July 31, 2020

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

Re: Comments Concerning Impact of Final Regulations under Section 951A on S Corporations and their Shareholders

Dear Commissioner Rettig:

Enclosed please find comments concerning the impact of the final regulations under Section 951A on S Corporations and their shareholders. 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

cc: Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury  
L. G. “Chip” Harter, Deputy Assistant Secretary (International Tax Affairs), Department of Treasury  
Krishna P. Vallabhaneni, Tax Legislative Counsel, Department of the Treasury  
Douglas Poms, International Tax Counsel, Office of International Tax Counsel, Department of Treasury  
Colin Campbell, Attorney-Advisor, Department of the Treasury  
Hon. Michael J. Desmond, Chief Counsel, Internal Revenue Service  
William M. Paul, Deputy Chief Counsel (Technical), Internal Revenue Service  
Peter Blessing, Associate Chief Counsel (International), Internal Revenue Service  
Holly Porter, Associate Chief Counsel (Passthroughs & Special Industries), Internal Revenue Service  
Samuel Starr, Special Counsel, Office of Associate Chief Counsel (Passthroughs & Special Industries), Internal Revenue Service
Comments Concerning the Impact of Final Regulations Under Section 951A on S Corporations and S Corporation Shareholders

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

Principal responsibility for preparing these Comments was exercised by Courtney A. Hollander, Robert S. Keller, Thomas J. Phillips, and Joseph E. Tierney III. The Comments have been reviewed by Jeanne M. Sullivan of the Committee on Government Submissions and Kurt L. Lawson, Vice Chair for 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.

Contact: Thomas J. Phillips
(414) 287-1524
tphillips@vonbriesen.com

Date: July 31, 2020
I. Background and Executive Summary

These Comments are part of a larger project undertaken by the Section to provide comments on the changes made by the Tax Cuts and Jobs Act (the “Act”). The Act created section 951A, which provides for the taxation of global intangible low-taxed income (“GILTI”) of a U.S. person who is a “United States shareholder” as defined in section 951(b) (a “U.S. Shareholder”). The Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) issued proposed regulations regarding section 951A on October 10, 2018 (the “Proposed Regulations”). Treasury and the Service published final regulations regarding section 951A on June 21, 2019 (the “Final Regulations”).

The preamble to the Final Regulations (the “Preamble”) states that Treasury and the Service are studying the application of section 1373(a) to section 951A, as well as the broader implications of treating S corporations as partnerships for purposes of subpart F, and requests comments in this regard.

GILTI earned by a controlled foreign corporation (a “CFC”) is subject to U.S. tax on a current basis, regardless of whether that income is distributed; this treatment is similar to the treatment of a CFC’s subpart F income under section 951(a)(1)(A). Specifically, each person who is a U.S. Shareholder of a CFC is required to include in gross income such shareholder’s GILTI. A shareholder’s GILTI is equal to the excess (if any) of the shareholder’s “net CFC tested income” (i.e., the excess, if any, of the aggregate pro rata shares of tested income over the aggregate pro rata shares of tested loss), over such shareholder’s “net deemed tangible income return” (i.e., the excess of ten percent of the adjusted basis of certain tangible property over certain interest expense).

---


2 Unless otherwise indicated, references to a “section” are to the Internal Revenue Code of 1986, as amended (the “Code”), and all “Treas. Reg. §” references are to the Treasury Regulations promulgated under the Code, all as in effect (or, in the case of proposed regulations that remain outstanding, as proposed) as of the date of these Comments.

3 Section 951(b) defines a “United States shareholder” as a U.S. citizen or resident, domestic partnership, domestic corporation, domestic estate, or domestic trust, as set forth in sections 957(c) and 7001(a)(30), who, under section 958, owns or is treated as owning ten percent or more of the total combined voting power of all classes of stock entitled to vote of a foreign corporation or ten percent or more of the total value of all classes of stock of the foreign corporation.


7 I.R.C. § 951A(a).

8 Id.

9 I.R.C. § 951A(b).
In accordance with the underlying policy of section 951A, a U.S. person computes a single GILTI inclusion amount by reference to all CFCs of which it is a U.S. Shareholder. However, this computation is complicated when CFC stock is owned by a domestic pass-through entity, such as a partnership or S corporation. In drafting the Proposed Regulations, Treasury and the Service weighed a spectrum of approaches to balance the underlying policy of section 951A with the reality of domestic pass-through entity ownership. At one end was the pure aggregate approach, which already applied to foreign partnerships under section 958(a)(2), and at the other end was the pure entity approach. The Proposed Regulations adopted a “hybrid” approach that would have treated a domestic partnership as an aggregate with respect to partners that were U.S. Shareholders, in the same manner as if the partnership were a foreign partnership under section 958(a)(2), but as an entity with respect to partners that were not U.S. Shareholders, and would have applied the same treatment to S corporations and their shareholders based on section 1373(a).

Instead of a hybrid approach, the Final Regulations adopt an aggregate approach for all partners (i.e., not just partners that are U.S. Shareholders). The Preamble explains that this approach treats a domestic partnership as an aggregate for purposes of determining the level (i.e., partnership or partner) at which a GILTI inclusion amount is calculated and taken into gross income by partners that are not U.S. Shareholders, by treating, for this purpose, all partners of a domestic partnership as owning proportionately the stock of CFCs owned by the partnership, in the same manner as if the partnership were a foreign partnership under section 958(a)(2). The Preamble also states that, under section 1373(a), an S corporation is treated as a partnership and its shareholders as partners for this purpose, and that, consequently, the S corporation and its shareholders are treated the same way. However, unlike the Proposed Regulations, the Final Regulations themselves do not have any examples involving S corporations, and, as noted above, the Preamble requests comments on exactly how section 1373(a) should be applied.

---

10 Id.; see Preamble, 84 Fed. Reg. at 29,315; see also Staff of S. Comm. on the Budget, 115th Cong., Reconciliation Recommendations Pursuant to H. Con. Res. 71, 371 (Comm. Print 2017), stating “[t]he Committee believes that calculating GILTI on an aggregate basis, instead of on a CFC-by-CFC basis, reflects the interconnected nature of a U.S. corporation’s global operations and is a more accurate way of determining a U.S. corporation’s global intangible income.”


12 Prop. Treas. Reg. § 1.951A-5; Preamble to the Proposed Regulations, 83 Fed. Reg. at 51,079. Under section 1373(a), an S corporation is treated as a partnership, and its shareholders are treated as partners for purposes of the foreign tax credit provisions (sections 901-909), the CFC provisions (sections 951-965), and the international boycott provision (section 999).


14 Preamble, 84 Fed. Reg. at 29,315-16.

15 Id. at 29,316.

16 See supra note 6.
We commend Treasury and the Service for their commitment to provide guidance regarding section 951A, and we respectfully request that consideration be given to the following recommendations as further guidance is developed regarding the inclusion of GILTI income of a CFC owned by an S corporation:

1. Alternative “A” takes a literal approach to section 1373(a), treating an S corporation as nothing but a conduit for its shareholders, and attempts to reconcile the aggregate approach with general subchapter K provisions.

2. Alternative “B” takes a more limited approach, and attempts to reconcile the aggregate approach with general subchapter S provisions, considering the underlying principles relating to both GILTI and S corporation income.

II. Discussion and Recommendations

As noted above, the Final Regulations adopt an aggregate approach for the purpose of determining the GILTI inclusion, by treating a domestic partnership in the same manner as a foreign partnership under section 958(a)(2). The Final Regulations explain the general rule as follows:

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).

However, the Final Regulations state that the general rule does not apply for purposes of determining whether a U.S. person is a U.S. Shareholder, whether any U.S. Shareholder is a controlling domestic shareholder (as defined in Treas. Reg. § 1.964-1(c)(5)), or whether any foreign corporation is a CFC (as defined in section 957(a)). Thus, they limit the aggregate approach to determining which taxpayer (i.e., the partnership or the partner) will calculate and report the GILTI inclusion.

---


18 Treas. Reg. § 1.951A-1(e)(1). Section 958(a)(2) treats stock owned by a foreign partnership as owned proportionately by its partners.

The Preamble explains that, under this approach, a partnership does not have a GILTI inclusion; instead, partners of a partnership who are treated as U.S. Shareholders have GILTI inclusions, while partners of the partnership who are not treated as U.S. Shareholders do not have GILTI inclusions.20

As noted above, the Preamble also explains that the same rules apply to S corporations and their shareholders based on section 1373(a).21 Accordingly, an S corporation is treated as a partnership, and, under the Final Regulations, a domestic partnership is treated as a foreign partnership. The S corporation is transparent for tax purposes (i.e., it is a pass-through), and CFC stock owned by the S corporation is treated as being owned proportionately by the S corporation shareholders. The S corporation shareholders thus calculate and report GILTI inclusions.

As noted above, however, the Preamble requests comments on exactly how section 1373(a) applies to section 951A. Despite the clarity of the general rule, we agree that additional guidance is needed, and commend Treasury and the Service for seeking more input. We believe that a significant source of uncertainty is the need for procedures to account for GILTI inclusions relating to CFCs and dividends from those CFCs in light of the general S corporation rules. There are no Treasury Regulations under section 1373(a) and little other guidance to help resolve these issues.

Specifically, the Final Regulations provide certainty regarding the limited applicability of the aggregate approach. The certainty ends, however, when considering how the general S corporation rules interact with the aggregate approach. For example, although it is clear that the GILTI inclusion is calculated and reported by the U.S. Shareholder, it is not clear what, if any, impact the GILTI inclusion has on the S corporation’s accumulated adjustment account (“AAA”) under section 1368,22 or the S corporation shareholder’s stock basis under section 1367.

Both AAA and stock basis are important in ensuring that distributions from an S corporation are taxed only once – a hallmark of S corporation taxation – but that distributions from any predecessor C corporation can be taxed again as dividends – a hallmark of C corporation taxation. Both AAA and stock basis are increased by the S corporation’s accumulated, but undistributed, net income, and thus provide a way of tracking its previously taxed income. If an S corporation is not required to maintain an AAA – because it has no earnings and profits (“E&P”) because it was not previously a C corporation and never acquired a C corporation – a distribution to a shareholder is tax-free to the extent it does not exceed the shareholder’s stock basis, and capital gain to the extent it does. If instead the S corporation has E&P and is required to maintain an AAA, it is tax-free to the extent it does not exceed the shareholder’s stock basis, and capital gain to the extent it does, but only up to the amount of the AAA balance; to the extent it

21 See supra note 15.
22 An S corporation’s AAA is a corporation-level account arising where the S corporation previously was a C corporation, or acquired a C corporation. I.R.C. § 1368(e)(1)(A). The AAA is not apportioned among the S corporation shareholders. Treas. Reg. § 1.1368-2(a)(1).
exceeds the AAA balance, it is a taxable dividend to the extent of the E&P balance that it inherited from the C corporation.

The relevance of either AAA or stock basis under the Final Regulations is unclear. Accordingly, we have included two alternatives, described below, to address this issue.

A. Alternative A

Under Alternative A, the section 1373(a) “partnership” would exist as an aggregate of the S corporation owners, whether or not such owners met the definition of a U.S. Shareholder, not only with respect to the section 951A GILTI inclusion but also with respect to any subsequent CFC dividend that was tied to that income (the “CFC Dividend”). Thus, the S corporation would not take the CFC Dividend into income, and there would be no adjustment to AAA or to the stock basis of the S corporation owners. Rather, the S corporation would be treated as holding the CFC Dividend as an agent for the section 1373(a) “partnership.”

If the S corporation distributed all or part of the CFC Dividend to its shareholders, the distribution would exist outside of the structure of the S corporation. The S corporation would merely be distributing funds to the “partnership” for which it held the CFC Dividend. Correspondingly, S corporation distributions that were not distributions of the CFC Dividend would be handled according to the usual S corporation rules, without regard to the GILTI inclusions or CFC Dividend, and without regard to whether they occurred before, during, or after either of those events. In this scenario, we recommend that Treasury and the Service allow the S corporation to use any reasonable mechanism to distinguish between the CFC Dividend distributions and normal S corporation distributions, or provide guidance on how that should be done.

On the other hand, if the S corporation did not distribute the CFC Dividend but instead applied it to the S corporation’s business, the undistributed amounts would be accounted for as pro rata contributions to the capital of the S corporation, increasing each shareholder’s basis in the stock of the S corporation, and similarly reducing whatever basis the shareholder received as a result of the GILTI inclusion (in the case of a U.S. Shareholder) or the CFC’s payment of the CFC Dividend (in the case of a non-U.S. Shareholder). We recommend that Treasury and the Service allow the S corporation to use any reasonable mechanism to distinguish between the distribution of all or part of the CFC Dividend and the S corporation’s application of the CFC Dividend to its business, or provide guidance on how that should be done.

In the common situation where the S corporation made a distribution to its shareholders for the payment of taxes associated with section 951A income, and expected to recoup it from the CFC Dividend, the tax distributions might be made without sufficient AAA or shareholder basis to avoid ordinary income tax. In such a situation, we recommend that any such tax distribution be treated as a distribution from the section

23 As used herein, the term “non-U.S. Shareholder” refers to a shareholder who does not meet the definition of a “United States shareholder” set forth in Section 951(b). See supra note 3.
1373(a) “partnership” that is financed by a loan made by the S corporation to the “partnership” against subsequent CFC Dividend distributions.

If Alternative A is adopted, we believe that the following issues also should be addressed in addition to the administrative issues noted above:

1. Will all activity between the CFC and the S corporation be traced separately – as if the CFC was owned directly by the S corporation shareholders for all purposes – including, for example, contributions to the CFC?

2. Should S corporation shareholders maintain separate bases as a result of any GILTI inclusions, and, if so, should they be in the CFC stock or in the section 1373(a) “partnership”?

B. Alternative B

Alternative A would have the virtue of clarity and consistency with section 1373(a), but – as evidenced by the recommendations for additional guidance above – it would not necessarily be easy to administer. That is primarily because Alternative A would circumvent the usual S corporation rules with respect to GILTI inclusions and CFC Dividends.

Under Alternative B, as under Alternative A, the section 1373(a) “partnership” would exist as an aggregate of the S corporation owners for purposes of determining whether such owners were U.S. Shareholders, and for determining the GILTI inclusion amount taken into gross income. However, unlike under Alternative A, under Alternative B the usual S corporation rules would apply to all distributions from the S corporation along with the receipt and subsequent distribution of any CFC Dividend.

We believe this would result in an approach that is easier to administer, both by S corporations and by the Service. We also believe it would be consistent with the Final Regulations: while they provide that the GILTI inclusion is to be calculated and reported at the U.S. Shareholder level (as opposed to the S corporation level), they also imply that the income associated with the GILTI inclusion is, for all purposes other than section 951A and its Treasury Regulations, income of the S corporation and should be treated as such under subchapter S and its Treasury Regulations. We do not believe that Alternative B will result in a second class of stock in violation of section 1361(b)(1)(D) and we recommend that if Alternative B is adopted, Treasury and the Service clarify that no violation has occurred.

Under Alternative B, the aggregate amount reported by all U.S. Shareholders as GILTI inclusions would be added to the S corporation’s AAA balance. We believe this would be critical because, as noted above, S corporations use AAA – in combination with stock basis – to keep track of previously taxed income and thus ensure a single layer of taxation – a foundational attribute of S corporation income. If the amount of each S corporation shareholder’s GILTI inclusion did not increase the S corporation’s AAA, there would be the potential for double taxation of the GILTI amount.
However, the above guidance might not be enough to avoid double-taxation of U.S. Shareholders if the S corporation also had non-U.S. Shareholders. That is because an S corporation’s AAA is an aggregate amount which is not allocated to specific shareholders. Thus, distributions to non-U.S. Shareholders could receive the benefit of some of the AAA that is attributable to GILTI inclusions even if they had no GILTI inclusions themselves, while distributions to U.S. Shareholders could lose some of that benefit. We believe that the only way to avoid that result would be to create the equivalent of a GILTI inclusion for non-U.S. Shareholders as well. Under this approach, at least if the S corporation itself was a U.S. Shareholder, the GILTI inclusion would be treated as occurring at the S corporation level and passing through to its shareholders, although solely for purposes of AAA. The latter rule would apply to all shareholders regardless of whether they had GILTI inclusions, i.e., regardless of whether they were U.S. or non-U.S. Shareholders. This would not result in a double tax benefit for non-U.S. Shareholders, but rather only an earlier adjustment than the one they would experience in any event once the CFC distributed the CFC Dividend.

Under Alternative B, if a U.S. Shareholder had a GILTI inclusion, and the S corporation later received a CFC Dividend tied to that income and distributed it to the shareholder, the usual S corporation distribution rules would be used to calculate the taxable portion of the distribution. Thus, when the CFC Dividend was received by the S corporation, it would be treated as income to the S corporation, but without further adjustment to AAA. No adjustment would be made at that time because AAA previously was adjusted (both for U.S. Shareholders and for non-U.S. Shareholders, as explained above) immediately upon inclusion of the section 951A income by the U.S. Shareholders. For income tax purposes, the S corporation would treat the CFC Dividend as exempt under section 959 as previously taxed income for U.S. Shareholders, but as taxable income for non-U.S. Shareholders. Later, when the S corporation distributed the CFC Dividend, the S corporation’s AAA would be reduced commensurately.

---

24 As the CFC distributed dividends, any shareholders who did not previously include income under section 951A, i.e., non-U.S. Shareholders, would include their portion of the dividends as taxable income. As a result, as such dividends were paid, any non-U.S. Shareholders would realign with U.S. Shareholders as to income inclusion. We recognize that certain situations might occur where AAA additions or basis adjustments have to be reversed subsequently as to the non-U.S. Shareholder’s pro rata portion of the adjustment, e.g., where an interim sale or redemption occurs after AAA and basis are adjusted, but before a corresponding dividend is distributed. We would be happy to work with Treasury and the Service to develop guidance to address these situations. 

25 The extent and timing of the stock basis adjustments resulting from these transactions are important issues on which we believe guidance is needed, under Alternative B as well as Alternative A, in order to avoid double-taxation, but they are beyond the scope of these Comments. We would be happy to work with Treasury and the Service to develop guidance on this point, with the goal of coordinating the basis adjustments under sections 1367(a)(2)(A) and 961(b), which overlap here. This guidance could provide, for example, that where the CFC made a distribution of a dividend to the S corporation, the downward basis adjustment of section 961(b) would not be made to the shareholder’s basis in his or her S corporation stock until (and then only to the extent) the S corporation distributed a dividend to its shareholders. This approach would be consistent with the discussion in Rev. Rul. 76-539, 1976-2 C.B. 232, which makes clear that the decrease in basis should not occur until the shareholder actually receives the excluded dividend. Careful coordination of other basis adjustments under sections 1367 and 961 will be required, as well. Some of these issues have been explored elsewhere, e.g., in the 2019 Comments.