Current Developments in Consolidated Returns

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Agenda

• 2018-19 Treasury/IRS Priority Guidance Plan

• Base Erosion & Anti-Abuse Tax (“BEAT”)

• Section 965 (“Transition Tax”)

• Section 168(k) (“Bonus Depreciation”)
2018-19 Treasury/IRS Priority Guidance Plan
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From the Priority Guidance Plan released November 8, 2018:

- Computational, definitional, and other guidance under new §163(j) (Proposed regulations published August 27, 2018).

- Guidance on new §168(k) (Proposed regulations published on August 8, 2018).

- Guidance implementing new §965 and other international provisions of the TCJA (Final Regulations released on January 15, 2019).

- Regulations under §1.1502-75(d) regarding group continuation.

- Final regulations under §1.1502-76 regarding when a member joins or leaves a consolidated group. (Proposed regulations published on March 6, 2015).

- Revenue Ruling amplifying Revenue Ruling 99-6 addressing intercompany sales of partnership interests.

- Regulations under §1502 and §1.1502-21(b) regarding absorption of consolidated net operating losses.
BEAT – Section 59A
BEAT – Overview

- Under new §59A(a), a minimum tax may be imposed on an **applicable taxpayer** making **base erosion payments** ("BEP") to related foreign persons and deriving **base erosion tax benefits** (e.g., deductions) in respect of such payments
  - The new tax is imposed at a 5% rate in 2018
  - Beginning in 2019, the new tax is imposed at a 10% rate
  - Beginning in 2026, the new tax is imposed at a 12.5% rate
  - Proposed Regulations introduce question whether §15 applies to fiscal-year taxpayers

- The additional tax imposed by §59A, *i.e.*, the BEAT tax liability, is equal to —
  - The percentage noted above (*i.e.*, 5, 10, or 12.5%) of the applicable taxpayer's **modified taxable income** ("MTI"); over
  - The Applicable Taxpayer's **regular tax liability** (as defined in §26(b), reduced by certain allowable credits (including foreign tax credits, but not R&D and certain other credits))

- A higher rate of tax applies where the Applicable Taxpayer is a member of an affiliated group (as defined in §1504(a)(1)) that includes a bank or a registered securities dealer

- A BEP is any amount **paid or accrued** by the taxpayer to a **foreign person** that is a **related party** of the taxpayer if:
  - a deduction is allowable for such amount (see §59A(d)(1)); or
  - such amount is in connection with the acquisition of property of a character subject to the allowance for depreciation (or amortization in lieu of depreciation) (see §59A(d)(2))
Proposed BEAT Regulations

- Proposed BEAT regulations released December 13, 2018
  - Effective for first tax year to which BEAT applies (tax years beginning after 2017)
  - If not finalized before June 23, 2019, expected to apply only to tax years ending after December 16, 2018
  - Until finalization, taxpayer may rely on proposed regulations for tax years beginning after 2017, provided taxpayer and all related parties consistently apply proposed regulations for all years that end before finalization date

- Issues not addressed in proposed regulations
  - No specific rules for BEAT purposes—
    - For determining whether a payment is a deductible payment, or, when viewed as part of a series of transactions, should be viewed in a different manner (see, e.g., principal-agent principles, reimbursement doctrine, case law conduit principles, assignment of income or other principles of generally applicable tax law)
    - For determining cost of goods sold (i.e., when BEPs are treated as included in COGS)
Proposed BEAT Regulations: Highlights

- Section 59A applied as an add on to regular tax liability (i.e., not a parallel system like repealed AMT rules)
  - MTI computation significantly clarified
    - Add-back, not re-computation of taxable income
    - Portion of NOL deduction added back to taxable income = base erosion percentage (“BE%”) for year of loss (0% for pre-2018 NOLs) × NOL absorbed in year of NOL deduction

- Favorable transition rules for post-2017 deductions of pre-2018 expenses

- To determine whether a payment is a BEP, partnership treated as aggregate of partners

- BEP can include cash, property, stock, or assumption of liabilities (including items received in non-recognition transactions)

- Combine all items of income, gain, loss, or deduction on a marked-to-market position

- Amount of BEP generally determined on gross basis

- Clarification of “services cost method exception”: the cost component of cost-plus payment for services need not be a BEP

- Regulatory exceptions to BEPs, including payments that result in ECI

- Treatment of exchange losses on §988 transactions
Applicable Taxpayer – Section 59A(e)

- Defined as a taxpayer:
  - That is a corporation other than a regulated investment company (a “RIC”), a real estate investment trust (a “REIT”), or an S corporation;
  - The **average annual gross receipts of which for the 3-taxable-year period** ending with the preceding taxable year are **at least $500,000,000**; and
  - The **BE%** (as determined under §59A(c)(4)) of which for the taxable year is **at least 3 percent** (2 percent in an instance where a bank (as defined in §581) or a registered securities dealer under §15(a) of the Securities Exchange Act of 1934 is a member of the relevant group)
    - The Proposed Regulations provide that the lower 2 percent threshold does not apply, however, in the case of an aggregate group or consolidated group that has de minimis bank or registered securities dealer activities, constituting less than 2 percent of the aggregate group’s total gross revenue.

- **Applicable Taxpayer – Aggregation rules apply:**
  - A taxpayer that is a member of an “aggregate group” determines whether it is an Applicable Taxpayer by aggregating gross receipts and its BE% on the basis of the aggregate group
  - All persons treated as a single employer under subsection (a) of §52 are treated as 1 person for purposes of this definition of Applicable Taxpayer, except that, in applying §1563 for purposes of §52, the exception for foreign corporations under §1563(b)(2)(C) is disregarded

- Pursuant to §59A(e)(3), the BE% of the Applicable Taxpayer is computed on the basis of the same aggregate group of corporations

- Prop. Reg. §1.59A-2(c) provides that these tests are applied on the basis of the members in the aggregate group **as of the end of the taxable year**
**Applicable Taxpayer: Aggregation Rules**

- Applicable Taxpayer excludes foreign corporations except with regard to ECI (unless not included in treaty net taxable income)
  - Generally, transactions between members of the Applicable Taxpayer are **not** taken into account
  - If aggregate group member is a foreign corporation transactions related to ECI or computation of net taxable income under a treaty are disregarded

- A consolidated group is treated as a single member of an aggregate group for purposes of the Aggregation Rule

- If a person is a related party with respect to **any** member of a consolidated group, that person is a related party of the group and of **each** of its members (see Prop. Treas. Reg. §1.1502-59A(b)(3))
Proposed BEAT Regulations: Consolidated Return Implications

- Under Prop. Treas. Reg. §1.1502-59A(b), the new tax under §59A is determined on a consolidated group basis, rather than determined separately for each member of the group.
  - Members’ deductions are aggregated in making the required computations under §59A.
  - This single taxpayer treatment for members of a consolidated group applies separately from the aggregate group concept in Prop. Treas. Reg. §1.59A-2(c), which also treats all members of the aggregate group as a single entity, but, in that case, only for purposes of applying the gross receipts test and BE% test for determining Applicable Taxpayer.

- Items from intercompany transactions are not taken into account for purposes of making the computations under §59A.
  - Intercompany items resulting from intercompany transactions (defined in Treas. Reg. §1.1502-13(b)(1)(i)) are disregarded for BEAT calculation purposes (e.g., additional depreciation deductions resulting from intercompany asset sales are not taken into account for purposes of applying the BE% test under §1.59A-2(e), interest payments on intercompany obligations (as defined in Treas. Reg. §1.1502-13(g)(2)(ii)) would not be taken into account).
  - This departure from basic -13 principles may result in distortions.
    - For example, if one member of a group purchases depreciable property from a foreign related party and sells that property to another member of the group, are the depreciation deductions with respect to the property a BEP?
• **Transition Rule:** If, during calendar year 2018, a corporation (S) joins a consolidated group during a consolidated return year beginning before January 1, 2018, the proposed regulations would provide that §59A would **not** apply to S’s short taxable year that is included in the group’s consolidated return year, even though S’s short taxable year begins after December 31, 2017. See Prop. Treas. Reg. §1.1502-59A(g)(2).

• The Proposed Regulations would amend Treas. Reg. §1.1502-2 to include a reference to the BEAT as a tax included in the computation of consolidated tax liability.
  – Allocation of the BEAT to members of the consolidated group is determined under §1552.
The Proposed Regulations would provide that any disallowed disqualified interest under former §163(j) that resulted from a payment or accrual to a foreign related party and that is carried forward from a taxable year beginning before January 1, 2018, is not a base erosion payment. See Prop. Treas. Reg. §1.59A-3(b)(3)(vii).

Section 59A(c)(3) and proposed §1.59A-3(c)(4) coordinate §163(j) with the determination of the amount of base erosion tax benefits when business interest expense (“BIE”) is paid to both unrelated parties and related parties. Those rules provide that, where §163(j) applies to limit the amount of business interest that is deductible in a taxable year, all disallowed business interest is allocable first to interest to unrelated parties and then to related parties.

Prop. Reg. §1.1502-59A(c) contains extensive rules to coordinate the proposed consolidated BEAT regulations with the recently proposed consolidated §163(j) regulations.

The classification rule in Prop. Reg. §1.1502-59A(c)(3) determines whether the consolidated group’s §163(j) interest deduction is a base erosion tax benefit. Classification rules apply on a year-by-year basis.

To the extent the consolidated group’s BIE for the current year is permitted as a deduction under §163(j)(1) in that year, the deduction is:

- first classified as from BIE paid/accrued for that year to a foreign related party and from BIE paid/accrued to a domestic related party, on a pro rata basis,
- then as BIE paid/accrued to an unrelated party.

Once the consolidated BIE has been allocated among related party and unrelated party interest then such amounts must be allocated pro rata to the group members that have current year BIE deductions in proportion to their BIE deductions pursuant to Prop. Reg. §1.1502-59A(c)(4).

This allocation can result in a treatment that differs from actual interest payments.
• If the group's aggregate current year BIE exceeds its §163(j) limitation, Prop. Reg. §1.1502-59A(c)(5) provides for an allocation of any remaining domestic related current year BIE, foreign related current year BIE, and unrelated current year BIE pro rata to the members.
  – The amount of domestic related BIE carryforward status equals the group’s domestic related BIE carryforward from that year multiplied by the percentage of disallowed BIE carryforward allocable to that member.
  – The amount of foreign related BIE carryforward status equals the group’s foreign related BIE carryforward from that year multiplied by the percentage of disallowed BIE carryforward allocable to that member.
  – Any excess of the member’s disallowed BIE carryforward is treated as from payments or accruals to an unrelated party.
  – This allocation can result in a treatment that differs from actual interest payments.

• When a member departs a group or its assets are acquired in a §381(a) transaction (such as reorganization or liquidation) member’s §163(j) disallowed BIE carryforwards retain their allocated status (i.e., as domestic related BIE carryforward, foreign related BIE carryforward, or unrelated BIE carryforward, as applicable (Prop. Reg. §1.1502-59A(c)(5)(v), (c)(6))).
  – The status of the SRLY disallowed BIE carryforward is taken into account in determining the acquiring group’s base erosion tax benefit when absorbed in the acquiring group (Prop. Reg. §1.1502-59A(c)(7)).
  – There is no coordination with the Treas. Reg. §1.1502-36(d) attribute reduction rules (i.e., if disallowed BIE carryforwards are reduced, may foreign related BIE carryforwards be reduced first?).
**Facts:**

- Foreign corporation (FP) wholly owns domestic corporation (P), which in turn wholly owns S1 and S2.
- P, S1, and S2 are members of a consolidated group.
- The consolidated group is a calendar year taxpayer.
- The members of the consolidated group have never engaged in intercompany transactions.
- For the 2019 taxable year, P, S1, and S2 were permitted the following amounts of deductions (within the meaning of §59A(c)(4)): $2,400x, $1,000x, and $2,600x, respectively. Such deductions for P, S1, and S2 include base erosion tax benefits of $180x, $370x, and $230x, respectively.
- The group’s consolidated taxable income for the year is $150x.
- In addition, the group satisfies the gross receipts test in §1.59A-2(d).
Analysis:

- Pursuant to §1.1502-59A(b), the receipts and deductions of P, S1, and S2 are aggregated for purposes of making the computations under §59A.
- The group’s BE% is 13% \(((180x + 370x + 230x)/(2,400x + 1,000x + 2,600x))\).
- The consolidated group is an applicable taxpayer under §1.59A-2(b) because the group satisfies the gross receipts test and the group’s BE% (13%) is higher than 3%.
- The consolidated group’s MTI is computed by adding back the members’ base erosion tax benefits (and, when the consolidated group has consolidated net operating loss available for deduction, the consolidated net operating loss allowed times BE%) to the consolidated taxable income of $150x, $930x ($150x + $180x + $370x + $230x).
- The group’s base erosion minimum tax amount is then computed as 10 percent of the MTI less the regular tax liability, $61.5x [(930x × 10%) – (150x × 21%)].
Facts:
• The facts are the same as in the facts in Example 1(i), except that S1 sold various inventory items to S2 during 2019.
• Such items are depreciable in the hands of S2 (but would not have been depreciable in the hands of S1) and continued to be owned by S2 during 2019.

Analysis:
• The result is the same as Example 1(i).
• Pursuant to §1.1502-59A(b)(2), items resulting from the intercompany sale (for example, gross receipts, depreciation deductions) are not taken into account in computing the group’s gross receipts under §1.59A-2(d) and BE% under §1.59A-2(e)(3).
• Further, items resulting from the intercompany sale (i.e., the depreciation deductions) are disregarded for purposes of the computations of tax under §59A(a).
Facts:

- Foreign corporation (FP) wholly owns domestic corporation (P), which in turn wholly owns S1 and S2.
- P, S1, and S2 are members of a consolidated group.
- The consolidated group is a calendar year taxpayer.
- During the current year (Year 1):
  - P incurred $150x of BIE to domestic related parties;
  - S1 incurred $150x of BIE to foreign related parties;
  - and S2 incurred $150x of BIE to unrelated parties.
- The group’s §163(j) limitation for the year is $300x.
- After applying the rules in §1.163(j)-5(b)(3), the group deducts $150x of P’s Year 1 BIE, and $75x each of S1 and S2’s Year 1 BIE.
- Assume the group is an applicable taxpayer for purposes of §59A.
Analysis:

- **Application of the absorption rule in §1.1502-59A(c)(2)**
  - Following the rules in §163(j), the group’s §163(j) interest deduction for Year 1 is $300x, and the entire amount is from members’ Year 1 BIE.

- **Application of the classification rule in §1.1502-59A(c)(3)**
  - Under §1.1502-59A(c)(3), the group’s aggregate current year BIE deduction of $300x is first classified as payments or accruals to related parties (pro-rata among domestic related parties and foreign related parties), and second as payments or accruals to unrelated parties.
  - For Year 1, the group has $150x of domestic related current year BIE and $150x of foreign related current year BIE, and the group’s aggregate current year BIE deduction will be classified equally among the related party expenses.
  - Therefore, $150x of the group’s deduction is classified as domestic related current year BIE deduction and $150x is classified as a foreign related current year BIE deduction.

- **Application of the allocation rule in §1.1502-59A(c)(4)**
  - After the application of the classification rule in §1.1502-59A(c)(3), the group has $150x each of domestic related current year BIE deduction and foreign related current year BIE deduction from the group’s aggregate current year BIE in Year 1.
• Application of the allocation rule in §1.1502-59A(c)(4) (cont.)
  – The domestic related current year BIE deduction and foreign related current year BIE deduction will be allocated to P, S1, and S2 based on each member’s deduction of its Year 1 BIE.
  – **Allocations to P**
    • The percentage of current year BIE deduction attributable to P is 50% (P’s deduction of its Year 1 current year BIE, $150x, divided by the group’s aggregate current year BIE deduction for Year 1, $300x).
    • Thus, the amount of domestic related current year BIE deduction status allocated to P is $75x (the group’s domestic related current year BIE deduction, $150x, multiplied by the percentage of current year BIE deduction allocable to P, 50%); and the amount of foreign related current year BIE deduction status allocated to P is $75x (the group’s foreign related current year BIE deduction, $150x, multiplied by the percentage of current year BIE deduction allocable to P, 50%).
  – **Allocations to S1 and S2**
    • The percentage of current year BIE deduction attributable to S1 is 25% (S1’s deduction of its Year 1 current year BIE, $75x, divided by the group’s aggregate current year BIE deduction for Year 1, $300x).
Analysis (cont.):

- **Application of the allocation rule in §1.1502-59A(c)(4) (cont.)**
  - **Allocations to S1 and S2 (cont.)**
    - Thus, the amount of domestic related current year BIE deduction status allocated to S1 is $37.5x (the group’s domestic related current year BIE deduction, $150x, multiplied by the percentage of current year BIE deduction allocable to S1, 25%); and the amount of foreign related current year BIE deduction status allocated to S1 is $37.5x (the group’s foreign related current year BIE deduction, $150x, multiplied by the percentage of current year BIE deduction allocable to S1, 25%).
    - Because S2 also deducted $75 of its Year 1 current year BIE, S2’s deductions are allocated the same pro-rata status as those of S1 under §1.1502-59A(f)(2)(ii)(C)(2).
  - **Application of the allocation rule in §1.1502-59A(c)(5)**
    - Although the group will have disallowed BIE carryforwards after Year 1 (the group’s aggregate current year BIE of $450x ($150x + $150x + $150x) exceeds the §163(j) limitation of $300x), all of the domestic related current year BIE and foreign related current year BIE in Year 1 has been taken into account pursuant to the classification rule in §1.1502-59A(c)(3).
    - Thus, under §1.1502-59A(c)(5)(iv), each member’s disallowed BIE carryforward is treated as from payments or accruals to unrelated parties.
Facts:
- Foreign corporation (FP) wholly owns domestic corporation (P), which in turn wholly owns S1 and S2.
- P, S1, and S2 are members of a consolidated group.
- The consolidated group is a calendar year taxpayer.
- During the current year (Year 1), P incurred $60x of BIE to domestic related parties; S1 incurred $40x of BIE to foreign related parties; and S2 incurred $80x of BIE to unrelated parties.
- The group’s §163(j) limitation for the year is $60x.
- After applying the rules in §1.163(j)-5(b)(3), the group deducts $20x each of P, S1, and S2’s current year BIE.
- Assume the group is an applicable taxpayer for purposes of §59A.
Analysis:

- **Application of the absorption rule in §1.1502-59A(c)(2)**
  - Following the rules in §163(j), the group’s §163(j) interest deduction is $60x, and the entire amount is from members’ Year 1 BIE.

- **Application of the classification rule in §1.1502-59A(c)(3)**
  - Under §1.1502-59A(c)(3), the group’s $60x of aggregate current year BIE deduction is first classified as payments or accruals to related parties (pro-rata among domestic related parties and foreign related parties), and second as payments or accruals from unrelated parties.
  - The group’s total related party interest expense in Year 1, $100x (sum of the group’s Year 1 domestic related current year BIE, $60x, and the group’s Year 1 foreign related current year BIE, $40x), exceeds the group’s aggregate current year BIE deduction of $60x.
  - Thus, the group’s aggregate current year BIE deduction will be classified, pro-rata, as from payments or accruals to domestic related parties and foreign related parties.
Analysis (cont.):

- **Application of the classification rule in §1.1502-59A(c)(3) (cont.)**
  - Of the group’s aggregate current year BIE deduction in Year 1, $36x is classified as a domestic related current year BIE deduction (the group’s aggregate current year BIE deduction, $60x, multiplied by the ratio of domestic related current year BIE over the group’s total Year 1 related party interest expense ($60x / ($60x+$40x))); and $24x of the group’s aggregate current year BIE deduction is classified as a foreign related current year BIE deduction (the group’s §163(j) interest deduction, $60x, multiplied by the ratio of foreign related current year BIE over the group’s total Year 1 related party interest expense ($40x / ($60x+$40x))).

- **Application of the allocation rule in §1.1502-59A(c)(4)**
  - After the application of the classification rule in §1.1502-59A(c)(3), the group has $36x of domestic related current year BIE deduction and $24x of foreign related current year BIE deduction from the group’s aggregate current year BIE in Year 1.
  - The domestic related current year BIE deduction and foreign related current year BIE deduction will be allocated to P, S1, and S2 based on each member’s current year BIE deduction in Year 1.
  - **Allocation of the group’s domestic related current year BIE deduction status**
    - Because each member is deducting $20x of its Year 1 business interest expense, all three members have the same percentage of current year BIE deduction attributable to them.
Analysis (cont.):

- **Allocations of the group’s foreign related current year BIE deduction status (cont.)**
  - The percentage of current year BIE deduction attributable to each of P, S1, and S2 is 33.33% (each member’s current year BIE deduction in Year 1, $20x, divided by the group’s aggregate current year BIE deduction for Year 1, $60x).
  - Thus, the amount of domestic related current year BIE deduction status allocable to each member is $12x (the group’s domestic related current year BIE deduction, $36x, multiplied by the percentage of current year BIE deduction allocable to each member, 33.33%).
  - The amount of foreign related current year BIE deduction status allocable to each member is $8x (the group’s foreign related current year BIE deduction, $24x, multiplied by the percentage of current year BIE deduction allocable to each member, 33.33%, as computed earlier in §1.1502-59A(f)(3) (Example 3).

- **Application of the allocation rule in §1.1502-59A(c)(5)**
  - In Year 1 the group has $60x of domestic related current year BIE, of which $36x is deducted in the year (by operation of the classification rule).
  - Therefore, the group has $24x of domestic related BIE carryforward.
Analysis (cont.):

- Application of the allocation rule in §1.1502-59A(c)(5) (cont.)
  
  - Similarly, the group has $40x of foreign related current year BIE in Year 1, of which $24x is deducted in the year.
  
  - Therefore, the group has $16x of foreign related BIE carryforward.
  
  - The $24x domestic related BIE carryforward status and $16x foreign related BIE carryforward status will be allocated to P, S1, and S2 in proportion to the amount of each member’s disallowed BIE carryforward.
  
  - Allocation to P
    
    - The percentage of disallowed BIE carryforward allocable to P is 33.33% (P’s Year 1 disallowed BIE carryforward, $40x ($60x-$20x), divided by the group’s Year 1 disallowed BIE carryforward, $120x ($60x + $40x + 80x - $60x)).
    
    - Thus, the amount of domestic related BIE carryforward status allocated to P is $8x (the group’s domestic related BIE carryforward, $24x, multiplied by the percentage of disallowed BIE carryforward allocable to P, 33.33%); and the amount of foreign related BIE carryforward status allocated to P is $5.33x (the group’s foreign related BIE carryforward, $16x, multiplied by the percentage of disallowed BIE carryforward allocable to P, 33.33%).
    
    - Under §1.1502-59A(c)(5)(iv), P’s disallowed BIE carryforward that has not been allocated a status as either a domestic related BIE carryforward or a foreign related BIE carryforward will be treated as interest paid or accrued to an unrelated party.
Analysis (cont.):

• Application of the allocation rule in §1.1502-59A(c)(5) (cont.)
  – Allocation to P (cont.)
    • Therefore, $26.67x ($40x P’s disallowed BIE carryforward - $8x domestic related BIE carryforward status allocated to P - $5.33x foreign related BIE carryforward status allocated to P) is treated as interest paid or accrued to an unrelated party.
  – Allocation to S1
    • The percentage of disallowed BIE carryforward allocable to S1 is 16.67% (S1’s Year 1 disallowed BIE carryforward, $20x ($40x - $20x), divided by the group’s Year 1 disallowed BIE carryforward, $120x ($60x + $40x + 80x - $60x).
    • Thus, the amount of domestic related BIE carryforward status allocated to S1 is $4x (the group’s domestic related BIE carryforward, $24x, multiplied by the percentage of disallowed BIE carryforward allocable to S1, 16.67%); and the amount of foreign related BIE carryforward status allocated to S1 is $2.67x (the group’s foreign related BIE carryforward, $16x, multiplied by the percentage of disallowed BIE carryforward allocable to S1, 16.67%).
    • Under §1.1502-59A(c)(5)(iv), S1’s disallowed BIE that has not been allocated a status as either a domestic related BIE carryforward or a foreign related BIE carryforward will be treated as interest paid or accrued to an unrelated party.
    • Therefore, $13.33x ($20x S1’s disallowed BIE carryforward - $4x domestic related BIE carryforward status allocated to S1 - $2.67x foreign related BIE carryforward status allocated to S1) is treated as interest paid or accrued to an unrelated party.
Analysis (cont.):

• Application of the allocation rule in §1.1502-59A(c)(5) (cont.)
  
  - Allocation to S2

  • The percentage of disallowed BIE carryforward allocable to S2 is 50% (S2’s Year 1 disallowed BIE carryforward, $60x ($80x-$20x), divided by the group’s Year 1 disallowed BIE carryforward, $120x ($60x+$40x+$80x-$60x)).
  
  • Thus, the amount of domestic related BIE carryforward status allocated to S2 is $12x (the group’s domestic related BIE carryforward, $24x, multiplied by the percentage of disallowed BIE carryforward allocable to S2, 50%); and the amount of foreign related BIE carryforward status allocated to S2 is $8x (the group’s foreign related BIE carryforward, $16x, multiplied by the percentage of disallowed BIE carryforward allocable to S2, 50%).
  
  • Under §1.1502-59A(c)(5)(iv), S2’s disallowed BIE that has not been allocated a status as either a domestic related BIE carryforward or a foreign related BIE carryforward will be treated as interest paid or accrued to an unrelated party.
  
  • Therefore, $40x ($60x S2’s disallowed BIE carryforward - $12x domestic related BIE carryforward status allocated to S2 - $8x foreign related BIE carryforward status allocated to S2) is treated as interest paid or accrued to an unrelated party.
Facts:

- The facts are the same as in §1.1502-59A(f)(3)(i)(A) (the facts in Example 3(i)), and in addition, none of the members incurs any BIE in Year 2.
- The group’s §163(j) limitation for Year 2 is $30x.

Analysis:

- Application of the absorption rule in §1.1502-59A(c)(2)
  - Following the rules in §163(j), each member of the group is deducting $10x of its disallowed BIE carryforward from Year 1.
  - Therefore, the group’s §163(j) deduction for Year 2 is $30x.
Analysis (cont.):

- Application of the classification rule in §1.1502-59A(c)(3)

  - Under §1.1502-59A(c)(3)(iv), to the extent members are deducting their Year 1 disallowed BIE carryforward in Year 2, the classification rule will apply to the deduction in Year 2 after the allocation rule in §1.1502-59A(c)(5) has allocated the related and unrelated party status to the member’s disallowed BIE carryforward in Year 1.

  - The allocation required under §1.1502-59A(c)(5) is described in §1.1502-59A(f)(3)(i)(B)(4).

  - Use of P’s allocated domestic related BIE carryforward status and foreign related BIE carryforward status

    - P has $40x of Year 1 disallowed BIE carryforward, and P was allocated $8x of domestic related BIE carryforward status and $5.33x of foreign related BIE carryforward status.
    - In Year 2, P deducts $10x of its Year 1 disallowed BIE carryforward.
    - Under the classification rule of §1.1502-59A(c)(3), P is treated as deducting pro-rata from its allocated status of domestic related BIE carryforward and foreign related BIE carryforward.
    - Therefore, P is treated as deducting $6x of its allocated domestic related BIE carryforward ($10x × $8x / ($8x + $5.33x)), and $4x of its allocated foreign related BIE carryforward ($10x × $5.33x / $8x + $5.33x)).
Analysis (cont.):

- **Application of the classification rule in §1.1502-59A(c)(3) (cont.)**
  - **Use of P’s allocated domestic related BIE carryforward status and foreign related BIE carryforward status (cont.)**
    - After Year 2, P has remaining $30x of Year 1 disallowed BIE carryforward, of which $2x has a status of domestic related BIE carryforward, $1.33x has the status of foreign related BIE carryforward, and $26.67x of interest treated as paid or accrued to unrelated parties.
  - **Use of S1’s allocated domestic related BIE carryforward status and foreign related BIE carryforward status**
    - S1 has $20x of Year 1 disallowed BIE carryforward, and S1 was allocated $4x of domestic related BIE carryforward status and $2.67x of foreign related BIE carryforward status.
    - In Year 2, S2 deducts $10x of its Year 1 disallowed BIE carryforward.
    - Because S2’s deduction of its Year 1 disallowed BIE carryforward, $10x, exceeds its allocated domestic related BIE carryforward status ($4x) and foreign related BIE carryforward status ($2.67x), all of the allocated related party status are used up.
    - After Year 2, all of S1’s Year 1 disallowed BIE carryforward, $10x, is treated as interest paid or accrued to an unrelated party.
Analysis (cont.):
- Application of the classification rule in §1.1502-59A(c)(3) (cont.)
  - Use of S2's allocated domestic related BIE carryforward status and foreign related BIE carryforward status
    - S2 has $60x of Year 1 disallowed BIE carryforward, and S2 was allocated $12x of domestic related BIE carryforward status and $8x of foreign related BIE carryforward status.
    - In Year 2, S2 deducts $10x of its Year 1 disallowed BIE carryforward.
    - Under the classification rule of §1.1502-59A(c)(3), S2 is treated as deducting $6x of its allocated domestic related BIE carryforward ($10x × $12x / ($12x + $8x)), and $4x of its allocated foreign related BIE carryforward ($10x × $8x / $8x + $12x)).
    - After Year 2, P has remaining $50x of Year 1 disallowed BIE carryforward, of which $6x has a status of domestic related BIE carryforward, $4x has the status of foreign related BIE carryforward, and $40x of interest treated as paid or accrued to unrelated parties.
Section 965 (Transition Tax)
Transition Tax – In General

- Section 965(a) imposes a tax on a U.S. shareholder's pro rata share of certain foreign subsidiaries' accumulated post-1986 deferred foreign income (i.e., previously untaxed foreign earnings), as of November 2, 2017, or December 31, 2017, whichever is higher.
  - Applies to earnings of a specified foreign corporation (“SFC”), i.e., a CFC or foreign corporation at least 10 percent owned by a U.S. corporation, that has positive accumulated post-1986 deferred foreign income (a deferred foreign income corporation or “DFIC”).
  - Treats the U.S. shareholder's inclusion amount as additional subpart F income.

- Inclusion may be reduced by E&P deficits (“specified E&P deficits”) of certain other foreign corporations (an E&P deficit foreign corporation or “EDFC”). See §965(b).

- A U.S. shareholder of a DFIC is entitled to a participation deduction to arrive at a tax rate of 8 or 15.5 percent, depending on the U.S. shareholder’s “aggregate foreign cash position.” See §965(c)(1).

- A taxpayer may make an election under §965(h) to pay the transition tax over a period of eight (8) years, subject to acceleration on specified events.

- Positive foreign E&P amounts are included in the U.S. shareholder’s subpart F income and are treated as previously taxed income (“PTI”) (i.e., will not be taxed upon distribution). See §§951(a)(1), 959.
  - A §958(a) U.S. shareholder’s basis in the stock of a DFIC is increased by the §965(a) inclusion amount. See §961(a); Treas. Reg. §1.965-2(e)(1).
  - Upon distribution of PTI, a §958(a) U.S. shareholder’s basis in the stock of a DFIC is decreased by the amount distributed. See §961(b)(1).
• **Allocation of aggregate foreign E&P deficit:**
  - The aggregate foreign E&P deficit of any U.S. shareholder is allocated among the shareholder’s DFICs in proportion to the shareholder’s pro rata shares of the accumulated post-1986 deferred foreign income of each DFIC. See §965(b)(2).
    - A shareholder’s aggregate foreign E&P deficit equals the smaller of –
      - The sum of the shareholder’s pro rata shares of the specified E&P deficits; or
      - The sum of the shareholder’s pro rata shares of the accumulated post-1986 foreign income of all DFICs. See §965(b)(3)(A)(i).
    - The pro rata share of a corporation’s deficit is determined by allocating the deficit among common shareholders of the corporation in proportion to the value of their common stock held on the last day of the corporation’s last taxable year that begins before January 1, 2018. See §1.965-1(f)(30)(ii).
  - To the extent a U.S. shareholder has reduced its share of DFIC income because of an allocable E&P foreign deficit, the reduction is treated as an amount that was included in income under §951(a) and as previously taxed E&P in applying §959. See §965(b)(4)(A).
    - To the extent attributable to that reduction, the shareholder’s pro rata share of the E&P of any E&P deficit foreign corporation is increased. See §965(b)(4)(B).
Transition Tax – In General (cont.)

- Proposed regulations under §965 were published on August 9, 2018.
  - The proposed regulations included guidance on the application of §965 to consolidated groups.
  - Notice 2018-78 (issued on October 1, 2018) included further guidance on the proposed regulations – e.g., excluding certain items in determining aggregate foreign cash position on a consolidated basis under Prop. Treas. Reg. §1.965-3(b) (generally, certain SFC-to-SFC loans and items that result in double counting).

- Guidance on §965 reporting is available on the IRS’s Section 965/Transition Tax FAQ webpage.

- Proposed §965 regulations were released as final on January 15, 2019, generally consistent with the proposal.

- Key consolidated return considerations under §965 regulations:
  - For a U.S. shareholder, the amount of the §965(a) inclusion (and the participation exemption under §965(c)) may differ depending on whether the U.S. shareholder is (i) a member of an affiliated, non-consolidated group, (ii) a member of a consolidated group, or (iii) filing on a stand-alone basis.
  - Investment adjustment rules and E&P adjustments apply to consolidated groups to account for the §965(a) inclusion and the participation exemption.
  - The election to defer transition tax is subject to procedural rules and acceleration rules, with specific application to consolidated groups.
Transition Tax – Stock Basis Adjustments

• The final regulations adopt without significant changes stock basis rules that were included in the proposed regulations as well as the general approach to the application of §965 to consolidated groups.

• **Default Rule**
  – A U.S. shareholder of a DFIC generally increases the adjusted basis in its DFIC stock by an amount equal to its §965(a) inclusion amount. See Prop. Reg. §1.965-2(e).
  – Absent an election, there is no reduction in the basis of an EDFC.

  – At the election of the U.S. shareholder, the following additional adjustments are made with respect to each DFIC and each EDFC in which it owns stock within the meaning of §958(a):
    • Adjusted basis in DFIC stock **increased** by the amount of §965(b) PTI created with respect to that U.S. shareholder.
    • Adjusted basis in EDFC stock **reduced** by the U.S. shareholder's pro rata share of the EDFC's specified E&P deficit taken into account under §965(b).
  – If the basis reduction in the stock of an EDFC exceeds the U.S. shareholder's adjusted basis in stock (or applicable property), the excess is treated as gain from the sale or exchange of property.
  – A single net adjustment is made if multiple adjustments are required on the same day.
  – Consistent elections are required to be made by related parties. The final regulations provide guidance on the form and timely filing of this election. See Treas. Reg. §1.965-2(f)(2)(iii)(B).
Section 965(a) Inclusion and Stock Basis Adjustments: Example 1

Facts:
- USP has a §965(a) inclusion of $20, due to F2's E&P of $100, as reduced by F1's E&P deficit of $80.

Analysis:
- F2 stock
  - Required Adjustment: $20 basis increase.
  - Elective Adjustment: $80 basis increase equal to §965(b) PTI.
- F1 stock
  - Required Adjustment: $0
  - Elective Adjustment: ($80) basis decrease equal to $80 E&P deficit taken into account under §965(b).
    - Sale or exchange gain to the extent decrease exceeds pre-adjustment basis.
Transition Tax – Rules for Consolidated Groups

• **General Approach:** The §958(a) U.S. shareholders in a consolidated group are treated as a single U.S. shareholder, with E&P deficits netted against E&P at the SFC level before being allocated to consolidated group members.
  – In general, all members of a consolidated group that are §958(a) U.S. shareholders of an SFC are treated as a single §958(a) U.S. shareholder for purposes of §965(b) and §965(c). See Treas. Reg. §1.965-1(b)(2); Treas. Reg. §1.965-8(e)(1).

• All members of a consolidated group are treated as a single person for purposes of §965(h) (discussed below), (k) (extended statute of limitations), **and** (n) (the election to forgo the use of NOLs). See Treas. Reg. §1.965-8(e)(1).

• Members are **not** treated as a single §958(a) U.S. shareholder or as a single person, as applicable, for any other purpose, including:
  – To determine a member's inclusion under §951 (including the §965(a) inclusion) and foreign taxes deemed paid. See Prop. Treas. Reg. §1.965-8(e)(2).
Transition Tax – Rules for Consolidated Groups (cont.)

• For purposes of determining the §965(c) deduction amount of any §958(a) U.S. shareholder that is a member of a consolidated group, the aggregate foreign cash position of the §958(a) U.S. shareholder is equal to that member's §965(a) inclusion amount multiplied by the **group's cash ratio**. See Treas. Reg. §1.965-8(e)(3).
  
  The **group's cash ratio** is the ratio of (i) the consolidated group's aggregate foreign cash position (determined by treating each member of the consolidated group that is a §958(a) U.S. shareholder as a single §958(a) U.S. shareholder) to (ii) the sum of the aggregate §965(a) inclusion amounts for all of its members. See Treas. Reg. §§1.965-8(f)(4) and (f)(8).

• E&P adjustments are made under Treas. Reg. §1.1502-33(d)(1) and stock basis adjustments are made under Treas. Reg. §1.1502-32(b)(3). See Treas. Reg. §1.965-8(d)(2).
Facts:
- USP is the common parent of an affiliated, consolidated group that includes S1, S2, and S3, each of which is wholly owned by USP.
- S1 wholly owns F1 and F2; S2 wholly owns F3; and S3 wholly owns F4.
- Each of F1, F2, F3, and F4 are foreign corporations that are not PFICs.
- F1 and F3 are DFICs with $600 and $300 of §965 earnings amounts, and cash positions of $0 and $50, respectively.
- F2 and F4 are EDFCs with ($400) and ($100) of specified E&P deficits, and cash positions of $100 and $50, respectively.
Section 965(a) Consolidated Group: Example 2 (Treas. Reg. §1.965-8(g)(2) Example 2)

- S1 and S2 increase their stock bases in F1 and F3, respectively, by the §965(a) inclusion amount.
- USP increases its S1 and S2 stock bases by the §965(a) inclusion amount for each corporation.
  - Those bases should not be reduced by the §965(c) deduction. See §1.1502-32(b)(3)(ii)(B).
  - Absent an election, no stock basis adjustments are made to account for §965(b). Thus, USP does not adjust its S2 stock basis to account for §965.

<table>
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<tr>
<th>Separate Inclusion Amount</th>
<th>Deficit Allocation</th>
<th>Inclusion After Deficit Allocation</th>
<th>§ 965(c) Deduction***</th>
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<tr>
<td>S1 $600</td>
<td>($333.33)</td>
<td>$266.67</td>
<td>$177.14*</td>
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<tr>
<td>S2 $300</td>
<td>($166.67)</td>
<td>$133.33</td>
<td>$88.56**</td>
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<tr>
<td>S3 NA – EDFC</td>
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<tr>
<td>Total $900</td>
<td>($500)</td>
<td>$400</td>
<td>$265.70</td>
</tr>
</tbody>
</table>

* $177.14 = ($133.33 x (19.5/35)) + ($133.33 x (27/35))
** $88.56 = ($66.67 x (19.5/35)) + ($66.67 x (27/35))
*** Group Cash Ratio: $200/$400 = 50%
Section 965(a) Consolidated Group: Example 2 (Treas. Reg. §1.965-8(g)(2) Example 2) - Expanded

**Analysis:**

- If the USP group makes the election under Prop. §1.965-2(f)(2) –
  - S1’s F1 stock basis is increased by $600, the amount under the general rule increased by F1’s allocable share of the aggregate §965(b) amount;  
  - S1’s F2 stock basis is reduced by $400, S1’s share of F2’s specified E&P deficit taken into account under §965(b);  
  - S2’s F3 stock basis is increased by $300, the amount under the general rule increased by S2’s allocable share of the aggregate §965(b) amount; and  
  - S3’s F4 stock basis is reduced by $100, S3’s share of F4’s specified E&P deficit taken into account under §965(b).

- With that election, USP adjusts its subsidiary stock bases as follows:
  - The S1 stock basis increases by $200 ($267 for the §965(a) inclusion amount, plus $333 for S1’s F1 stock basis increase, minus $400 for S1’s F2 stock basis reduction);  
  - The S2 stock basis increases by $300 ($133 for the §965(a) inclusion amount, plus $167 for S2’s F3 stock basis increase); and  
  - The S3 stock basis decreases by $100 (for S3’s F4 stock basis reduction).

- §1.1502-32(b)(3)(ii)(B) and (iii)(B). Thus, the basis adjustments are made in the same manner as if each subsidiary took its share of §965(a) earnings and specified E&P deficits into account as income and loss.
Final Regulations: Separate vs. Single Entity Treatment

- Treasury and the IRS rejected various comments requesting broader single entity treatment for:
  - Computing the foreign taxes deemed paid with request to a §965(a) inclusion.
  - Applying the special “netting rule” in Treas. Reg. §1.965-3(b)(i) for various receivables and payables held by specified foreign corporations of a §965(a) U.S. shareholder.
  - Applying the anti-abuse rule of Treas. Reg. §1.965-4(b).
  - Determining the aggregate foreign cash position of each member of an affiliated group that does not file a consolidated U.S. federal income tax return.

- Treasury did adopt a comment to determine consolidated group aggregate foreign cash position as if all members of a consolidated group that are §958(a) U.S. shareholders of a specified foreign corporation were a single §958(a) U.S. shareholder.
Deferred Payment of Section 965(h) Net Tax Liability

• **Context:**
  – Section 965(h) provides an election to pay the §965(h) net tax liability in **eight** annual, graduated installments. See Treas. Reg. §1.965-7(b)(2) and Notice 2018-26 (election requirements).
  – All members of a consolidated group are treated as a single person for purposes of §965(h). Thus, for example, any election governed by §965(h) and Treas. Reg. §1.965-7(b) must be made by the agent (within the meaning of Treas. Reg. §1.1502-77) of the consolidated group on behalf of all members of the consolidated group.

• **Key Considerations:**
  – Acceleration events in regulations that trigger total, unpaid transition tax broader than statutory language.
  – Only certain acceleration events may be postponed by a transfer agreement (for **covered acceleration events**).
  – Final regulations expand scope of covered acceleration events.
  – Transfer agreement must be timely executed by the appropriate parties (using Treas. Reg. §1.1502-77 agency rules).
  – Guidance on §965 reporting (including transfer agreement) is available on the IRS’s Section 965/Transition Tax FAQ webpage.
Acceleration Events

• **Acceleration rule**: Remaining installments are accelerated and due immediately in the event of an acceleration event by a person that has made a §965(h) election (unless the transfer agreement exception applies).

• **“Person”**: The event is with respect to (i) a U.S. shareholder or (ii) the U.S. owner of a domestic passthrough entity.

• **Acceleration events**: Under Treas. Reg. §1.965-7(b)(3)(ii), such events include:
  - An addition to tax being assessed for the failure to timely pay an installment ("Failure to Pay Event");
  - The person liquidating, selling, exchanging, or otherwise disposing of substantially all of its assets ("Sub All Event");
    • *Note*: For this purpose, the consolidated group is treated as a single person. Treas. Reg. §1.965-8(e)(1).
  - The person ceasing to conduct its business ("Business Cessation Event");
  - The person becoming a non-U.S. person ("Non-U.S. Event");
  - A person that is not a member of a consolidated group becoming a consolidated group member ("Consolidation Event");
  - For a consolidated group, the group ceasing to exist or otherwise discontinuing filing consolidated returns ("Termination Event"); or
  - The Commissioner determines that the transfer agreement includes a material misrepresentation or material omission.
Acceleration by Joining Consolidated Group: Example 3

Facts:
• Target (standalone C corporation) makes a §965(h) election for the transition tax owed.
• USP, the common parent of a consolidated group, acquires the stock of Target, and Target joins the USP consolidated group.

Analysis:
• Acquisition of Target stock by USP constitutes an acceleration event.
• This transaction also constitutes a covered acceleration event; thus, the transfer agreement exception may apply (discussed below).

Consideration:
• What if the acquisition constituted a group continuation event as a reverse acquisition described in Treas. Reg. §1.1502-75(d)(3)?
**Acceleration in Terminating Consolidated Group: Example 4**

**Facts:**
- Target consolidated group terminates for (e.g., Target merges downstream with and into USS1, with USS1 surviving or USS1 liquidates, leaving Target as a standalone filer).

**Analysis:**
- The termination of the Target consolidated group for **any** reason is an acceleration event.
- This transaction also constitutes a covered acceleration event; thus, the transfer agreement exception may apply (discussed below). See Treas. Reg. §1.965-7(b)(3)(iii)(A)(1)(v).
Covered Acceleration Events

• **Exception to Acceleration Rule**
  – The acceleration rule does **not** apply if the **eligible §965(h) transferor** and the **eligible §965(h) transferee** of a covered acceleration event file a **transfer agreement**.

• **Covered Acceleration Events**
  – **Sub All Event, with qualifying consolidated group member transaction**: A liquidation, sale, exchange, or other disposition of substantially all of the assets of the person (the “**departing member**”), **and** the departing member continues to exist or substantially all of the assets survive in a domestic corporation or a domestic consolidated group (a “**qualifying consolidated group member transaction**”);
  – **Sub All Event, without a qualifying consolidated group member transaction**: A liquidation, sale, exchange, or other disposition of substantially all of the assets of the person in a transaction that is **not** a qualifying consolidated group member transaction;
  – **Consolidation Event**: A person that was not a member of any consolidated group becomes a member of a consolidated group;
  – **Termination Event, with a new consolidated group**: For a consolidated group, the group ceases to exist or otherwise discontinues filing consolidated returns as a result of the acquisition of such group within the meaning of Treas. Reg. §1.1502-13(j)(5), **and** the acquired consolidated group members join a different consolidated group as of the day following the acquisition;
  – **Termination Event, with one member remaining**: For a consolidated group, the group ceases to exist by reason of one or more members of the group transferring all of their assets to other members, with only one member remaining; or
  – **Termination Event, due to termination of subchapter S election**: For a consolidated group, the group ceases to exist by reason of the termination of the subchapter S election of a shareholder of the common parent of the group **and**, for the shareholder’s taxable year immediately following the termination, the shareholder joins in the filing a consolidated return that includes all of the former members of the former consolidated group.
Covered Acceleration Event: Example 5

Facts:
- USP, the common parent of a consolidated group, acquires the stock of Target, the common parent of another consolidated group, causing the Target consolidated group to terminate.

Analysis:
- Target consolidated group has an acceleration event.
- Because (i) the Target consolidated group was acquired within the meaning of Treas. Reg. §1.1502-13(j)(5), and (ii) the Target consolidated group members join the USP consolidated group, the acceleration event is a covered acceleration event.
- Transfer agreement exception is available if timely executed by the appropriate parties.

Consideration:
- What if the acquisition constituted a group continuation event as a reverse acquisition described in Treas. Reg. §1.1502-75(d)(3)?
Transfer Agreement

• The transfer agreement must meet certain requirements, including:
  – be timely filed, i.e., within 30 days of the covered acceleration event;
    • Note: No relief for late filing is available.
  – be signed by both a person who is authorized to sign a return on behalf of the eligible §965(h) transferor and by a person who is authorized to sign a return on behalf of the eligible §965(h) transferee; and
  – contain certain information and representations.

• A transfer agreement that meets the above qualifications will be deemed to be consented to by the Commissioner.

• The effect of the transfer agreement is that the eligible §965(h) transferee assumes all of the outstanding obligations and responsibilities of the eligible §965(h) transferor with respect to the §965(h) net tax liabilities (i.e., making payments and reporting).

• The eligible §965 transferor remains jointly and severally liable for the outstanding §965(h) net tax liabilities.

• Guidance on §965 reporting (including filing of transfer agreements) is available on the IRS’s Section 965/Transition Tax FAQ webpage.
**Eligible §965(h) Transferor and Eligible §965(h) Transferee**

- **Eligible §965(h) transferor**: Defined as a person with respect to which a covered acceleration event occurs.

- **Eligible §965(h) transferee**: Defined as a single U.S. person that is not a domestic pass-through entity; varies depending on the type of covered acceleration event (see summary below).

- For purposes of the transfer agreement, in the case of a consolidated group, the terms “eligible §965(h) transferor” and “eligible §965(h) transferee” each refer to a consolidated group that is a party to a covered acceleration event. Treas. Reg. §1.965-7(b)(3)(iii)(B)(5). In such a case, the transfer agreement must be entered into by the agent (as defined in Treas. Reg. §1.1502–77) of the relevant consolidated group.

### Eligible §965(h) Transferee

- **Failure to Pay Event**: N/A
- **Sub All Event**: N/A
- **Business Cessation Event**: N/A
- **Non-U.S. Event**: N/A
- **Consolidation Event**: The agent (within the meaning of Treas. Reg. §1.1502-77) of the consolidated group that the eligible §965(h) transferee joins.
- **Termination Event**: The agent (within the meaning of Treas. Reg. §1.1502-77) of the surviving consolidated group.

- The departing member (or its qualified successor) in a qualifying consolidated group member transaction.
- Otherwise, the person who acquires substantially all of the assets of an eligible §965(h) transferor.
Sale of Substantially All Assets, Eligible §965(h) Transferor, Eligible §965(h) Transferee: Example 6

**Facts:**
- The stock of USS1 constitutes substantially all of the assets of the USP consolidated group.
- USP transfers the stock of USS1 to Buyer in exchange for cash and a joint §338(h)(10) election is made to treat the purchase of the stock of USS1 as the purchase of USS1 assets.

**Analysis:**
- The sale of the USS1 stock is a covered acceleration event.
- USP is the eligible §965(h) transferor.
- New USS1 or Buyer (if a consolidated group) enters into the transfer agreement as the eligible §965(h) transferee.
- Consider obligation for the §965(h) net tax liability under Treas. Reg. §1.1502-6.
- What if no §338(h)(10) election was made? Same result?
Section 168(k)
Section 168(k) – Pre-TCJA Immediate Expensing

• Pre-TCJA §168(k)
  – Section 168(k), prior to amendment by the TCJA, allowed an additional first-year depreciation deduction for the placed-in-service year equal to 50% of the adjusted basis of qualified property.
  – Qualified property was determined in part as property the “original use” of which began with the taxpayer, i.e., the first use to which the property was put, whether or not such use corresponded to the use of such property by the taxpayer. See Treas. Reg. §1.168(k)-1(b)(3).
Overview of New §168(k)

• Amended §168(k) allows for 100% expensing for purchases of new and used “qualified property” through 2016 (through 2027 for certain longer production period property)
  – “Qualified property” is limited to:
    • Tangible property predominantly used in the U.S. that is subject to MACRS with an applicable recovery period ≤ 20 years;
    • Computer software not covered by §197 (i.e., §167 property);
    • Certain other property (e.g., water utility and qualified film, television, and live production property); and
    • Qualified improvement property (including leasehold, restaurant, and retail improvement property) placed in service after September 27, 2017 and before January 1, 2018 (Prop. §1.168(k)-2(b)(2)(A)).

• Effective for property acquired and placed in service after September 27, 2017
  – The 100% first-year deduction is available for property acquired and placed in service after September 27, 2017, and before January 1, 2019 (January 1, 2024, for certain longer production period property).
  – Percentage allowed as a deduction is phased down by 20% per year for property placed in service beginning in 2023 (2024 for certain longer production period property).

• May elect out for a class of property placed in service in a given taxable year
  – May not want to expense to extent would create an NOL subject to the new 80% limitation in §172.
Overview of New §168(k) (cont.)

• For used property to qualify, it must satisfy the following acquisition requirements:
  – The property was not used by the taxpayer (or a predecessor) before its acquisition ("No Prior Use Requirement");
  – The property was not acquired from a related person (see §179(d)(2)(A) and (B)) (a "Related Party Acquisition"); and
  – The property was acquired in a cost-basis transaction (i.e., the basis was not determined in whole or in part based on the basis of the transferor) as defined in §179(d)(2)(C) (or §1014) (the "Cost-Basis Requirement").

• A Related Party Acquisition is defined as any acquisition of property:
  – For which any loss would be disallowed under §§267 or 707(b) (generally a more than 50% value standard);
  – By one component member of a controlled group from any component member of the same group as defined in §1563 (generally an 80% or more vote or value standard); and

• Property acquired by the “new target” as a result of a §338 election or a §336(e) election is treated as acquired by purchase. See §1.179-4(c)(2) and Prop. §1.179-4(c).
Overview of Guidance under §168(k)

- Proposed regulations under new §168(k) were published on August 8, 2018, and would generally be effective for qualified property placed in service during a taxable year that includes the date of publication of final regulations. The proposed regulations include guidance on the application of §168(k) to consolidated groups and immediate expensing of acquired assets.

- Special consolidated return rules were included regarding:
  - Treatment of property owned or acquired by other members or former members of the consolidated group
  - Timing for testing qualification for acquisitions of used property
  - Treatment of a series of related transactions involving members of a consolidated group

- Notice 2018-30 modified Notice 2003-65 to provide that expensing under new §168(k) would not apply for purposes of determining recognized built-in gain ("RBIG") using hypothetical amortization under the §338 method
  - Affects companies with NOLs and other tax attributes that have experienced (or are expecting to experience) an ownership change as defined under §382(g).
  - Provides that the computation of RBIG and recognized built-in loss for purposes of §382 should be made without regard to §168(k).
  - Effective for ownership changes after May 8, 2018
Key Considerations of §168(k)

- The change in the immediate expensing rule under §168(k) expands its availability and relevance in the acquisition context.
  - Incentivizes structuring transactions as asset sales, e.g., may not have offsetting gain at seller’s side, and immediate recovery of basis by the buyer, so no time value detriment; however, creation of an NOL on account of immediate expensing may not be beneficial.
  - Purchase price allocations important, as well as due diligence on targets, e.g., eligible assets, zero basis assets.
  - Interaction with NOL rules (post-TCJA NOLs, 80% taxable income limit) and new §168(j) (limit based on ATI, which includes EBIT beginning in 2022; certain businesses not eligible for §168(k)) should be kept in mind.

- Under the proposed regulations, consolidated groups generally are treated as a single taxpayer, which can impact application of the §168(k) rules to members of such groups.
Proposed §168(k) Regulations and “Prior Use”

• Prop. §1.168(k)-2(b)(3)(iii)(B) would provide that an acquisition of “used” property would not meet the requirements for additional depreciation if
  – The taxpayer or a predecessor used the property at any time prior to the acquisition
  – For this purpose, prior use is defined as whether the taxpayer (or its predecessor) had a depreciable interest in the property

• Used property must be acquired by purchase as contemplated by §179(d)(2)(A), (B), and (C), and Treas. Reg. §1.179-4(c)(1)(ii), (iii), and (iv), and (c)(2), i.e., the property may not be acquired from a related party and may not have a carryover basis. Such acquisition must meet the cost requirements of §179(d)(3) and Treas. Reg. §1.179-4(d).
  – The property may not be acquired from a person whose relationship to the person acquiring it would result in the disallowance of losses under §§267 or 707(b).
  – The property may not be acquired by one component member of a controlled group from another member, e.g., a “parent-subsidiary” controlled group or a “brother-sister” controlled group.
  – The basis of the property in the hands of the person acquiring the property must not be determined with reference to the adjusted basis of such property in the hands of the person from whom the property was acquired or under §1014.
Proposed §168(k) Regulations and “Prior Use” (cont.)

• Note: Property acquired by new target as a result of a §338 election is considered to be acquired by purchase. See Treas. Reg. §1.179-4(c)(2).
  – Under the proposed regulations, property deemed to have been acquired by a new target corporation as a result of a §338 election or a §336(e) election would be considered acquired by “purchase.” See Prop. Treas. Reg. §1.179-4(c)(2).
  – Consider impact of §336(e) approach for §168(k) purposes as between a construct of a sale to an unrelated person (consistent with §338) and, if §336(e) applies due to failure to meet §§355(d) or (e), as a “sale-to-self,” e.g., for the “no prior use” requirement and location of immediate expensing.

• Application to Consolidated Groups: Prop. §1.168(k)-2(b)(3)(iii)(B)(3)(i) would provide that
  – A consolidated group will be treated as having a depreciable interest in property during the time any current or previous member had a depreciable interest in the property while a member of the group

• The Preamble to the Proposed Regulations requested comments on whether a safe harbor should be provided on how many taxable years a taxpayer, its predecessor, or a consolidated group must look back to determine whether there has been “prior use” with respect to acquired property
Proposed §168(k) Regulations and “Prior Use” (cont.)

- Series of Related Transactions – General Rule (Prop. §1.168(k)-2(b)(3)(iii)(C)) would provide that for an acquisition as part of a series of related transactions
  - The property is treated as directly transferred from the original transferor to the ultimate transferee; and
  - The relation between the original transferor and the ultimate transferee is tested immediately after the last transaction in the series.

- Series of Related Transactions – Consolidated Groups
  - The proposed regulations would provide that an acquiring group member is treated as having a prior use (so not a qualifying acquisition) if: (i) any current or previous member had a depreciable interest in the property while a member of the group, or (ii) a corporation that had a depreciable interest in the property becomes a member of the group pursuant to a series of related transactions that includes the acquisition of the relevant property. See Prop. Treas. Reg. §1.168(k)-2(b)(3)(iii)(B)(3).
  - The proposed regulations would provide that, in the case of a series of related transactions, the transfer of the property will be treated – for the acquisition requirements for used property, i.e., no prior use, no acquisition by related party, cost basis – as directly transferred from the original transferor to the ultimate transferee, and the relationship between the original transferor and the ultimate transferee is tested immediately after the last transaction in the series. See Prop. Treas. Reg. §1.168(k)-2(b)(3)(iii)(C).
  - No limit on how far back a taxpayer must look for prior use. Comments have been requested.
• Series of Related Transactions – Consolidated Groups (cont.)
  – Prop. §1.168(k)-2(b)(3)(iii)(B)(ii) would provide that a consolidated group would be treated as having previously used the property if, in a series of related transactions
    • Qualified property is acquired by a member of the consolidated group; and
    • A corporation that had a depreciable interest in the property becomes a member of the group.
  – Prop. §1.168(k)-2(b)(3)(iii)(B)(iii) would provide that if, in a series of related transactions, property is acquired by a member of a consolidated group and the transferee ceases to be a member, whether the transferee is a member of the group is tested immediately after the last transaction in the series
§168(k) and Related Party Acquisitions

- When is “relatedness” tested?
  - §179(d) does not define when to test relatedness for purposes of determining whether the acquisition is from a related party.
  - §267 authorities are inconsistent as to the time to test relatedness
    - Test at the time of the binding contract for the sale
      - \textit{Drake v. Comm’r}, 145 F.2d 365 (10th Cir. 1944) (loss disallowed on sale by corporation to greater than 50% shareholder even though shareholder no longer held 50% following the transaction).
      - \textit{Fed. Cement & Tile Co. v. Comm’r}, 338 F.2d 691 (7th Cir. 1964) (loss disallowed on sale by corporation to shareholders who sold their stock as part of same plan);
    - Test after the transaction or series of transactions
      - \textit{Moore v. Comm’r}, 17 T.C. 1030 (1951) (loss disallowed on exchange of property with corporation in which taxpayers became sole shareholders simultaneously with the exchange).
      - PLR 201203004 (losses on deemed sales pursuant to a §338(h)(10) election allowed under §267(f) where as part of a §355 transaction the stock of the subsidiary was distributed as part of the series of transactions); PLR 201145007 (same).
Proposed §168(k) Regulations and Related Party Acquisitions

- Series of Related Transactions – Prop. §1.168(k)-2(b)(3)(iii)(C) would provide that for an acquisition as part of a series of related transactions:
  - The property is treated as directly transferred from the original transferor to the ultimate transferee; and
  - The relation between the original transferor and the ultimate transferee is tested immediately after the last transaction in the series.

- The Proposed Regulations do not otherwise address the scope of “Related Party Acquisitions.”

- Examples in the Proposed Regulations (described below) illustrate the application of the “Related Party Acquisition” provision.
§168(k) and Cost Basis Requirement

- §168(i)(7) provides that if property is transferred in certain tax-free transactions or in an intercompany transaction, the transferee is treated as the transferor for purposes of computing the depreciation deduction to the extent of the basis in the hands of the transferor.
  - The tax-free transactions include those described in §§332, 351, 361, 721, or 731.

- Under §1.1502-13, an intercompany transaction is a transaction between corporations that are members of the same consolidated group immediately after the transaction.
  - If a transaction occurs in part while S and B are members of the consolidated group and in part while they are not members, the transaction is treated as occurring upon the earliest of:
    - When performance by either S or B takes place, or
    - When payment for performance would be taken into account under the intercompany transaction rules.
  - Private letter rulings have consistently viewed a transaction among members of a consolidated group as intercompany transactions notwithstanding that either the transferor or the transferee departs from the consolidated group as part of a series of related transactions. See PLR 201203004, PLR 201145007, and PLR 201818010.
Proposed §168(k) Regulations and “Cost Basis Transactions”

- The Proposed Regulations do not expressly address whether a sale of property to which §168(i)(7) applies fails to satisfy the Cost Basis Requirement for additional depreciation.

- Prop. §1.168(k)-2(b)(4)(vi) provides that in the case of a transaction to which §168(i)(7) applies in the same taxable year as the transferor’s acquisition of the property, the “placed in service date” for the property in the hands of the transferee is treated as the date the property was placed in service by the transferor.

- Examples (described below) appear to apply a different test for the “Cost Basis Requirement.”
Facts:
• Parent owns all of the stock of B Corp and C Corp; all three are members of a consolidated group. C Corp has a depreciable interest in Equipment #1. In 2018, C Corp sells Equipment #1 to B Corp. B Corp never had a depreciable interest in the equipment.

Analysis:
• B Corp’s acquisition of Equipment #1 is not eligible for expensing under §168(k) as it does not satisfy the no “Prior Use” requirement.
  – B Corp and C Corp are related parties within the meaning of §179(d)(2)(B) and §1.179-4(c)(2)(iii).
  – B Corp is treated as previously having a depreciable interest in Equipment #1 because (i) B Corp is a member of the Parent consolidated group, and (ii) C Corp had a depreciable interest in Equipment #1 while a member of the Parent consolidated group.
Prop. §1.168(k)-2(b)(3)(v), Example 20

Facts:
- Parent owns all of the stock of D Corp and E Corp; all three are members of a consolidated group. D Corp has a depreciable interest in Equipment #2 (that is otherwise eligible for depreciation under §168(k)), but no other members of the Parent group ever had a depreciable interest in Equipment #2. In 2018, D Corp sells Equipment #2 to unrelated Buyer. In 2019, in an unrelated transaction, E Corp acquires Equipment #2 from Buyer.

Analysis:
- E Corp’s acquisition is not eligible for expensing under §168(k), as it does not satisfy the acquisition requirements.
  - E Corp is treated as previously having a depreciable interest in Equipment #2 because E Corp is a member of the Parent consolidated group, and D Corp, while a member of the Parent consolidated group, had a depreciable interest in Equipment #2.
  - The result would be the same if D Corp had ceased to be a member of the Parent consolidated group prior to E Corp’s acquisition of Equipment #2.
  - The Proposed Regulations effectively would require the Parent group to track the otherwise eligible property previously owned by all current and former members of its group.
Facts:
- Parent owns all of the stock of F Corp and G Corp; all three are members of a consolidated group. G Corp has a depreciable interest in Equipment #3 (that is otherwise eligible for depreciation under §168(k), e.g., no prior use in Parent consolidated group other than G Corp or in X Corp consolidated group). X Corp is the common parent of a consolidated group and is not related to any member of the Parent consolidated group. No member of the X Corp group has had a depreciable interest in Equipment #3. In a series of related transactions, G Corp sells Equipment #3 to F Corp, and Parent sells the F Corp stock to X Corp.

Analysis:
- F Corp's acquisition satisfies the used property acquisition requirements for expensing under §168(k).
  - For purposes of the “related party” prohibition, F Corp's membership in the Parent consolidated group is tested immediately after the last transaction in the series of related transactions (i.e., the sale of the F Corp stock to X Corp). Thus, F Corp is not treated as previously having a depreciable interest (i.e., prior use) in Equipment #3 by virtue of G Corp's interest.
  - Because F Corp is not a member of the Parent consolidated group at the end of the series of related transactions, it is not treated as previously having a depreciable interest in Equipment #3 by virtue of G Corp's interest.
Prop. §1.168(k)-2(b)(3)(v), Example 21 (cont.)

Analysis (cont.):

- Because no member of the X consolidated group previously had a depreciable interest in Equipment #3, F Corp is not treated as previously having a depreciable interest in Equipment #3 by through membership in that group.
- F Corp and G Corp are not related because relatedness is tested after F Corp leaves the Parent consolidated group.

- Under §168(i)(7) would F Corp (the transferee) be treated as G Corp (the transferor) for purposes of computing the depreciation deduction with the result that no deduction under §168(k) would be available?
- What if the sale of F Corp was an unrelated transaction?
- What happens if G Corp transfers Equipment #3 to F Corp in a “busted” §351 exchange, where stock is issued subject to binding agreement to dispose of such stock?
Facts:
- H Corp, which is not a member of a consolidated group, has a depreciable interest in Equipment #4. Parent and I Corp are members of a consolidated group, and neither is related to H Corp. No member of the Parent consolidated group ever had a depreciable interest in Equipment #4. Neither Parent nor I Corp is related to H Corp within the meaning of §179(d)(2)(A) or (B) and Treas. Reg. §1.179-4(c). In 2018, H Corp sells Equipment #4 to X, a third party unrelated to H Corp, Parent, or I Corp. In a series of related transactions, in 2019, Parent acquires all of the stock of H Corp, and I Corp acquires Equipment #4 from X, an unrelated person.

Analysis:
- I Corp’s acquisition of Equipment #4 is not eligible for expensing under §168(k), as it does not satisfy the used property acquisition requirements.
  - In a series of related transactions, H Corp became a member of the Parent consolidated group, and I Corp, also a member of the Parent consolidated group, acquired Equipment #4. Because H Corp previously had a depreciable interest in Equipment #4, I Corp is treated as having had a depreciable interest in Equipment #4.
- What if H Corp is acquired by Parent corporation prior to I Corporation’s acquisition of Equipment #4 but not as part of a series of related transactions? If instead Equipment #4 is acquired first, but not as part of a series of related transactions?
Prop. §1.168(k)-2(b)(3)(v), Example 23

Facts:
- K Corp, J Corp, and L Corp are unrelated parties within the meaning of §179(d)(2)(A) or (B) and §1.179-4(c) and are not members of a consolidated group. J Corp has a depreciable interest in Equipment #5. In 2018, J Corp sells Equipment #5 to K Corp. In 2020, J Corp merges into L Corp in a reorganization described in §368(a)(1)(A). In 2021, L Corp acquires Equipment #5 from K Corp.

Analysis:
- L Corp’s acquisition is not eligible for expensing under §168(k).
  - Because J Corp is the predecessor of L Corp and J Corp previously had a depreciable interest in Equipment #5, L Corp’s acquisition of Equipment #5 does not satisfy the requirement that the property was not used by the taxpayer or its predecessor prior to the acquisition.
Proposed §168 Regulations and “Prior Use”

Facts:
- Parent, B Corp, and C Corp file a consolidated return. Unrelated Buyer, the parent of a consolidated group, acquires all of the stock of C Corp from Parent and Equipment #1 from B Corp in a series of related transactions.

Consideration:
- Is Equipment #1 eligible for additional depreciation or does the Unrelated Buyer group fail the “Prior Use” requirement?
Expensing With & Without a §338(h)(10) Election

**Facts:**

- Publicly traded Distributing forms Newco and contributes Target to Newco in exchange for common and non-voting preferred stock at a time when Distributing is under a binding commitment to sell the preferred stock of Newco to an unrelated third party. Newco and Distributing make an election under §338(h)(10) for Target.
- Distributing contributes tangible assets constituting qualified property to Newco in exchange for common and non-voting preferred stock at a time when Distributing is under a binding contract to sell Newco preferred stock to an unrelated third party.
- Distributing contributes Newco and an active trade or business to Controlled.
- Distributing distributes Controlled to Distributing’s shareholders in a distribution to which §355 applies.

*Newco preferred stock not depicted.*
Expensing With & Without a §338(h)(10) Election (cont.)

Analysis:
- Is expensing under §168(k) available for both Target’s Tangible Assets and D’s Tangible Assets?
- Is there a stronger case for expensing under §168(k) for Target’s Tangible Assets (where a §338(h)(10) election has been made) versus for D’s Tangible Assets (where no election is made)?
  - §1.338-3(b)(3)(ii)(C): relatedness is tested immediately after the last transaction in a series of transactions effectuated pursuant to an integrated plan to dispose of Target stock.
  - Under §1.338-1, if a §338 election is made, then old target is treated as transferring assets and new target is treated as acquiring old target’s assets, each from an unrelated person.
  - §1.338-1(b)(1)(i): New target is not considered related to old target for purposes of §168, and may make new elections under §168 without taking into account the elections made by old target.
  - §1.338(h)(10)-1(d)(3)(i): Old target is treated as transferring all of its assets to an unrelated person in exchange for consideration including the discharge of its liabilities in a single transaction at the close of the acquisition date.
- Under §267(b), if relatedness is tested at the time of the binding contract, Newco and Distributing would be related, but if tested after the series of transactions, they would not.
- To the extent that expensing under §168(k) is available, when and on what return is the deduction taken? What if several days pass between steps 1 and 2, on the one hand, and step 4, on the other hand?
Expensing With & Without a §338(h)(10) Election (cont.)

Analysis (cont.):
- In general, due to the §338(h)(10) election, “Old” Target would be treated as selling its assets to unrelated “New” Target in a taxable asset sale, with the Distributing consolidated group recognizing gain or loss (through Old Target), and New Target obtaining a cost basis in its assets.
- New target is not considered related to old target for purposes of §168. See Treas. Reg. §1.338-1(b)(i).
- Section 168(k) considerations
  - For the used property acquisition rules, Treas. Reg. §1.179-4(c)(2) provides that property acquired by a new target corporation as a result of a §338 election is considered acquired by "purchase."
  - Consolidated group membership is tested, for the prior use limitation, immediately after a related series of transactions. See Example 21; see also Prop. Treas. Reg. §1.168(k)-2(b)(3)(iii)(C).
  - On what return is the deduction taken – the Distributing group’s return or the Newco group’s return?
  - Could the intercompany transaction regulations (including attribute redetermination and the anti-abuse rule) apply if the deduction is claimed on the Distributing group’s return?
Expensing With Taxable Distribution

**Facts:**
- Pursuant to a single plan, on Day 1, S distributes all of the stock of T to P in a taxable distribution and P sells all of the stock of S to unrelated Buyer for cash on Day 3. P and S make a §338(h)(10) election with respect to T. P and S are unrelated at the end of the transaction.

**Questions:**
- Can the P group expense T’s tangible assets under §168(k)?
- If P, S, and T were members of the same consolidated group, is P treated as having a prior use that precludes the deduction?
  - See Prop. §1.168(k)-2(b)(3)(iii)(B)(3)(i) (treating a consolidated group as having a depreciable interest in property during the time any current or previous member of the group had a depreciable interest).
Prop. §1.168(k)-2(b)(3)(v), Successor Group

Facts:
- Parent owns all of the stock of D Corp and E Corp; all three are members of a consolidated group. D Corp has a depreciable interest in Equipment #2, but no other members of the Parent group ever had a depreciable interest in Equipment #2. Neither Parent nor I Corp is related to D Corp or H Corp within the meaning of §179(d)(2)(A) or (B) and Treas. Reg. §1.179-4(c). In 2018, D Corp sells Equipment #2 to unrelated Buyer. Later in 2018, Parent merges into A Corp in a reorganization to which §368(a)(1)(A) applies and that is not a reverse acquisition within the meaning of -75(d)(3). In 2019, X Corp, a corporation that was a subsidiary of A Corp prior to and after the merger, acquires Equipment #2 from Buyer.

Analysis:
- Does the Parent consolidated group’s prior use carry over to the members of the A Corp consolidated group that were not members of the Parent consolidated group such that X Corp will be treated as having a prior use of Equipment #2 for purposes of §168(k)?
In a series of related transactions, H Corp became a member of the Parent consolidated group, and I Corp, also a member of the Parent consolidated group, acquired Equipment #4.

Should H Corp be viewed as previously having a depreciable interest in Equipment #4? If so:

- I Corp is treated as having a depreciable interest in Equipment #4 pursuant to Prop. Treas. Reg. §1.168(k)-2(b)(3)(iii)(B)(3)(ii);
- I Corp's acquisition of Equipment #4 does **not** satisfy the used property acquisition requirements of Prop. Treas. Reg. §1.168(k)-2(b)(3)(iii); and
- I Corp's acquisition of Equipment #4 is **not** eligible for the additional first-year depreciation deduction.