposed Regulations expand the GILTI HTE, under an elective regime, to include certain high-taxed income even if such income would not otherwise be FBCI or insurance income.

In providing this expanded and elective GILTI HTE, Treasury and the Service pointed to the legislative history as indicating an intent by Congress to have high-taxed income excluded from gross Tested Income. 250 This supports the general policy that, at least consistent with its name (i.e., global intangible low-taxed income), GILTI is meant to be in large part a global minimum tax and including high-taxed income in its calculations is inconsistent with that intent, at least on a jurisdiction-by-jurisdiction basis. Treasury and the Service also recognize that the current GILTI HTE may motivate taxpayers that are able, and for whom it may be advantageous (e.g., among others, taxpayers that may have U.S. losses or other attributes that may be inefficiently utilized to offset GILTI income at a 10.5% rate instead of other income that is subject to the higher 21% rate, and taxpayers that may not be able to utilize high-tax GILTI foreign tax credits), to restructure their operations to cause certain high-tax CFCs and their operations to generate income that would be FBCI or insurance income but for the high-tax exclusion of section 954(b)(4). 251 Such planning, while not necessarily considered abusive under current rules, is not desirable from Treasury and the Service’s perspectives (which are focused on the view that business needs and not tax benefits should dictate that structure of business operations). 252 Accordingly, Treasury and the Service included the proposed rules discussed below, at least in part, to reduce taxpayer’s motivations to restructure their operations to get into the high-tax exclusion of section 954(b)(4). 253

Under the 2019 Proposed Regulations, a CFC’s controlling domestic shareholders may elect under section 954(b)(4) to exclude from gross Tested Income all gross income subject to an effective rate of foreign income tax greater than 18.9% (i.e., 90% of the U.S. corporate tax rate, currently 21%). If the election is made, it is binding on all U.S. Shareholders of the CFC and applies with respect to each item of income of each CFC in a group of commonly controlled CFCs that meet an effective rate test. Although the election may be revoked, a new election generally cannot be made for any CFC inclusion year that begins within five years after the close of the CFC inclusion year for which the election was revoked, and if such re-election is made, it cannot be revoked for any CFC inclusion year that begins within five years after the close of the CFC inclusion year for which the re-election was revoked.

250 “The Committee believes that certain items of income earned by CFCs should be excluded from the GILTI, either because they should be exempt from U.S. tax—as they are generally not the type of income that is the source of base erosion concerns—or are already taxed currently by the United States. Items of income excluded from GILTI because they are exempt from U.S. tax under the bill include foreign oil and gas extraction income (which is generally immobile) and income subject to high levels of foreign tax.” S. Comm. on the Budget, Reconciliation Recommendations Pursuant to H. Con. Res. 71, S. Print No. 115-20, at 371 (2017).

251 Proposed Regulations, Preamble at 29,123.

252 See id.

253 Proposed Regulations, Preamble at 29,124.
The determination of the effective rate of foreign income tax is made at the qualified business unit (“QBU”) level and on a QBU-by-QBU basis. The gross income attributable to a QBU is computed by reference to the items of gross income properly reflected on the books and records of the QBU, as adjusted to account for certain disregarded payments.

b. Effective Date

The GILTI HTE in the 2019 Proposed Regulations is proposed to apply to tax years of foreign corporations beginning on or after the date that final Regulations are published in the Federal Register, and to tax years of U.S. Shareholders in which or with which such tax years of foreign corporations end.254

We recommend that the effective date of the proposed GILTI HTE be revised to allow taxpayers to choose to apply the 2019 Proposed Regulations in their entirety to all open tax years, provided that they apply them consistently. Because the 2019 Final Regulations are in effect and would be inconsistent with the 2019 Proposed Regulations, the Service is not subject to its internal guidelines that generally discourage its personnel from taking positions contrary to the 2019 Proposed Regulations.255 As a consequence, the election is not available for the 2018 tax year and any following tax year that begins before the final Regulations are published. Because Treasury and the Service have already determined that the GILTI HTE should be expanded to apply to income that would not otherwise be FBCI or insurance income,256 we recommend that taxpayers be allowed to rely on the 2019 Proposed Regulations with respect to tax years as of June 21, 2019.257

c. Five-Year Limitations

As mentioned above, under the 2019 Proposed Regulations, the election under section 954(b)(4) to exclude from gross Tested Income all gross income that meets the effective tax rate test may be revoked by the controlling domestic shareholders.258 However, upon revocation of the election for a CFC inclusion year, a new election generally cannot be made for CFC inclusion years that begin within 60 months after the close of the CFC inclusion year for which the election was revoked (the “Initial Five-Year Limitation”).259 In addition, upon re-election after revocation, the new election cannot be revoked for any CFC inclusion year that begins within 60 months after the close of the CFC inclusion year for which the new election was made

254 Prop. Reg. § 951A-7(b).
255 See I.R.M. 32.1.1.2.2(3) (“If there are no final or temporary regulations currently in force addressing a particular matter, but there are proposed regulations on point, the Office of Chief Counsel generally should look to the proposed regulations to determine the office’s position on the issue. The Office of Chief Counsel ordinarily should not take any position in litigation or advice that would yield a result that would be harsher to the taxpayer than what the taxpayer would be allowed under the proposed regulations.”).
256 See Prop. Reg. § 951A-2; Proposed Regulations, Preamble at 29,120.
257 We believe there is also no reason to postpone the applicability of the GILTI HTE to allow taxpayers to assess its effects because taxpayers that need additional time to assess the effect of the GILTI HTE to their facts and circumstances would simply make the election in a future year.
(the “Subsequent Five-Year Limitation” and, together with the Initial Five-Year Limitation, the “Five-Year Limitations”). Finally, despite the Five-Year Limitations, Treasury and the Service may permit an election or revocation to be made if more than 50% of the total combined voting power of all classes of the stock of a CFC entitled to vote as of the beginning of such CFC inclusion year are owned by persons that did not own any interests in the CFC as of the close of the CFC inclusion year for which the prior election or revocation became effective (i.e., the CFC undergoes a change of control).

We applaud Treasury and the Service’s attempt to provide relief to taxpayers that have high-taxed income that is included in GILTI to such taxpayer’s detriment (e.g., if the high-tax foreign taxes associated with such foreign income in the GILTI basket are lost). However, we note that the limitations of the election and the volatile nature of tax liability under the GILTI regime are likely to cause the use of this election to be underutilized and thus less likely to achieve the policies and goals underpinning the need for the election in the first place.

Although not specifically stated, Treasury and the Service appear to have imposed time limitations similar to the Five-Year Limitations in other situations to prevent taxpayers from “cherry-picking” whether a particular tax provision applies on a yearly basis with respect to various elective regimes. In the context of the GILTI HTE, a taxpayer may have competing incentives in determining whether to make the election or not, and the conclusion may change from tax year to tax year.

Treasury and the Service’s concerns that taxpayers will cherry-pick the election are perhaps most apparent when the initial election into the GILTI HTE election is made. However, because the election covers all commonly-controlled CFCs, we would expect that well-advised taxpayers will elect out the first year the election stops providing the anticipated benefit (e.g., as a result of a tax rate change in one or more foreign jurisdictions where the group conducts business). The same taxpayers could then engage in the sort of “business follows tax” planning to get into the high-tax exception of section 954(b)(4) that the GILTI HTE election is meant to avoid.

For example, the Five-Year Limitations create disparities between subpart F and GILTI that preserve incentives for taxpayers to restructure their operations to achieve the most efficient tax result. Even with the expanded GILTI HTE, there remain circumstances where it would be beneficial to convert Tested Income into subpart F income for a variety of reasons such as the ability to make an annual CFC-by-CFC election, or use excess foreign tax credits to offset other business income and carry-over excess credits for ten years. Treasury and the Service are aware that certain taxpayers were considering converting what would otherwise be GILTI to subpart F

260 Id.
262 See, e.g., Reg. § 301.7701-3(c)(iv); Prop. Reg. § 1.1297-1(d)(1)(iv)(B).
263 The analysis as to whether the GILTI HTE would be beneficial in a given year depends on multiple factors such as foreign tax credit positions, foreign tax rates, the distribution of foreign activity between high- and low-tax jurisdictions, the applicability of other special tax regimes such as the BEAT. Treasury and the Service have acknowledged the complexity in the Proposed Preamble as they did not provide quantitative estimates with respect to the GILTI HTE. Proposed Regulations, Preamble at 29,123-29,125.
income in order to reduce their effective tax rate and suggested that taxpayer comments reference such efforts. Arguably, the taxpayers most likely to exploit these disparities may be able to do so, regardless of the Five-Year Limitations, by restructuring their foreign operations to generate subpart F income and thus achieve a different foreign tax credit position or use the section 954(b)(4) election on an annual basis. However, taxpayers with less complex structures that are not so easily able to restructure to take advantage of such other considerations can be expected to bear most of the burden.

We recommend that the Five-Year Limitations be changed to an annual limitation, like the high-tax exclusion for subpart F income. The Five-Year Limitations seem to be included as an anti-abuse rule to prevent a taxpayer from “cherry-picking” which years to make the GILTI HTE election based on what is most advantageous to such taxpayer. However, the worst “cherry-picking” benefits are already reduced by the GILTI HTE being applied across all commonly-controlled CFCs, and the GILTI HTE already allows for “cherry picking” the first election into and the first revocation out of the GILTI HTE. Additionally, the Five-Year Limitations undermine a principle motivation for providing taxpayers the GILTI HTE in the first place. More specifically, the extended lock-in and lock-out effects of the Five-Year Limitations at best delay the sort of restructuring into the high-tax exception of section 954(b)(4) that the Treasury and the Service intend to reduce by implementing the GILTI HTE (because taxpayers are likely to engage in such transactions when the GILTI HTE no longer is beneficial, and such taxpayers are unlikely to ever elect back into the GILTI HTE prior to engaging in such additional section 954(b)(4) planning). Moving to an annual limitation provides a much greater incentive to taxpayers to indefinitely avoid the costly and inefficient (from a business perspective) tax restructuring that motivated the creation of the GILTI HTE.

d. Calculations on a QBU-by-QBU Basis

2019 Proposed Regulations section 1.951A-2(c)(6)(ii)(A)(1) provides that the tentative gross Tested Income item for a CFC is the aggregate of all items of items of income attributable to a single QBU in a CFC inclusion year that would be gross Tested Income without regard to the GILTI HTE and that would be a single Tested Income group within the meaning of Regulation section 1.960-1(d)(2)(ii)(C). The term “QBU” has the same meaning as in section 989(c), and includes QBUs owned by a CFC in addition to the QBU that is the CFC itself. Gross income is attributable to a QBU if it is reflected on the books and records of the QBU, with such gross income determined under U.S. federal income tax principles and by applying Regulation section 1.904-4(f)(2)(vi) to adjust the gross income of the QBU to reflect disregarded payments (e.g., payments between a disregarded entity and its owner).

264 Jennifer McLoughlin, Taxpayers Encouraged to ‘Kick Tires’ of GILTI High-Tax Exclusion, 164 TAX NOTES FEDERAL 89 (July 1, 2019).

265 Generally, we believe that any reduction of the Five-Year Limitations periods would not conflict with Treasury and the Service’s intent and the underlying policy.


According to the Proposed Preamble, Treasury and the Service examined three options to
determine high-taxed income for purposes of the GILTI HTE. The first option examined was
whether to determine high-taxed income on an item-by-item basis. Although consistent with the
language of section 954(b)(4), this option was thought to be too complex and difficult to
administer, and was thus rejected.\textsuperscript{268} The second option examined was whether to determine
high-taxed income based on all items of a CFC.\textsuperscript{269} Treasury and the Service determined this
option would allow taxpayers to “blend” low- and high-taxed income, with the low-taxed income
being the type of income meant to be covered by the GILTI rules; thus, this option was also
rejected. The third option examined, and the option adopted, was to determine high-taxed
income on a QBU-by-QBU basis. Treasury and the Service felt that this approach minimizes
concerns related to “blending” of rates and, although more complex and administratively
burdensome than measuring on a CFC-by-CFC basis, concluded it more accurately determines
income subject to a high rate of foreign tax, allowing the GILTI rules to apply to low-taxed
income as intended.\textsuperscript{270}

Treasury and the Service requested comments on whether special rules are needed for
associating taxes with income with respect to partnerships, hybrid entities, disregarded entities,
or situations in which QBUs are allowed to share losses by forming part of a fiscal unity or
similar group.

We recommend that the final Regulations adopt special rules for determining high-taxed
income that take into account a fiscal unity or similar group where the entities that form such
groups are allowed to share income and deductions in determining the taxable income of the
group. We believe that a special fiscal unity rule would allow for a more accurate determination
of the effective tax rate for that group of QBUs under the rules of the QBUs’ jurisdiction. Thus,
the adoption of such a rule would be consistent with Treasury and the Service’s reason for
choosing a QBU-by-QBU approach and the disregarded payment rules.

5. GILTI – QBAI Related Issues

a. Dual Use Property

In the 2018 ABA GILTI Comment Letter, we recommended additional examples
illustrating the application of the rules regarding “dual use” property in Regulation section
1.951A-3(d)(3), in particular that the method for determining the dual use ratio with respect to
Specified Tangible Property does not change if (i) the dual use property becomes or ceases to be
Specified Tangible Property during the year, or (ii) the dual use property gives rise to increasing
or decreasing gross Tested Income across quarters in a taxable year.\textsuperscript{271} Treasury and the Service
confirmed in the Final Preamble that the “dual use” ratio is not determined on the basis of the
type and amount of gross income produced by the property as of any particular quarter close, but
rather is determined based on the type and the amount of gross income produced by the property

\textsuperscript{268} Proposed Regulations, Preamble at 29,124.
\textsuperscript{269} Id.
\textsuperscript{270} Id.
\textsuperscript{271} 2018 ABA GILTI Comment Letter at 26-27.
for the entire taxable year. On this basis, Treasury and the Service determined additional
examples were not necessary.

We appreciate Treasury and the Service confirming our interpretation of the “dual use”
rule in the Final Preamble; in light of the confirmation in the Final Preamble, we agree that the
additional examples are not necessary.

b. Determination of Disqualified Basis

Treasury and the Service requested comments on the application of the rules that reduce
or increase “disqualified basis,” which is relevant for purposes of both the rule in Regulation
section 1.951A-2(c)(5) (allocating deductions attributable to disqualified basis to residual CFC
gross income) and the rule in Regulation section 1.951A-3(h)(2) (disregarding Disqualified Basis
for purposes of calculating QBAI). Treasury and the Service specifically asked for comments
on how the rules should apply in an exchange under section 1031 where property with
Disqualified Basis is exchanged for property with no Disqualified Basis.

In the Final Preamble, Treasury and the Service noted that, while Disqualified Basis in
property generally is an attribute specific to the property itself (rather than an attribute of a CFC
or a U.S. Shareholder with respect to the property), the Regulations provide rules to treat basis in
other property as Disqualified Basis if such basis was determined, in whole or in part, by
reference to the basis in property with Disqualified Basis. In the Final Preamble, Treasury and
the Service stated that these new rules of Regulation section 1.951A-3(h)(2)(ii)(B)(2) are
intended to prevent taxpayers from eliminating Disqualified Basis in nonrecognition transactions
that would otherwise have the effect of granting taxpayers the benefit of the Disqualified Basis;
for example, if property with Disqualified Basis is transferred in a like-kind exchange under
section 1031 in exchange for other depreciable property.

In the case of the rule at Regulation section 1.951A-3(h)(2)(ii)(B)(2)(ii) for determining
when property with Disqualified Basis is exchanged for property with no Disqualified Basis, we
recommend formulating the rule in a manner similar to the rule at Regulation section 1.197-
2(g)(2)(iii), which applies under analogous circumstances to treat a portion of the basis in
replacement property in an exchange under section 1031 or 1033 as amortizable section 197
property by reference to the adjusted basis in the predecessor property that was amortizable
section 197 property. Also under Regulation section 1.197-2(g)(2)(iii), the replacement property
is treated, with respect to so much of its adjusted basis as exceeds the adjusted basis of the
predecessor property, in the same manner for purposes of section 197 as property acquired from
the transferor in a transaction that is not subject to section 1031 or 1033. Adopting the
formulation of the rule at Regulation section 1.197-2(g)(2)(iii) would also address an
ambiguity in Regulation section 1.951A-3(h)(2)(ii)(B)(2)(ii) as it applies to exchanges of loss
property in nonrecognition transactions with boot. Under the rule at Regulation section 1.951A-


273 We do not discuss here whether these rules should, as a policy matter, be included in the Regulations but offer
only recommendations for their improvement.

274 Reg. § 1.197-2(g)(2)(iii).
3(h)(2)(ii)(B)(2)(ii), the transferor’s Disqualified Basis includes “the amount of the disqualified basis in any property by reference to which the adjusted basis in the exchanged basis property was determined, in whole or in part”; however, under typical nonrecognition rules, losses are not recognized in transactions with boot, and the transferor’s basis in the replacement property (or property permitted to be received without the recognition of gain) is reduced by the cash or fair market value of property received. Therefore, the taxpayer’s basis in the exchanged-basis property received may necessarily be less than the adjusted basis in the transferred or relinquished property, and we believe the rules should take such reduction into account.

6. Interaction of the High-Tax Exclusion and the Full Inclusion Test

Section 954(b)(4) provides that, for purposes of section 954(a) and section 953, FBCI and insurance income does not include any item of income received by a CFC if the taxpayer establishes to the satisfaction of the Secretary that such income was subject to an effective rate of income tax imposed by a foreign country greater than 90% of the maximum rate of tax specified in section 11.

Regulation section 1.954-1(b)(2) treats as “full-inclusion FBCI” any gross income included in adjusted gross FBCI because the full inclusion test of Regulation section 1.954-1(b)(1)(ii) is met. Regulation section 1.954-1(d)(6) provides that, notwithstanding Regulation section 1.954-1(b)(1)(ii), full inclusion FBCI will be excluded from subpart F income if more than 90% of the adjusted gross FBCI and adjusted gross insurance company income of a CFC (determined without regard to the full inclusion test of Regulation section 1.954-1(b)(1)) is attributable to net amounts excluded from subpart F income pursuant to an election to have the high tax exception described in section 954(b)(4) and Regulation section 1.954-1(d) apply.

The preamble to Regulation section 1.954-1(d)(6) indicates that this rule generally is intended to apply when full inclusion FBCI is subject to a low tax rate.

Section 1.954-1T(a)(3) and (5) (temporary regulations) apply the de minimis and full inclusion tests of section 954(b)(3) before the high tax exception of section 954(b)(4). Commenters have expressed concern that, in certain cases, the only amounts required to be included in the gross income of the United States shareholders of a controlled foreign corporation may be full inclusion income. This result may occur when subpart F income, other than full inclusion foreign base company income, qualifies for the high tax exception. In response to these comments, §1.954-1(d)(6) provides that an amount that otherwise would be included as full inclusion foreign base company income, pursuant to the operation of the full inclusion test of section 954(b)(3)(B), will be excluded from full inclusion foreign base company income if more than 90% of the adjusted gross foreign base company and adjusted gross insurance income qualifies for the high tax exception described in section 954(b)(4) and the high tax election is actually made.

275 See, e.g., I.R.C. §§ 358(a), 1031(d).
Regulation section 1.951A-2(c)(4)(iii)(C) provides that full inclusion FBCI excluded from subpart F income by reason of Regulation section 1.954-1(d)(6) is not excluded from gross Tested Income by reason of the subpart F exclusion and the GILTI high tax exclusion.277

Based on a literal reading of Regulation section 1.951A-2(c)(4)(iii), it appears that full inclusion FBCI that is excluded from subpart F income under Regulation section 1.954-1(d)(6) is included in gross Tested Income even if full inclusion FBCI is subject to a high effective foreign tax rate.

For example, assume a CFC earns $5 of gross non-FBCI, $95 of gross FBCI and all of the CFC’s income is subject to a foreign tax rate greater than 90% of the maximum rate of tax specified in section 11. If this interpretation of Regulation section 1.951A-2(c)(4)(iii) is correct, it appears as though the $5 of full inclusion FBCI would be excluded from subpart F income but included into gross Tested Income by reason of Regulation section 1.951A-2(c)(4)(iii)(C).

If the intent for Regulation section 1.951A-2(c)(4)(iii)(C) is to include into gross Tested Income all full inclusion FBCI even if such full inclusion FBCI (i.e., the $5 in the above example) is subject to a high effective foreign tax rate, the underlying policy rationale for excluding such income from qualifying for the GILTI high tax exclusion to gross Tested Income is unclear.

7. **Deductibility of Deemed Royalties under Section 367(d)**

When a U.S. person transfers intangible property to a foreign corporation in a nonrecognition transaction, section 367(d) generally requires the U.S. transferor to include into income annual amounts contingent on the productivity, use, or disposition of the property (“deemed royalties”). The E&P of the foreign transferee is reduced by the amount of these deemed royalties.278 Temporary Regulation section 1.367(d)-1T(c)(2)(ii) provides that these deemed royalties may be treated as an expense of the foreign corporation properly allocated and apportioned to gross income subject to subpart F. No other adjustments to E&P, basis, or gross

277 The Final Preamble discusses the coordination of these rules by stating the following:

The Treasury Department and the IRS have determined that it would be inappropriate for an item of gross income that would be included in gross tested income but for the full inclusion rule to be excluded from both gross tested income (by reason of the subpart F exclusion) and subpart F income (by reason of §1.954-1(d)(6)). Accordingly, the final regulations provide that full inclusion FBCI excluded from subpart F income by reason of §1.954-1(d)(6) is not excluded from gross tested income by reason of the subpart F exclusion. See §1.951A-2(c)(4)(iii)(C). The final regulations further clarify that income excluded from subpart F income under §1.954-1(d)(6) is also not excluded from gross tested income by reason of the GILTI high tax exclusion (discussed in part IV.B of this Summary of Comments and Explanation of Revisions section). See id. Accordingly, income excluded from subpart F income by reason of §1.954-1(d)(6) is included in gross tested income.

Final Regulations, Preamble at 29,297.

income are permitted by reason of these deemed royalties.\textsuperscript{279} The Temporary Regulations, however, do not specify whether these deemed royalties may be treated as an expense properly allocated and apportioned to Tested Income. We believe that for the same policy rationale that led Treasury and the Service to conclude that deemed royalties should be deductible when the intangible property is used in the production of subpart F income (\textit{i.e.}, that were the intangible property actually sold in exchange for contingent payments as is the hypothetical construct required under section 367(d), those payments would generally be deductible or added to the transferee’s basis in the property) is equally applicable when the intangible property is used in the production of Tested Income. Moreover, we note that inconsistent treatment would result in noneconomic distortions and inappropriate double taxation. For these reasons, we recommend that Temporary Regulation section 1.367(d)-1T(c)(2)(ii) be revised to provide that deemed royalties under section 367(d) are treated as expenses properly allocated and apportioned to Tested Income.\textsuperscript{280}

\textsuperscript{279} Temp. Reg. § 1.367(d)-1T(c)(2).

\textsuperscript{280} We note that the Service recently exercised its discretion under Regulation section 1.1502-13(c)(6)(ii)(D) in ruling on the application of Temporary Regulation section 1.367(d)-1T(c) in another context where the plain language of the Regulation arguably could have led to a noneconomic outcome. \textit{See} PLR 201936004 (June 5, 2019) (where the transferee foreign corporation transferred intangible property (where that intangible property was already subject to the section 367(d) deemed royalty regime) to a U.S. corporation that joined the U.S. transferor’s consolidated group, the deemed royalty was redetermined to be excluded from the U.S. transferor’s gross income, resulting in no net income or deduction for the consolidated group).