Impact of TCJA on Corporations, Part II: Section 951A (GILTI), Section 250 (FDII), Section 59A (BEAT), and Section 965 (Transition Tax)

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Agenda

- GILTI-related Consolidated Issues
- FDII-related Issues
  - M&A-related Issues
  - Consolidated Issues
- BEAT-related Issues
  - "Non-cash Payment" Issues
  - Consolidated Issues
- Section 965(h)(3)-Related Issues

Consolidated Issues in Section 951A (GILTI)

Section 951A (GILTI) Overview

- US shareholders of CFCs are required to include into income their pro rata share of their CFCs' global intangible low-taxed income ("GILTI").

- GILTI generally represents the net active earnings of CFCs for a given year.

- Corporate US shareholders ("CUSSHs") are entitled to a deduction under section 250 generally equal to 50% of their total GILTI inclusions. Thus, for CUSSHs, GILTI is effectively taxed at 10.5% (this rate is scheduled to increase after 2025).

Section 951A (GILTI) Overview (cont.)

- Section 951A was introduced to ensure a minimum level of taxation on foreign subsidiary earnings.
- The reduction for the net deemed tangible income return is intended to permit a tax-free routine return on foreign business investment.
- GILTI is determined on a year-by-year basis (and there are no carryover of GILTI-year losses). Therefore, foreign losses in one year generally cannot be used to reduce GILTI inclusions in other years.
- Unlike subpart F, GILTI is not limited by or determined with reference to E&P.

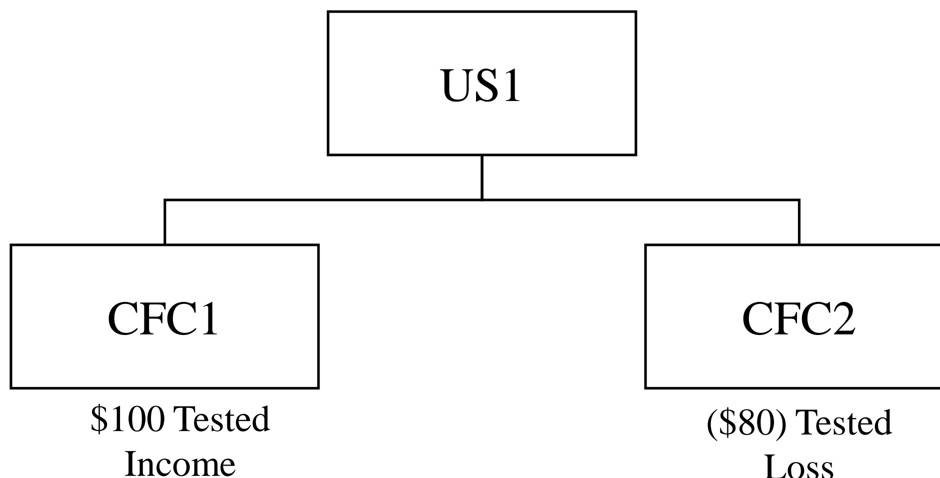
Section 951A (GILTI) Overview (cont.)

- Section 951A(b): GILTI = Net CFC Tested Income – [(10% × Qualified Business Asset Investment) – Specified Interest Expense]
  - Net CFC Tested Income = aggregate tested income of each CFC, less aggregate tested loss of each CFC.
    - Tested Income = Gross income of CFC (other than ECI, subpart F income, §954(b)(4) high tax foreign base company income, related person dividends, certain oil and gas income), less allocable deductions.
    - Tested Loss = allocable deductions > tested income of the CFC.
  - Qualified Business Asset Investment ("QBAI") = average adjusted basis (straight line) of specified depreciable tangible property at close of each quarter.
  - Specified interest expense = net interest expense included in tested income or tested loss

Section 951A (GILTI) Overview (cont.)

- A U.S. shareholder aggregates each of the items of its CFCs to determine its GILTI inclusion.
  - "Used tested loss": The tested loss of a CFC that offsets tested income of another CFC of the same shareholder.
  - "Offset tested income": The tested income of a CFC that is offset by tested loss of another CFC.
- GILTI is similar to and follows many of the rules of subpart F, but there is an important distinction.
  - Subpart F income is only positive. By contrast, a CFC can have a tested loss that offsets tested income from a CFC of the same shareholder.
- Treating a consolidated group as a single shareholder requires elaborate rules.

Section 951A (GILTI) Overview – Example



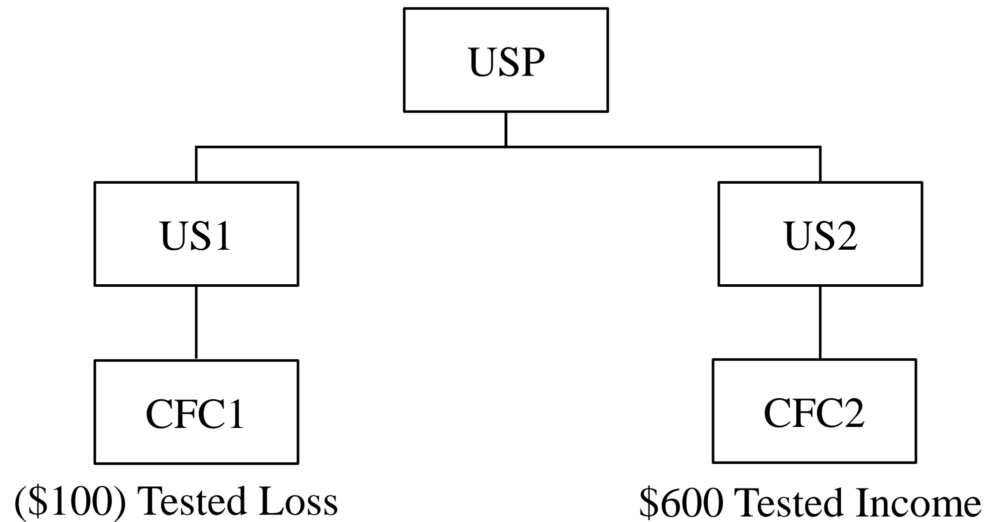
Example

- US1 owns 100% of two CFCs. CFC1 has $100 of tested income, CFC2 has $80 of tested loss.
- The GILTI inclusion is $100 minus $80, or $20.
  - US1's basis in CFC1 goes up by $20, and CFC1 has $20 of PTI (previously taxed income).
  - CFC1 has $80 of offset tested income but has $100 of E&P rather than $20 of PTI. Generally this E&P can be distributed tax free with the 100% DRD under section 245A, subject to certain holding period requirements and section 1059 (i.e., 2-year holding period for certain extraordinary distributions).
  - CFC2 has $80 of used tested loss.
- Prop. Treas. Reg. §1.951A-6(e):
  - When a U.S. shareholder disposes of stock of a CFC, the basis of the CFC is reduced immediately before the disposition by the CFC's used tested loss. (See also Section 961(d)).

Consolidated GILTI Overview – Prop. Treas. Reg. § 1.1502-51

- Single-Entity Treatment for Consolidated Groups (See Prop. Treas. Reg. §1.1502-51)
  - First, determine each member's tested income.
  - Second, aggregate tested loss, QBAI, and interest expense of all of the consolidated group's members. A CFC with a tested loss has no QBAI.
  - Third, allocate tested loss, QBAI, and interest expense to each member of the group that is a U.S. shareholder of a tested income CFC based on the proportion of such member's aggregate pro rata share of tested income to the total tested income of the consolidated group.
- Query whether this methodology can cause distortions between economics and basis and E&P adjustments.

Consolidated GILTI Inclusion – Example



- If USP, US1, and US2 are members of the same consolidated group, US2 can offset CFC1's $100 tested loss against CFC2's $600 of tested income, resulting in a GILTI inclusion of $500. The location of the CFCs with in the group does not change the result.

Basis Adjustments for GILTI Inclusions

Increase Basis in CFC Stock

- GILTI inclusion is treated as a section 951(a)(1)(A) inclusion, resulting in a basis increase under section 961(a).
- Stock basis increases are allocated proportionately to stock of tested income CFCs (See Prop. Treas. Reg. §1.951-6(b)).

Increase Basis in Member Stock

- GILTI inclusion by member of a consolidated group increases member's stock basis under Treas. Reg. §1.1502-32(b)(3) as either:
  - Taxable income, or
  - Tax-exempt income if offset by either a section 250 deduction or distributions of NDTIR offset by section 245A DRD (see §1.1502-32(b)(3)(ii)(B) (treating S's taxable income that is permanently offset by a deduction as tax-exempt income)).

Basis Adjustments for Tested Losses

No Decrease in Basis in CFC Stock

- No immediate reduction to stock of tested loss CFCs even if its losses were used to offset tested income of another CFC.
- Only reduced immediately prior to stock "disposition."

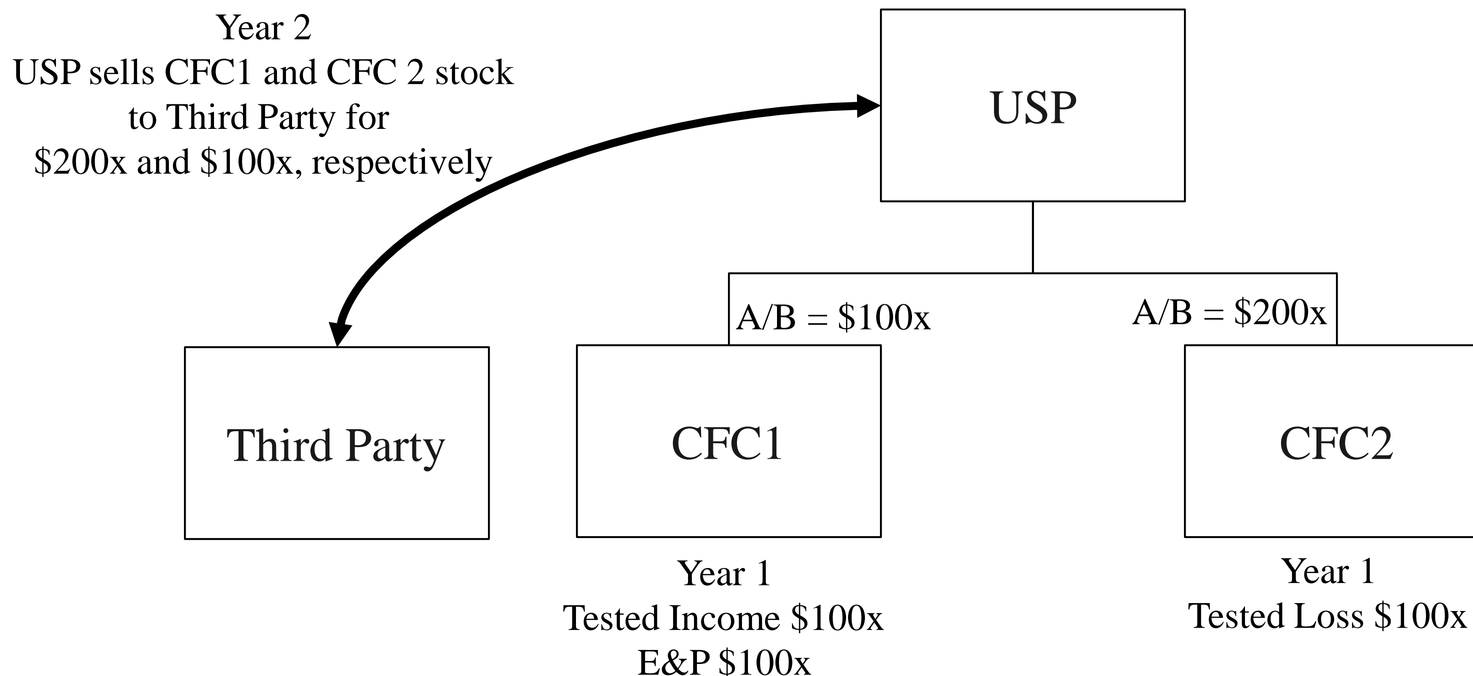
Adjustments to Member Stock

- Prop. Treas. Reg. §1.1502-32(b)(3)(iii)(C) immediately decreases the basis of stock of a member with respect to the used tested loss of its CFC.
- Under Prop. Treas. Reg. § 1.1502-32(b)(3)(ii)(E), a member's tax-exempt income for a taxable year includes the member's offset tested income with respect to a CFC for all of its inclusion years to the extent that CFC has a used tested loss (determined on a cumulative basis).

Basis Adjustments for Net Used Tested Loss

- Background
  - Government concerned that in certain cases the lack of adjustments to stock basis of a tested loss CFC can lead to inappropriate results.
  - Example provided in Preamble: If USSH's basis in tested loss CFC stock is not reduced to reflect the use of a tested loss to offset tested income, USSH would "recognize a second and duplicative benefit of the loss" upon disposition of tested loss CFC stock.
  - Limited to CUSSHs because untaxed tested income CFCs that are later sold would likely be eligible for section 245A DRD as a result of section 964(e) (for lower-tier sales) or section 1248(a) and (j) to the extent gain recharacterized as a dividend.
- Authority
  - section 951A does not provide Treasury with regulatory authority to adjust basis. Only regulatory authority in section 951A (i.e., outside of section 7805) can be found in section 951A(d)(4) (relating to QBAI) and (f)(2) (relating to expanding the treatment of GILTI inclusions similarly to subpart F inclusions to additional Code provisions beyond those listed in section 951A(f)(1)).
  - Government cites to *Charles Ilfeld Co. v. Hernandez* and *U.S. v. Skelly Oil*.

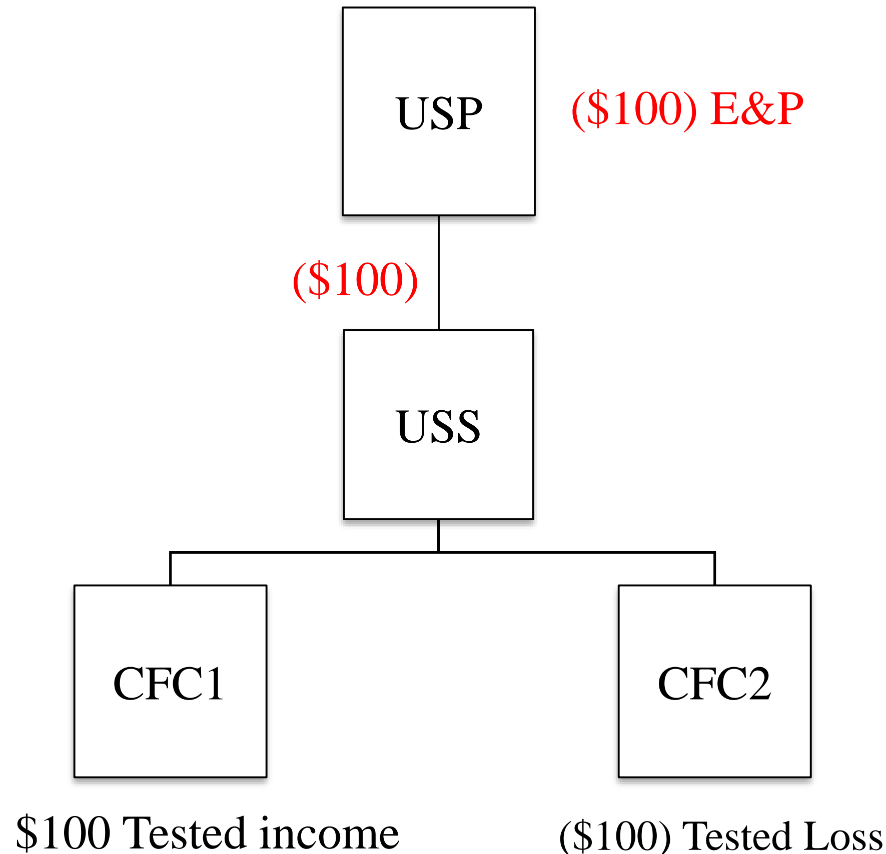
Basis Adjustments for Net Used Tested Loss: Duplicated Loss



- In Year 1, USP has no GILTI inclusion as CFC2's tested loss offsets CFC1's tested income. CFC1 has $100x of E&P which has not been converted to PTI as no section 951 inclusion.
- In Year 2, $100x gain on USP's sale of CFC1 stock is recharacterized as a dividend under section 1248(a) and eligible for the section 245A DRD under section 1248(j).
- In Year 2, USP's sale of CFC2 stock results in a $100 loss to USP.
- End result: Absent application of Prop. Treas. Reg. §1.951A-6(e), the benefit of CFC2's $100x loss could be used twice—once to offset CFC1's $100x of GILTI Tested Income and a second time on USP's sale of CFC2.

Consolidated GILTI – Example 1

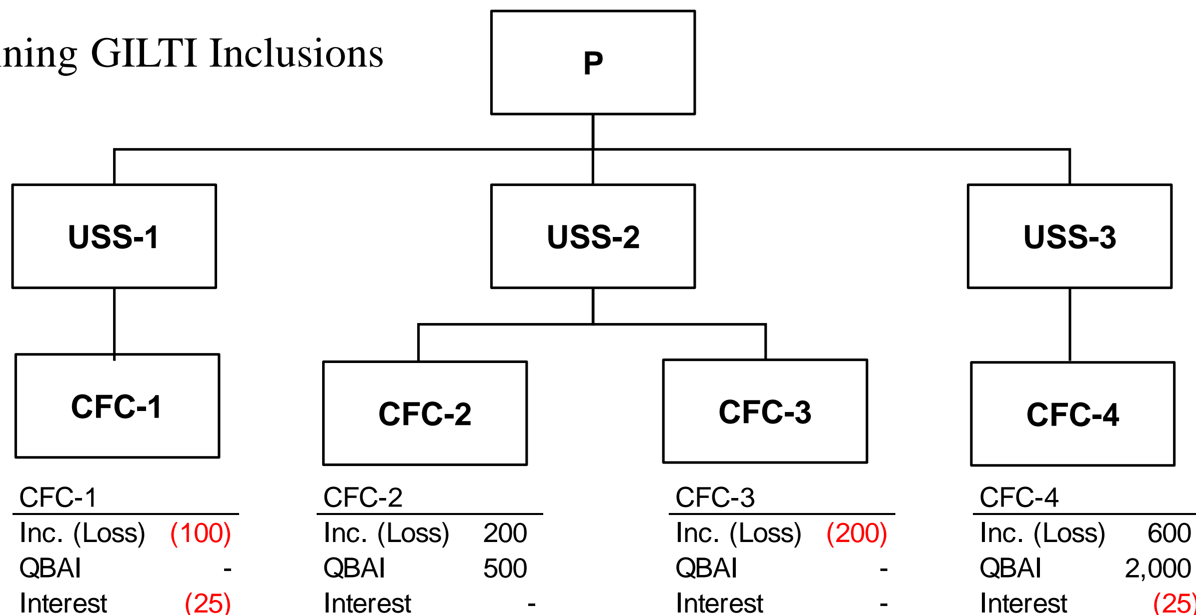
GILTI Inclusion is 0



- Under Treas. Reg. § 1.1502-33(b)(1), E&P is adjusted in accordance with the principles of Treas. Reg. § 1.1502-32.

Consolidated GILTI – Example 2

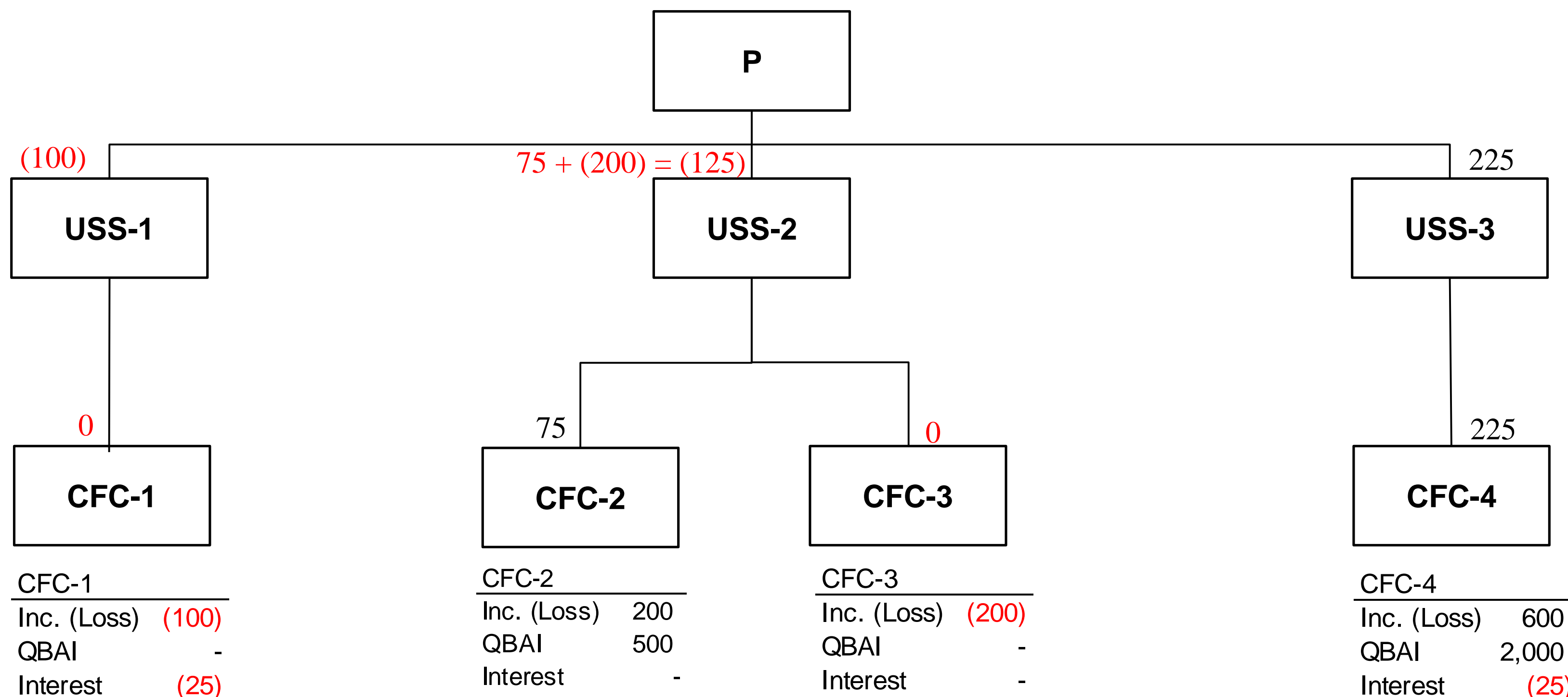
<u>Year 1</u>: Determining GILTI Inclusions



	USS-1		USS-2		USS-3		P Group
Tested Income | *Ratio*	-	*0.00%*	200.00	*25.00%*	600.00	*75.00%*	800.00
Tested Loss	-		(75.00)		(225.00)		(300.00)
Net CFC Tested Income	-		125.00		375.00		500.00
QBAI	-		625.00		1,875.00		2,500.00
DTIR (10% x QBAI)	-		62.50		187.50		250.00
Interest	-		(12.50)		(37.50)		(50.00)
Net DTIR	-		50.00		150.00		200.00
GILTI Inclusion Amount	-		75.00		225.00		300.00

Consolidated GILTI – Example 2

Year 1: Determining Basis Adjustments



- Unused Offset Tested Income
  - CFC-2 Year 1 = 75
  - CFC-4 Year 1 = $225

GILTI Basis Adjustments for Year of Sale

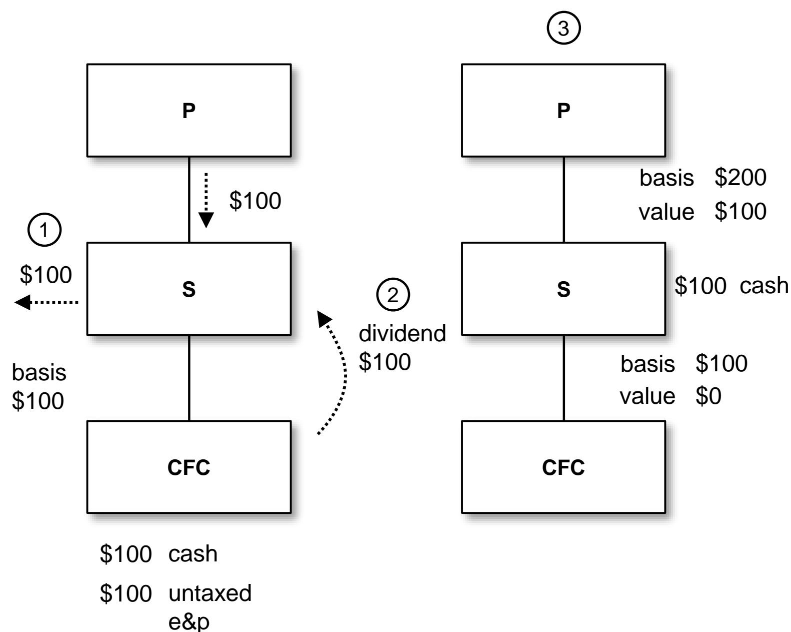
Adjustments to Member Stock

- In the case of a corporate U.S. shareholder, gain recognized on the disposition of stock of a CFC attributable to offset tested income may be eligible for 100% DRD under § 245A as a result of §964(e)(4) or §1248(a).
- Prop. §1.1502-32(b)(3)(ii)(F) provides that if a consolidated group member that owns a CFC is sold (the "transferred member"), it is treated as receiving tax-exempt income immediately before the selling member recognizes income, gain, deduction, or loss with respect to a share of the transferred member's stock.
  - The tax-exempt income amount is the net offset tested income amount allocable to the shares of any CFC owned by the transferred member (i.e., the remaining offset tested income that did not previously reverse the basis decreases for used tested losses) to the extent that a distribution of such amount would have been characterized as a dividend eligible for a §245A deduction and not subject to §1059.
- What if a CFC makes an actual distribution of net DTIR and gets a 100% DRD? Tax-exempt income results in an increase to the basis of S's stock.

Coordination of Section 951A Rules with the Unified Loss Rules

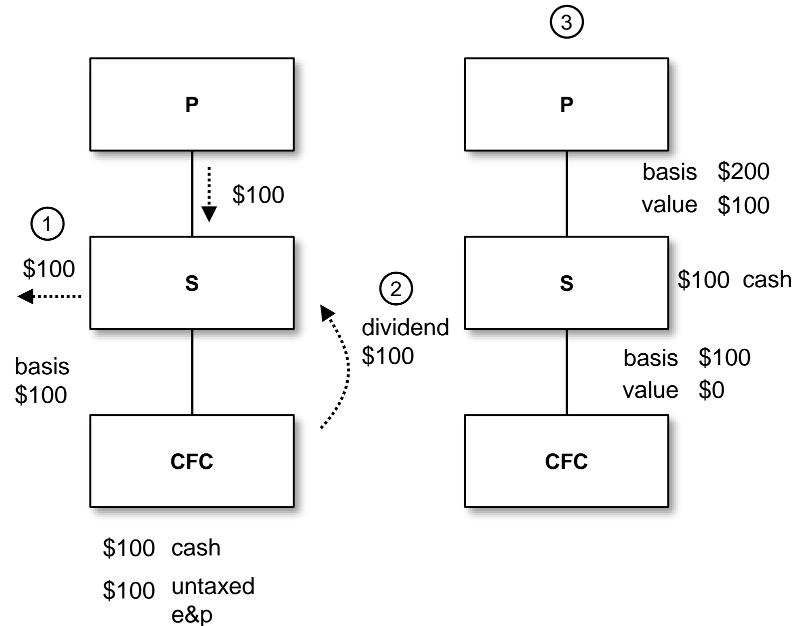
“Son of Mirror” from Exempt Income of CFC

- P contributes $100 to newly formed S, S buys stock of a CFC. The only asset of the CFC is $100 of cash representing untaxed E&P from QBAI (assets giving rise to exempt income).
- After three years (so that Section 1059 does not apply), the CFC distributes the $100 of cash to S as a dividend. Assume Section 245A applies to the dividend.
  - S is not taxed on the dividend because of the Section 245A deduction.
  - S is treated as having tax exempt income, increasing P’s basis in S to $200.
  - Assuming section 1059 does not apply, S’s basis in the CFC remains at $100, even though the FMV of the CFC is $0.
  - S has two assets, cash of $100 and stock of the CFC worth $0.



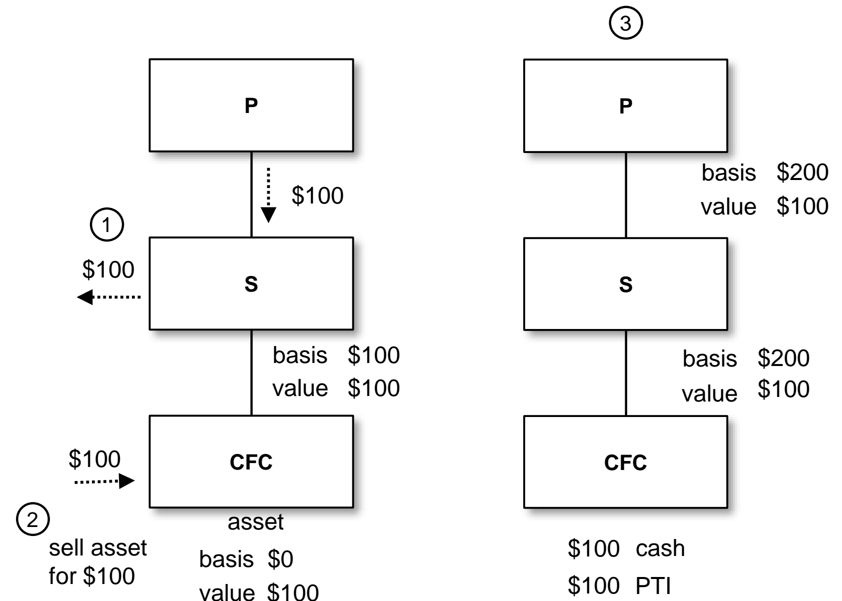
“Son of Mirror” from Exempt Income of CFC

- If S sells the stock of the CFC for $0, the loss is disallowed under Section 961(d) (which disallows losses on stock of a CFC to the extent of Section 245A dividends from the CFC).
- Suppose S retains the stock of the CFC, but P sells the stock of S for $100. Since P’s basis is $200, P has an uneconomic loss of $100.
  - -36(c) does not apply, since there is no disconformity amount. P’s outside basis is $200, and S’s inside basis is $100 cash plus $100 basis in the CFC, or $200.
  - There is a duplicated loss of $100 under -36(d). P’s loss would be allowed, but S’s basis in the CFC would be reduced to $0.
  - Query whether the uneconomic loss should be allowed in this case.



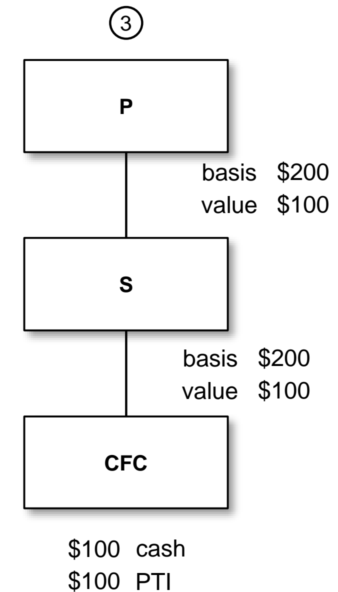
"Son of Mirror" from Built-in Gain of CFC

- P contributes $100 to newly formed S, S buys stock of a CFC. The only asset of the CFC is an asset with a basis of $0 and value of $100.
- The CFC sells the asset for $100. Assume the $100 of gain is tested income under the GILTI rules in Section 951A.
  - S has an income inclusion of $100 under Section 951A, and a Section 250 deduction of $50.
  - Under Section 961(a), S's basis in the CFC increases by the $100 income inclusion, to $200. The CFC has $100 of previously taxed income (PTI).
  - P's basis in S increases to $200.
- If S sells the stock of the CFC for $100, the loss is allowed. Section 961(d) does not apply since no dividend eligible for Section 245A has been paid.



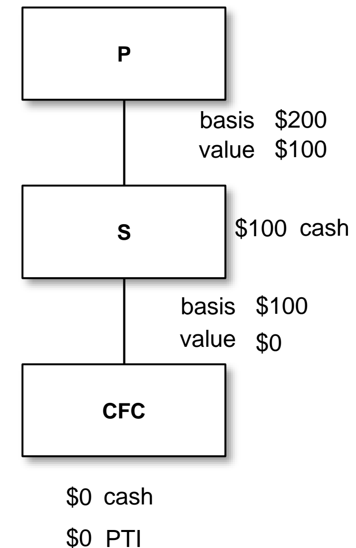
"Son of Mirror" from Built-in Gain of CFC

- Suppose S retains the stock of the CFC, but P sells the stock of S for $100. Since P's basis is $200, P has an uneconomic loss of $100.
  - -36(c) does not apply, since there is no disconformity amount. P's outside basis is $200, and S's inside basis in the stock of the CFC is $200.
  - There is a duplicated loss of $100 under -36(d). P's loss would be allowed, but S's basis in the CFC would be reduced to $100.
- Query whether the uneconomic loss should be allowed in these cases. They are similar to "son of mirror" losses, but the step up in tax basis is in an asset initially held by the CFC.



"Son of Mirror" from Built-in Gain of CFC

- The same results arise if the CFC distributes its $100 of cash to S.
  - The distribution of PTI reduces S's basis in the CFC to $100.
  - P's basis in S remains at $200.
  - If S sells the stock in the CFC for $0, S obtains a loss of $100 just as if the $100 cash had not been distributed.
  - If P sells the stock of S for $100, as before, -36(c) does not disallow the loss because inside basis in S assets and outside basis in S stock are both $200. Likewise, -36(d) allows the loss but causes the basis in the CFC stock to be reduced to $0.



Proposed FDII Regulations

Foreign-Derived Intangible Income

- To avoid treating intangible income earned offshore much more favorably than intangible income earned onshore, favored treatment is provided to a U.S. corporation that earns "Foreign-Derived Intangible Income" ("FDII").
- In essence, it is a favorable rate applied to exports and leases and licenses of property outside the United States.
- Conceptually, provides a 13.125% rate (increased to 16.406% after 2025) on foreign derived income from intangibles held in the United States.
- Section 250 provides a deduction for 37.5% of FDII (in addition to a deduction of 50% of GILTI).
- FDII plus GILTI is limited to taxable income.

FDII (cont'd)

- FDII: $\text{Deemed intangible income} \times \frac{\text{foreign-derived deduction eligible income}}{\text{deduction eligible income}}$
- Deemed intangible income: Deduction eligible income ("**DEI**") over 10% of the qualified business asset investment ("**QBAI**").
- DEI: Excess of:
  - the domestic corporation's gross income excluding (a) subpart F, GILTI, financial services income, dividends from a CFC, domestic oil and gas extraction income, *foreign branch income*; over
  - (b) deductions (including taxes) properly allocable to such gross income.
- Foreign-Derived Deduction Eligible Income ("**FDDEI**"): DEI derived in connection with property that is sold, leased, licensed, or disposed of to any person who is not a U.S. person for *foreign use*, consumption, or disposition outside the United States or for services rendered to a person or with respect to property outside the United States.

Proposed FDII Regulations and Corporate M&A

- Sales of Stock
  - The sale of stock, partnership or trust interests, notes, bonds, and any other instrument defined as a “security” under section 475(c)(2) does **not** qualify as a foreign-derived deduction eligible income sale (an “FDDEI sale”). Prop. Treas. Reg. § 1.250(b)-4(f).
- Section 367(d)
  - Deemed royalties received under section 367(d) qualify as a FDDEI sale. Prop. Treas. Reg. § 1.250(b)-3(b)(7).
  - What if section 367(d) sale occurred prior to section 250 effective date?
  - How is interest expense allocated under section 861 with respect to deemed royalties for purposes of calculating FDDEI when underlying intangible is owned by CFC?

FDII and Foreign Branches of Domestic Corporations

- Section 250(b)(3)(A)(i)(VI) excludes "foreign branch income" from the definition of "deduction eligible income" or "DEI".
- Prop. Treas. Reg. section 1.250(b)-1(c)(11) defines "foreign branch income" as "gross income attributable to a foreign branch of a domestic corporation or a partnership under §1.904-4(f)(2)," subject to certain modifications and the Prop. Treas. Reg. section 1.904-4(f)(2)(v) anti-abuse rule.
- Under such a rule, it appears that a domestic corporation's income, for example, from the sale of property to its foreign branch that then resells such property to an unrelated foreign person for foreign use may qualify as an FDDEI sale.

FDII and Effectively Connected Income

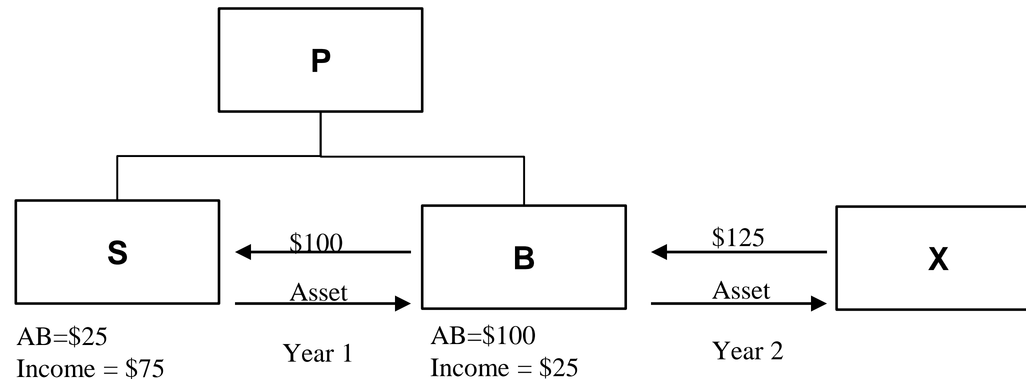
- **Hypothetical**: CFC forms a U.S. branch through which it manufactures goods in the United States and sells the manufactured goods outside the United States. Does CFC's U.S. branch income from its manufacturing and sales activities qualify for an FDII deduction?
  - The manufacturing and sales income should be effectively connected income ("ECI") to the conduct of a U.S. trade or business under §§ 864(c)(3) and 863(b).
  - In determining its net ECI, the CFC is allowed to take deductions "to the extent that they are connected with [ECI] . . . ." (See IRC § 882(c)(1)(A)).
  - The manufacturing and sales income may fall within the definition of FDII (i.e., sale of property for foreign use (see IRC § 250(b)(4)(A)).
  - FDII can be considered as "connected with" ECI because the activities that give rise to ECI are the same activities that give rise to FDII (i.e., the manufacturing and sales activities).
  - **BUT** section 250 requires the taxpayer to be a domestic corporation. Query whether a CFC should be treated as a domestic corporation for FDII purposes? *See* Treas. Reg. § 1.250(a)-1(c)(1) ("domestic corporation" definition does not include U.S. branches of CFCs).
    - *Compare* H. R. Rep. No. 115-466, at 599 n. 1486 (2017) (Conf. Rep.) (with respect to section 245A, inserting after the phrase "by domestic corporation" the statement "[i]ncluding a controlled foreign corporation treated as a domestic corporation for purposes of computing the taxable income thereof. *See* [Treas. Reg. section] 1.952-2(b)(1). Therefore, a CFC receiving a dividend from a 10-percent owned foreign corporation that constitutes subpart F income may be eligible for the DRD with respect to such income."

Interaction of Section 250(a)(2) with Sections 163(j) and 172(a)(2)

- Section 250 deduction is subject to a taxable income limitation. If, for any taxable year, the sum of a domestic corporation's FDII and GILTI exceeds its taxable income, the excess is allocated pro rata to reduce the corporation's FDII and GILTI solely for purposes of computing the amount of the section 250 deduction. *See* section 250(a)(2); Prop. Treas. Reg. § 1.250(a)–1(b)(2).
- Section 172(d)(9) provides that a taxpayer's NOL for a taxable year is determined without regard to the section 250 deduction.
- Section 163(j)(8)(A)(iii) provides that a taxpayer's adjusted taxable income is determined without regard to section 172.
- As the Code was silent as to an ordering rule between sections 163(j) and 250, the proposed regulations adopted a rule whereby the section 250 deduction is determined after all of the corporation's other deductions are calculated. *See* Prop. Treas. Reg. § 1.250-1(f)(2), *Example 2* (providing a five-step sequencing process).

Consolidated Section 250 FDII

Intercompany Transaction Prior to Sale to Unrelated Foreign Party: Prop. Treas. Reg. § 1.1502-13(c)(7)(ii)(T), Ex. 20



Analysis: Timing and Attributes

(A) Amount S takes into account in year 1: $0

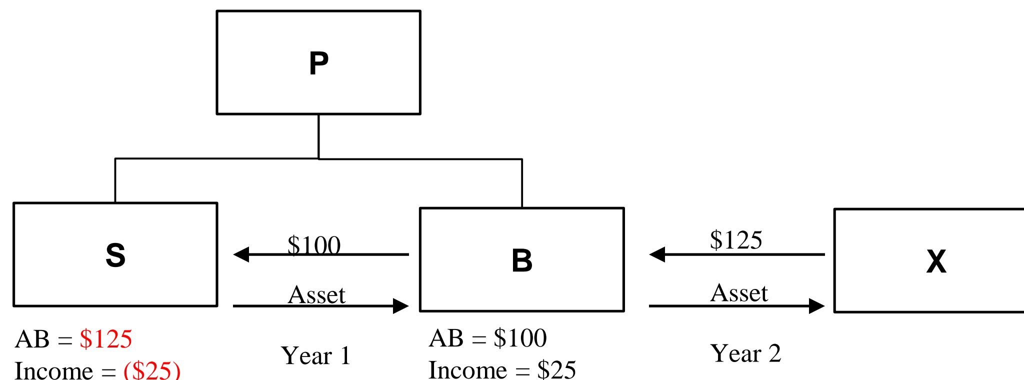
(B) Amount S takes into account in year 2: $100 (B's recomputed corresponding item) - $25 (B's corresponding item) = $75

(C) If S and B are divisions of a single corporation: $100 of B's gross income would be FDDEI (i.e., $125 - $25 (B's basis))

(D) If S and B are separate corporations: S would have $75 of DEI and no FDDEI; B would have $25 of DEI all of which would be FDDEI

(E) S's $75 of DEI is redetermined to be included in gross FDDEI

Intercompany Transaction at a *Loss* Prior to Sale to Unrelated Foreign Party: Prop. Treas. Reg. § 1.1502-13(c)(7)(ii)(T), Ex. 20



Analysis: Intercompany Sale at a Loss

(A) Amount S takes into account in year 1: $0

(B) Amount S takes into account in year 2: $0 (B's recomputed corresponding item) - $25 (B's corresponding item) = $(25)

(C) If S and B are divisions of a single corporation: DEI would be $0 (i.e., $125 - $125)

(D) If S and B are separate corporations: S would have DEI = ($25) and no FDDEI; B would have $25 of DEI all of which would be FDDEI

(E) "S's ($25) loss is allocated and apportioned solely to B's $25 income for purposes of determining B's DEI and FDDEI"

(F) B's $25 of gross income is not taken into account for purposes of apportioning any other deductions under § 861 for purposes of determining any member's DEI or FDDEI

FDII and Consolidated Groups: Prop. Treas. Reg. § 1.1502-50

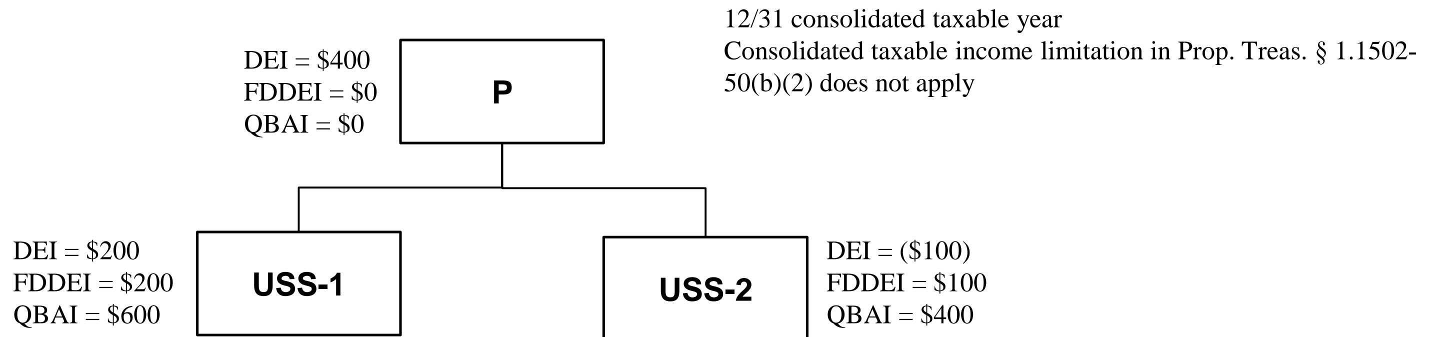
- Prop. Treas. Reg. § 1.1502-50(a) and (e) – Section 250 applies on a consolidated basis (relevant items are determined using group-wide calculation)

- Prop. Treas. Reg. § 1.1502-50(b)(1) – Consolidated FDII Deduction allocable to a member is equal to the sum of:
  - The Consolidated FDII deduction amount multiplied by the member's FDII allocation ratio, and
  - The Consolidated GILTI deduction amount multiplied by the member's GILTI deduction allocation ratio

- Prop. Treas. Reg. § 1.1502-50(c) – Impact of Intercompany Transactions
  - For determining QBAI, the basis of specified tangible property does not include gain or loss from intercompany transactions

- Prop. Treas. Reg. § 1.1502-50(d) – Adjustments to Member Stock Basis
  - Income offset by section 250 deduction treated as tax exempt income for investment adjustment purposes

Prop. Treas. Reg. § 1.1502-50(f), Ex. 1



Analysis

(A) Consolidated DEI: $400 + $200 + (-$100) = $500 > 0

(B) Consolidated FDDEI: $0 + $200 + $100 = $300 > 0

(C) Consolidated DTI: (0.1 x $0) + (0.1 x $600) + (0.1 x $400) = $100

(D) Consolidated DII: $500 - $100 = $400

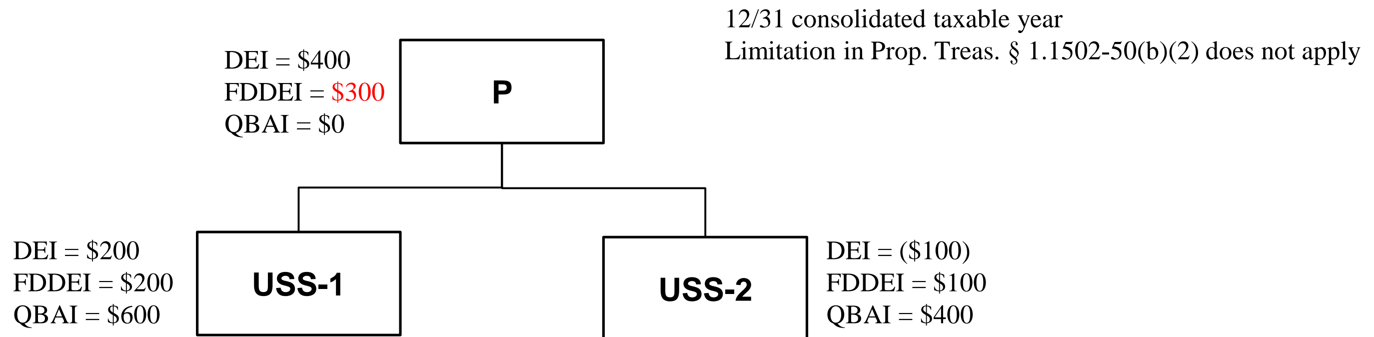
(E) Consolidated FDII: ($300/$500) = 0.6 (consolidated foreign-derived ratio) < 1; $400 x 0.6 = $240

(F) Consolidated FDII deduction: 0.375 x $240 = $90

(G) Member's deduction attributable to consolidated FDII deduction:

- P – $90 x ($0/$300) = 0
- USS-1 - $90 x ($200/$300) = $60
- USS-2 - $90 x ($100/$300) = $30

Prop. Treas. Reg. § 1.1502-50(f), Ex. 2



Analysis

(A) Consolidated DEI: $400 + $200 + (-$100) = $500 > 0

(B) Consolidated FDDEI: $300 + $200 + $100 = $600 > 0

(C) Consolidated DTI: (0.1 x $0) + (0.1 x $600) + (0.1 x $400) = $100

(D) Consolidated DII: $500 - $100 = $400

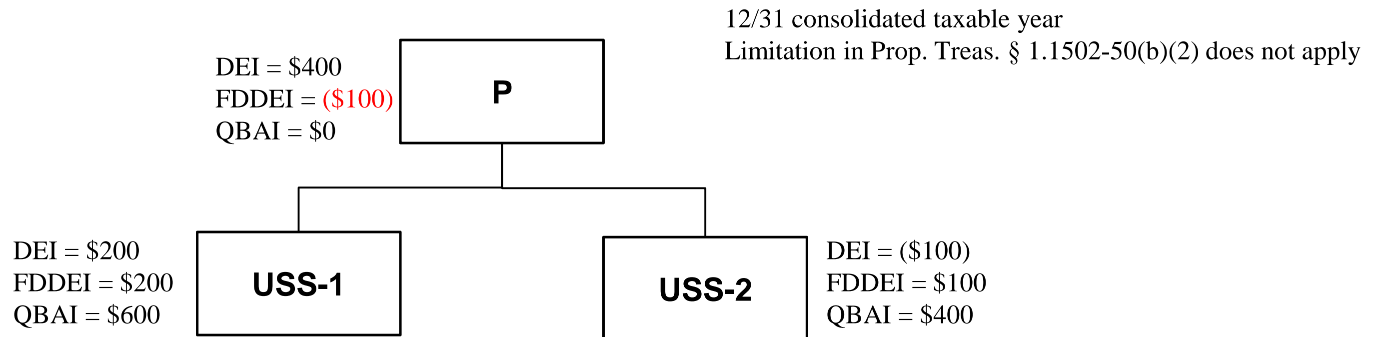
(E) Consolidated FDII: ($600/$500) = 1.2 > 1; $400 x 1 = $400

(F) Consolidated FDII deduction: 0.375 x $400 = $150

(G) Member's deduction attributable to consolidated FDII deduction:

- P – $150 x ($300/$600) = $75
- USS-1 - $150 x ($200/$600) = $50
- USS-2 - $150 x ($100/$600) = $25

Prop. Treas. Reg. § 1.1502-50(f), Ex. 3



Analysis

(A) Consolidated DEI: $400 + $200 + (-$100) = $500 > 0

(B) Consolidated FDDEI: (-$100) + $200 + $100 = $200 > 0

(C) Consolidated DTI: (0.1 x $0) + (0.1 x $600) + (0.1 x $400) = $100

(D) Consolidated DII: $500 - $100 = $400

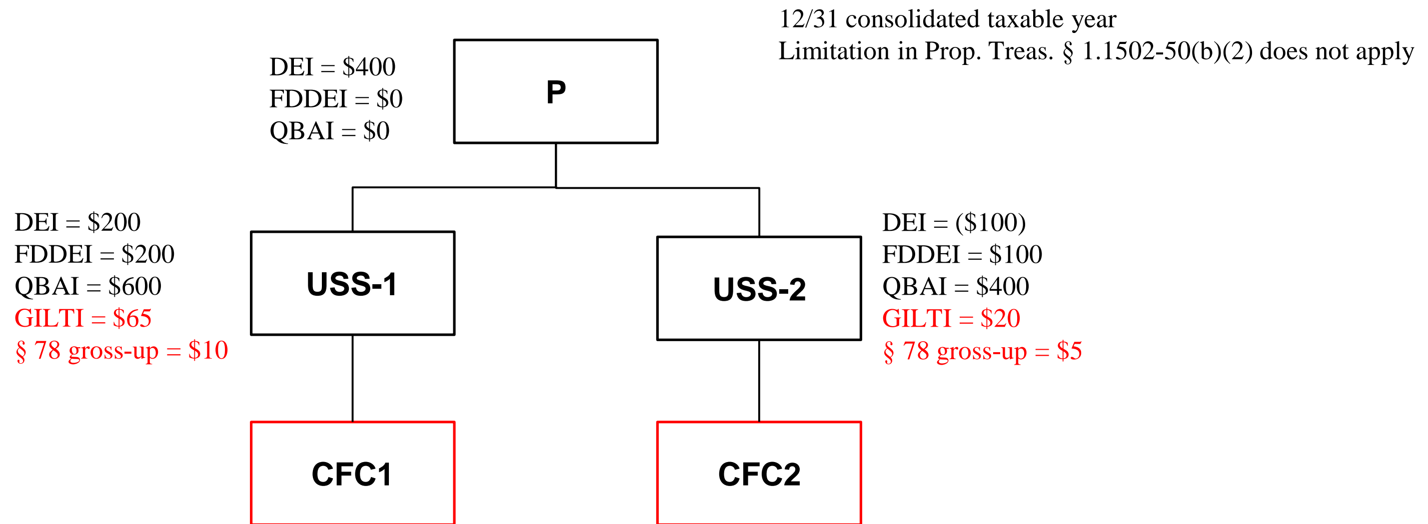
(E) Consolidated FDII: ($200/$500) = 0.4 < 1; $400 x 0.4 = $160

(F) Consolidated FDII deduction: 0.375 x $160 = $60

(G) Member's deduction attributable to consolidated FDII deduction:

- P has negative FDDEI; therefore, no allocation of FDII deduction
- USS-1 - $60 x ($200/$300 (the sum of positive FDDEI)) = $40
- USS-2 - $60 x ($100/$300) = $20

Prop. Treas. Reg. § 1.1502-50(f), Ex. 4



Analysis

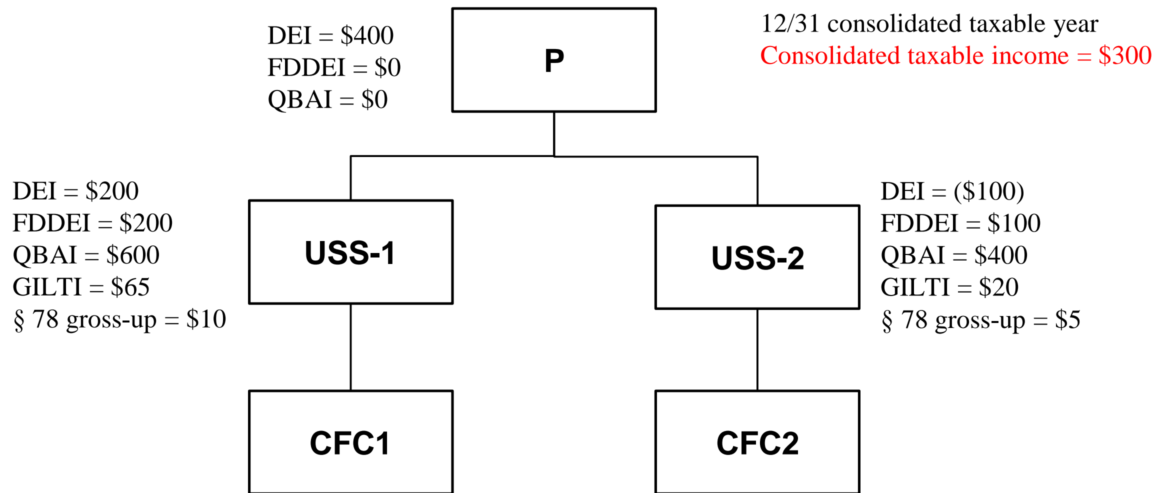
(A) Consolidated GILTI: $0 + $65 + $20 = $85

(B) Consolidated GILTI deduction: 0.5 x ($85 +$10 +$5) = $50

(C) Member's deduction attributable to consolidated GILTI deduction:

- P - $50 x ($0/$100 (the sum of GILTI and § 78 gross-up)) = $0
- USS-1 - $50 x ((65+$10)/$100) = $37.5; FDII deduction from Ex. 1 = $60; total $97.5
- USS-2 - $50 x (($20+$5)/$100) = $12.5; FDII deduction from Ex. 1 = $30; total $42.5

Prop. Treas. Reg. § 1.1502-50(f), Ex. 5



Analysis

(A) Consolidated FDII: $240 (see Example 1)

(B) Consolidated GILTI: $0 + $65 + $20 = $85

(C) Consolidated limitation: ($240 + $85) - $300 (consolidated taxable income) = $25

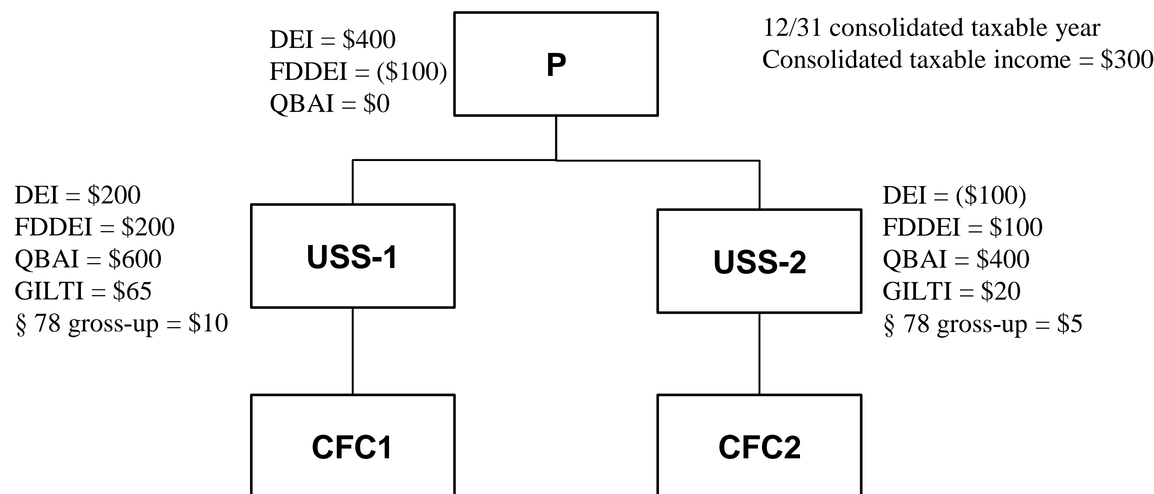
(D) Allocation of reduction:

- To FDII – $25 x ($240/$325) = $18.46; $240 - $18.46 = $221.54 reduced FDII
- To GILTI - $25 x ($85/$325) = $6.54; $85 - $6.54 = $78.46 reduced GILTI

(E) Consolidated FDII deduction: $221.54 x 0.375 = $83.08

(F) Consolidated GILTI deduction: $78.46 x 0.5 = $39.23

Prop. Treas. Reg. § 1.1502-50(f), Ex. 5 (cont.)



Analysis (cont.)

(G) Member's deduction attributable to the consolidated FDII deduction:

- P - $83.08 x ($0/$300) = $0
- USS-1 - $83.08 x ($200/$300) = $55.39
- USS-2 - $83.08 x ($100/$300) = $27.69

(H) Member's deduction attributable to the consolidated GILTI deduction:

- P - $39.23 x ($0/$100 (GILTI + gross-up)) = $0
- USS-1 - $39.23 x (($65+$10)/$100) = $29.42
- USS-2 - $39.23 x (($20+$5)/$100) = $9.81

(I) Member's total deduction:

- P - $0
- USS-1 - $55.39 + $29.42 = $84.81
- USS-2 - $27.69 + $9.81 = $37.5

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.

"Applicable Taxpayer"

- An applicable taxpayer is a corporation (other than an S corporation, a regulated investment company, or a real estate investment trust) that has:
  - average annual gross receipts of at least $500 million for the 3-taxable-year period ending with the taxable year preceding the one for which BEAT liability is being determined, and
  - a "base erosion percentage" (generally the ratio of base erosion tax benefits to the aggregate deductions (with limited exceptions) allowable to the taxpayer during the taxable year) in excess of three percent. I.R.C. § 59A(e). The base erosion percentage threshold is reduced to two percent in the case of taxpayers that are members of an affiliated group that includes a bank or registered securities dealer.
- An aggregation rule generally treats all persons that would be treated as a single employer under section 52(a) as a single person, solely for purposes of defining an applicable taxpayer and determining the base erosion percentage.

Section 59A(d): Base Erosion Payments

- A "base erosion payment" ("BEP") is any amount paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer:

  - and with respect to which a deduction is *allowable* (section 59A(d)(1)); or

  - in connection with the acquisition by the taxpayer from such person of property of a character subject to the allowance for depreciation (or amortization in lieu of depreciation) (section 59A(d)(2)).

- There are special rules for reinsurance payments (section 59A(d)(3)) and payments to expatriated entities (section 59A(d)(4)) and there is an exception for certain amount paid or accrued with respect to services (section 59A(d)(5)).

Section 59A(c)(2): Base Erosion Tax Benefit

- Base erosion tax benefit
  - Deduction *allowed* for the taxable year
- Amounts taxed under section 881 (FDAP) are excluded in proportion to the rate of tax applied to reduce the 30% statutory rate
  - Reduction in gross receipts, but only for certain expatriated entities (again using Nov. 9, 2017 date)

Base Erosion Payments and Nonrecognition Transactions under the Proposed Regulations

- The proposed regulations provide an operating rule providing that an "amount paid or accrued includes an amount paid or accrued using any form of consideration, including cash, property, stock, or the assumption of a liability." Prop. Treas. Reg. section 1.59A-3(b)(2)(i).

- The preamble to the proposed section 59A regulations ("Preamble") provides that each of the following are BEPs (in an amount equal to the depreciable/amortizable basis in the assets so acquired):

  - an exchange described in section 351:
  - a liquidation described in section 332, and
  - a reorganization described in section 368.

- Such is the case even if "the importation of depreciable or amortizable assets into the United States in these transactions may increase the regular income tax base as compared to the non-importation of those assets." NPRM Fed. Reg. p. 65960.

  - The preamble does not provide any reasoning behind Treasury and the Service's decision to deny an exclusion for nonrecognition transactions except to provide that basis can be imported in these transactions.

"Amount Paid or Accrued"

- Treasury and the IRS interpret the phrase "amount paid or accrued" found in section 59A(d) broadly.

- The Preamble does not cite to any authorities to explain how Treasury and the IRS arrived at such a broad interpretation.

- Section 7701(a)(25) provides that "[t]he terms 'paid or incurred' and 'paid or accrued' shall be construed according to the method of accounting upon the basis of which the taxable income is computed under subtitle A."

- In *De Soto Securities Company v. Commissioner*, the Seventh Circuit observed "that 'accrued' relates to the incidence of a tax or interest obligation, while 'incurred' relates to the incidence of any other obligation." 235 F.2d 409 (7th Cir. 1956).

- Additional reasons why "paid or accrued" arguably should not apply to equity issuances in nonrecognition transactions include:
  - Aside from boot (and liability assumption), issuer does not transfer assets to the shareholder.
  - No amount is currently recognized.
  - Equity typically does not contain a maturity date or entitle shareholder to a sum certain.

Base Erosion Payments and Section 301

- The Preamble provides that:

  > In contrast, for transactions in which a taxpayer that owns stock in a foreign related party receives depreciable property from the foreign related party as an in-kind distribution subject to section 301, there is no base erosion payment *because there is no consideration provided by the taxpayer to the foreign related party in exchange for the property*. Thus, there is no payment or accrual. (Emphasis added).

- Open Questions:
  - May a distribution subject to section 301(c)(3) be treated as a BEP?
  - What about section 301(c)(2)?
  - Does it matter whether the asset distributed is a built-in loss asset (as opposed to a built-in gain asset)? *See* section 311(b) (providing that "… gain shall be recognized to the distributing corporation as if such property were sold to the distributee at its fair market value").

Base Erosion Payments and Section 302

- Are section 302(d) redemptions (i.e., dividend equivalent redemptions) base erosion payments?
  - In form, there is an exchange (and, thus, consideration paid by the applicable taxpayer to the related foreign party), but the Code treats such redemptions (consistent with their substance) as distributions with respect to stock under section 301. *See also* Prop. Treas. Reg. section 1.302-5(a); *cf*. Treas. Reg. section 1.367(a)-8(n).
  - If section 302(d) redemptions are base erosion payments, should there be an exception for meaningless gesture redemptions?
- What about section 302(a) redemptions (i.e., sale or exchange redemption)?

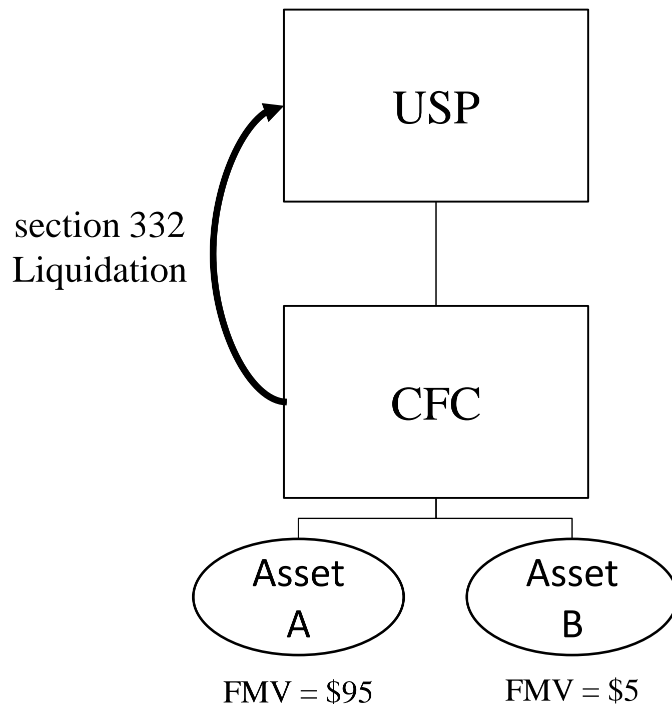
Why Section 332 Liquidations?

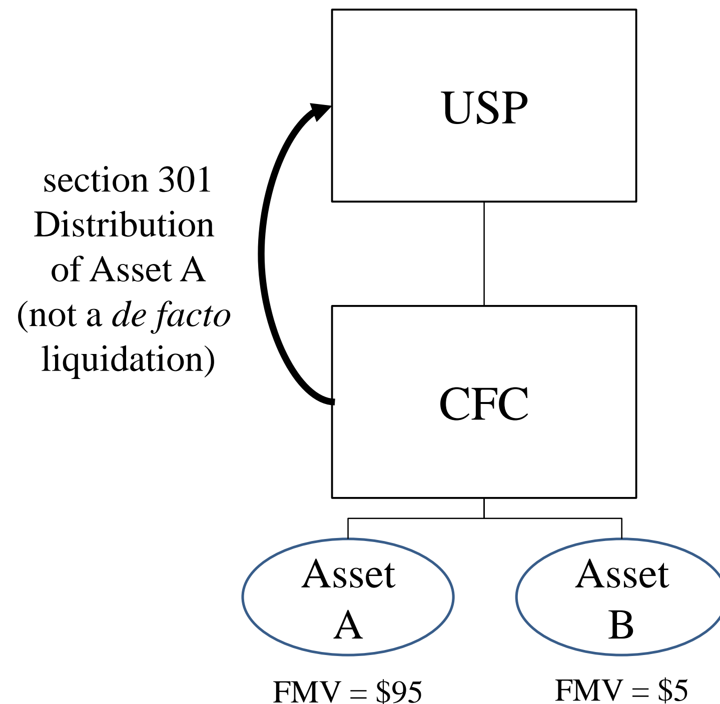
- From a legal perspective, there is an exchange of the shareholder corporation's shares in the liquidating corporation for the liquidating corporation's assets. However, the liquidating subsidiary no longer exists once the transaction is completed and its stock has been cancelled.

- Section 332, however, provides that "no gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation." *Compare* Section 331 (liquidating distributions "treated as in full payment in exchange for the [liquidating corporation's] stock").

- Should a section 332 liquidation give rise to an "amount paid or accrued," when the "consideration received" by the liquidating subsidiary goes out of existence in the liquidation and is never enjoyed by that liquidating subsidiary?

Form over Substance?





- Liquidating distribution treated as a BEP.
- Section 301 distribution not treated as a BEP.

Base Erosion Payments and Losses

- The Preamble provides that:

> ... because section 59A(d)(1) defines the first category of base erosion payment as “any amount paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer and with respect to which a deduction is allowable under this chapter,” a base erosion payment also includes a payment to a foreign related party resulting in a *recognized* loss; for example, a loss recognized on the transfer of property to a foreign related party. (Emphasis added).

Base Erosion Payments and Losses: Coordination Issues

- If U.S. taxpayer uses built-in loss property to pay for depreciable property, is the payment described in section 59A(d)(1) (a deductible payment), 59A(d)(2) (a payment for depreciable property), or both? Are both the loss and the depreciation deductions base erosion tax benefits, so the same payment results in multiple benefits subject to the BEAT?

- If a U.S. taxpayer uses built-in loss property to make a payment that otherwise qualifies for an exception to base erosion payments (e.g., qualified derivatives or services cost method fees), is the payment a base erosion payment? If so, is the deduction that would otherwise have been exempt a base erosion tax benefit because it is allowable with respect to a base erosion payment?

- How does the exception for payments on which withholding tax is imposed apply to a transfer of built-in loss property?

- Where the foreign related party purchases the loss property for cash, what are the rules for determining whether the receipt of the property is ECI?

Base Erosion Payments and Section 267(f)

- Losses recognized on transfers of built-in loss property to related foreign parties will frequently be deferred under section 267(f).

- Presumably, there is no base erosion tax benefit until the loss is triggered, such as when the asset leaves the controlled group.

  - Where the loss is triggered by the U.S. taxpayer and related foreign party becoming unrelated, is the deduction appropriately a base erosion tax benefit? If such a transaction should be exempt, what if the asset appreciates in related foreign party's hands?

  - What if the parties become unrelated for purposes of section 267(f) (50% threshold) but remain related for purposes of the BEAT (25% threshold)?

- Where the loss was "recognized" before the domestic corporate seller was an "applicable taxpayer," is the loss a base erosion tax benefit if the seller is an "applicable taxpayer" on the triggering date?

Modified Taxable Income and Losses

- MTI = taxable income under § 63 + the gross amount of base erosion tax benefit + the base erosion percentage ("BE Percentage") of any NOL. *See* Prop. Treas. Reg. § 1.59A-4(b)(2).
  - If the taxpayer has negative taxable income for the year and no deductible NOL carryovers or carrybacks, such negative taxable income is a starting point for calculating the MTI.
  - If the taxpayer has a positive taxable income for the year and deductible NOL carryovers or carrybacks that exceed positive taxable income, the starting point for calculating MTI is zero. *See* Prop. Treas. Reg. § 1.59A(b).
    - The BE Percentage of the NOL deduction is calculated following the same principles—only that portion of NOL that reduces taxable income to zero is added back. *See* Prop. Treas. Reg. § 1.59A-4(b)(2)(ii).
    - The BE Percentage of an NOL is determined based on the year in which the NOL arose rather than the year in which the taxpayer recognizes it. Prop. Treas. Reg. § 1.59A-4(b)(2)(ii).
    - For NOLs incurred before January 1, 2018, and that are deductible after December 31, 2017, the BE Percentage is zero. *See* § 1.59A-4(b)(2)(ii) and (c)(2), *Ex.* 2.
    - The BE Percentage is calculated on the aggregate group basis rather than separately for each taxpayer. Prop. Treas. Reg. § 1.59A-2(c).

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) 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 raise questions.
    - 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?

Proposed BEAT Regulations: Consolidated Return Implications (cont.)

- **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.

BEAT in Consolidation: Coordination with §163(j)

- The Proposed Regulations would provide that any disallowed disqualified interest under <u>former</u> §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 <u>not</u> 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.

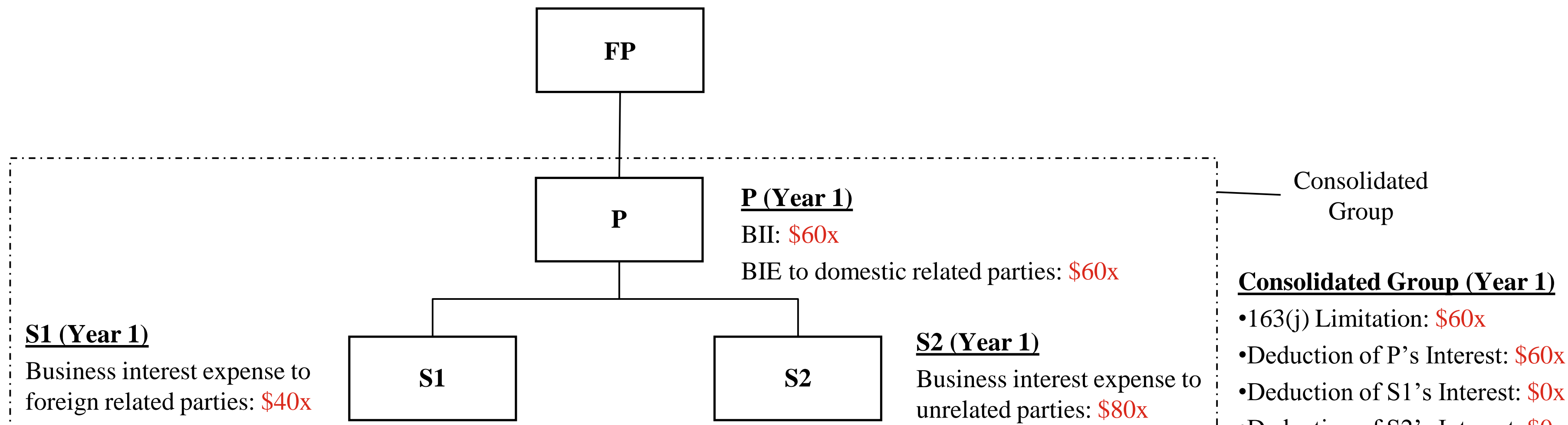
- Prop. Reg. §1.1502-59A(c) contains extensive rules to coordinate the proposed consolidated BEAT regulations with the recently proposed consolidated §163(j) regulations.
  - The classification rule in Prop. Reg. §1.1502-59A(c)(3) determines whether the consolidated group's §163(j) interest deduction 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.

BEAT in Consolidation: Coordination with §163(j) (cont.)

- If the group's aggregate current year BIE exceeds the §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 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 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), such member's §163(j) 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?).

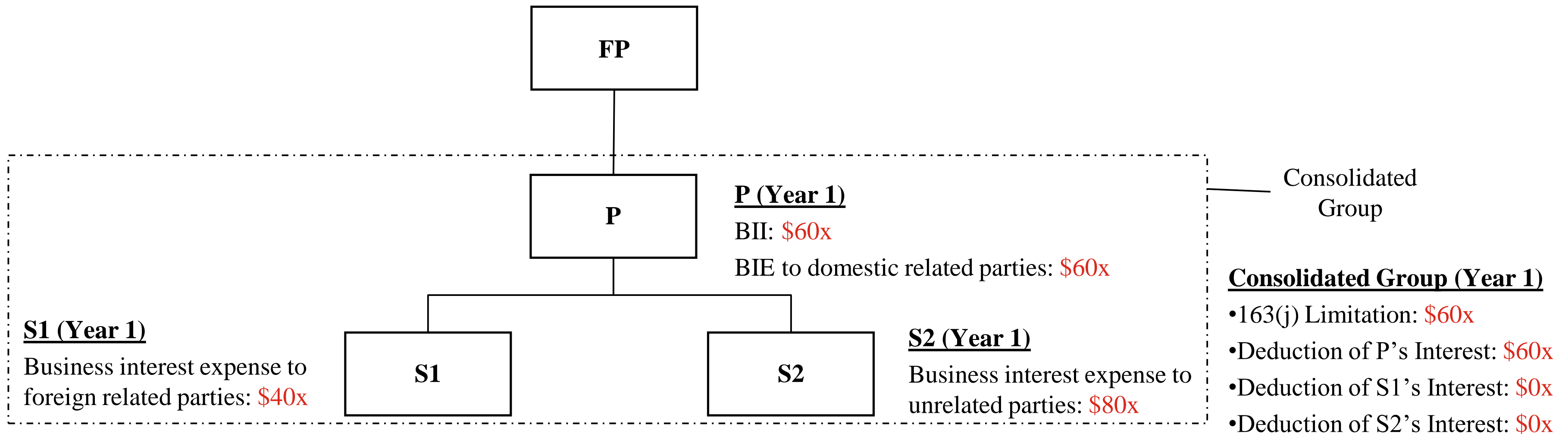
Example 1 - BEAT in Consolidation: Coordination with §163(j)



Facts:

- Foreign corporation (FP) owns domestic corporation (P), which in turn 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 had $60 of BII and 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 ($0 ATI + P's BII of $60x).
- After applying the rules in §1.163(j)-5(b)(3), the group deducts $60x of P's current year BIE and none of S1 and S2's.
- Assume the group is an applicable taxpayer for purposes of §59A.

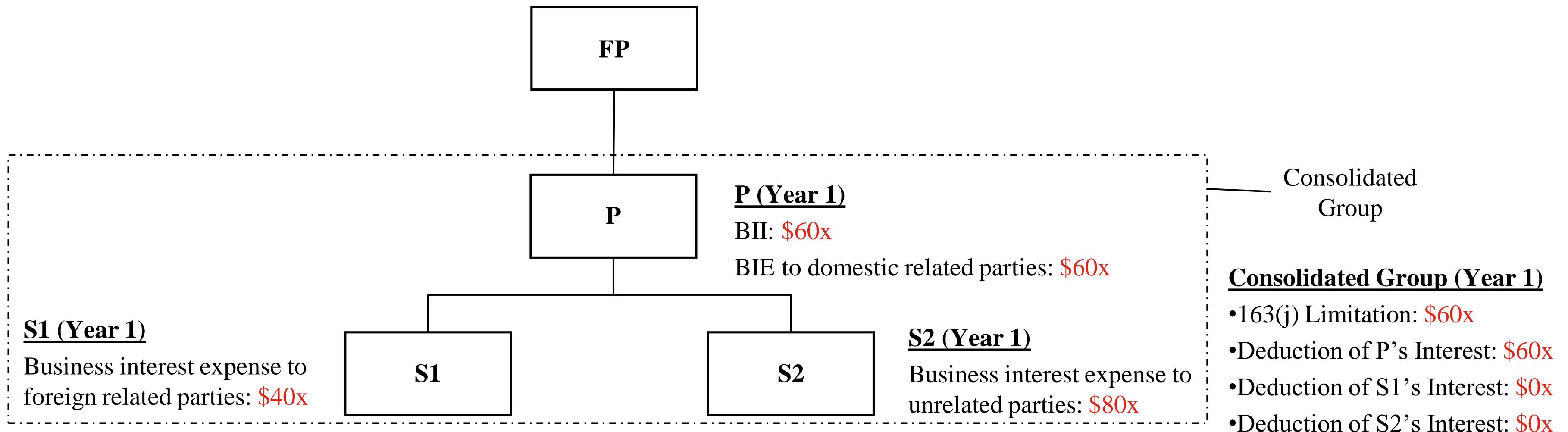
Example 1 - BEAT in Consolidation: Coordination with §163(j)



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.

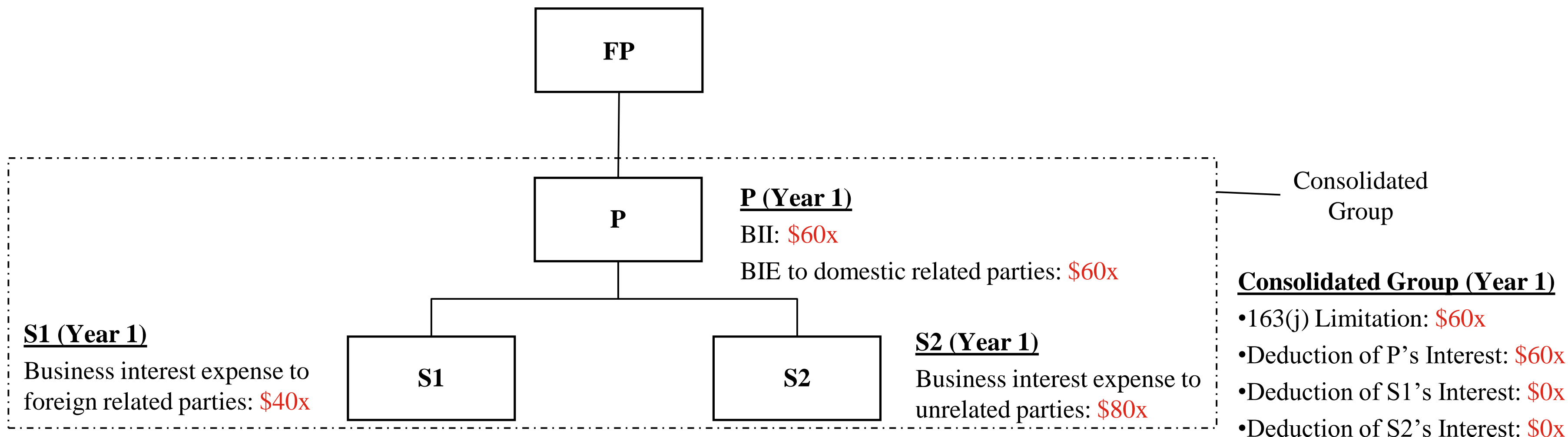
Example 1 - BEAT in Consolidation: Coordination with §163(j)



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.

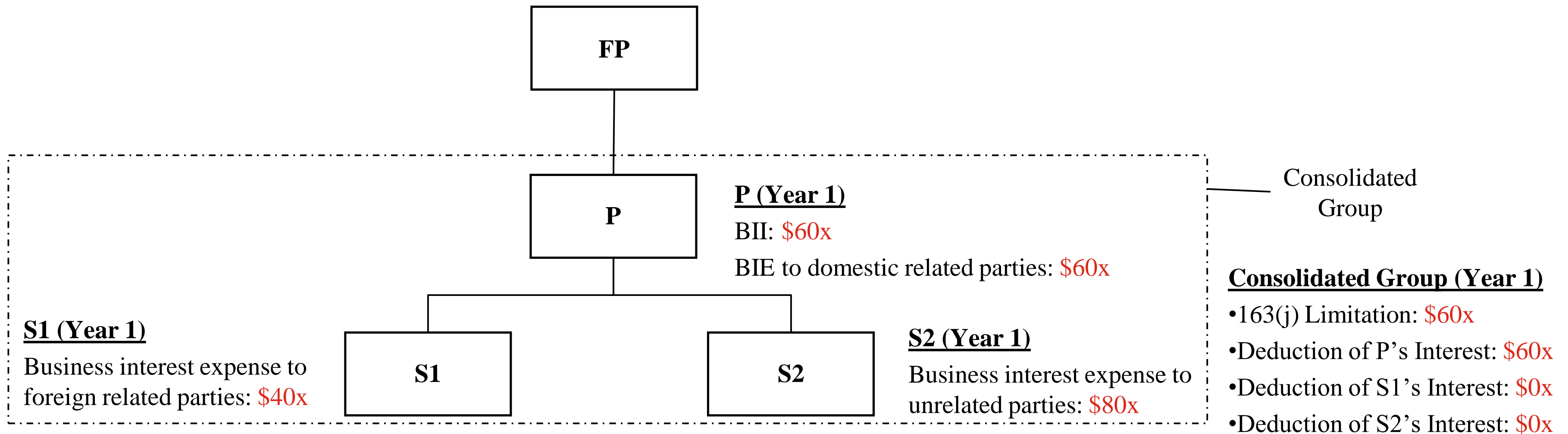
Example 1 - BEAT in Consolidation: Coordination with §163(j)



Analysis (cont.):

- Application of the allocation rule in §1.1502-59A(c)(4) (cont.)
  - *Allocations of the group's foreign related current year BIE deduction status*
    - The percentage of current year BIE deduction attributable to P is 100% (P's current year BIE deduction in Year 1, $60x, 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 P is $36x (the group's domestic related current year BIE deduction, $36x, multiplied by the percentage of current year BIE deduction allocable to P, 100%).
      - S1 and S2 are allocated $0x of domestic related current year BIE deduction
    - The amount of foreign related current year BIE deduction status allocable to P is $24x (the group's foreign related current year BIE deduction, $24x, multiplied by the percentage of current year BIE deduction allocable to P, 100%.
      - S1 and S2 are allocated $0x of foreign related current year BIE deduction.

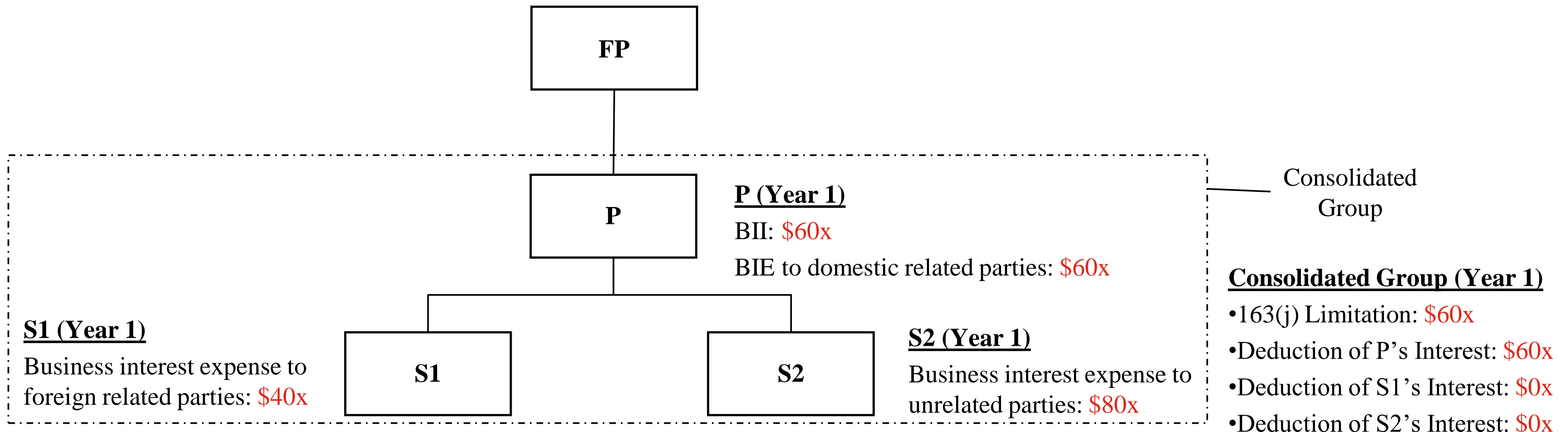
Example 1 - BEAT in Consolidation: Coordination with §163(j)



Analysis (cont.):

- 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.
  - 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.

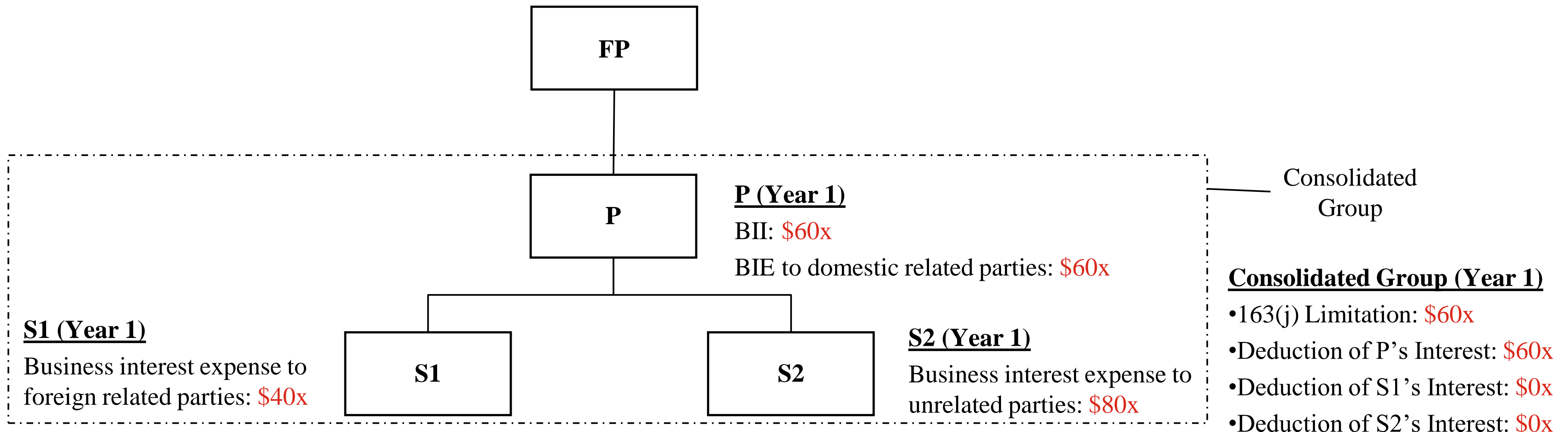
Example 1 - BEAT in Consolidation: Coordination with §163(j)



Analysis (cont.):

- Application of the allocation rule in §1.1502-59A(c)(5) (cont.)
  - P has $0 disallowed BIE carryforward ($60x – 60x), and its percentage of disallowed BIE carryforward is 0%.
  - The percentage of disallowed BIE carryforward allocable to S1 is 33.33% (S1's Year 1 disallowed BIE carryforward, $40x ($40x - $0x), divided by the group's Year 1 disallowed BIE carryforward, $120x ($60x + $40x + 80x - $60x).
  - The percentage of disallowed BIE carryforward allocable to S2 is 66.67% (S2's Year 1 disallowed BIE carryforward, $80x ($80x-$0x), divided by the group's Year 1 disallowed BIE carryforward, $120x ($60x+$40x+80x-$60x).

Example 1 - BEAT in Consolidation: Coordination with §163(j)

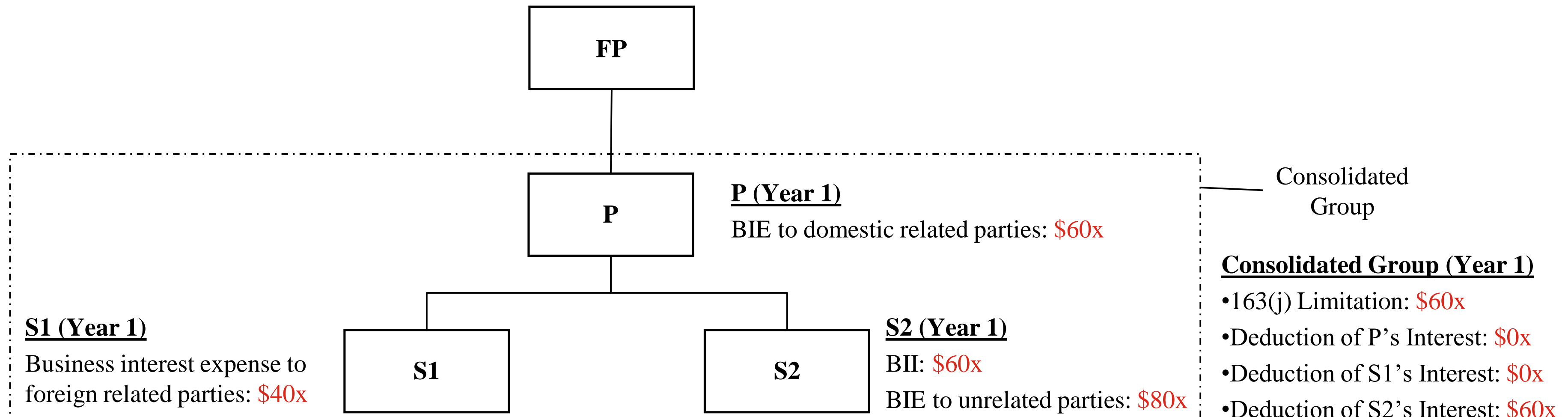


Analysis (cont.):

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

	P	S1	S2
Domestic Related BIE Carryforward	$0x	$8x ($24x * 33.33%)	$16x ($24x * 66.67%)
Foreign Related BIE Carryforward	$0x	$5.33x ($16x * 33.33%)	$10.66x ($16x * 66.67%)
Unrelated BIE Carryforward	$0x	$26.67x (($40x - ($8x + $5.33x))	$53.34x ($80x - ($16x + $10.66x))

Example - BEAT in Consolidation: Coordination with §163(j)



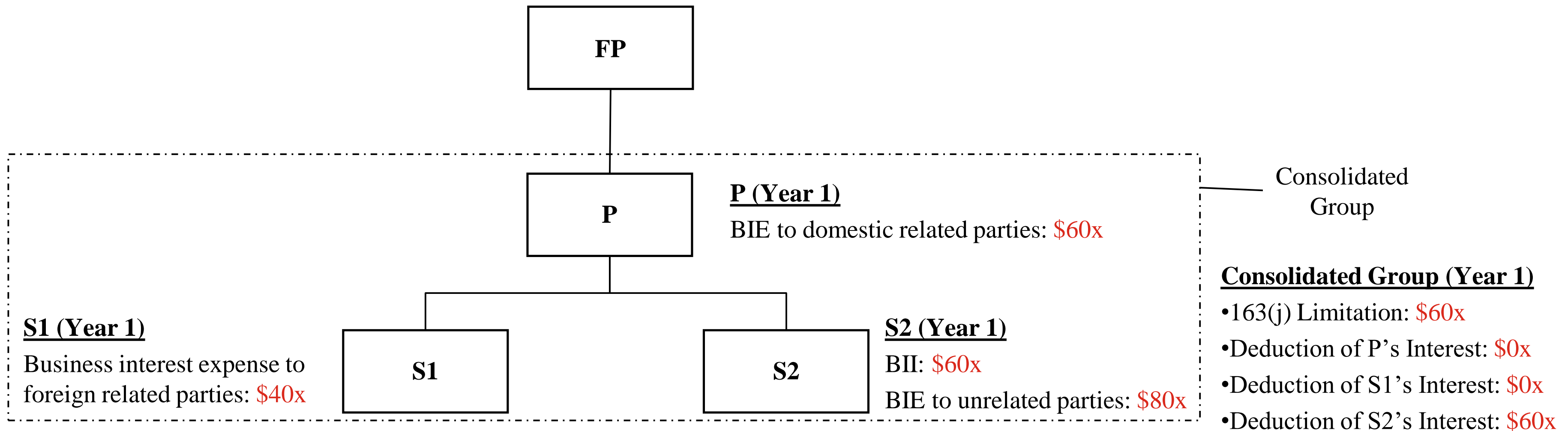
Facts;

- Facts are the same as in example 1, except that S2 had $60x of BII instead of P. Accordingly, the P Group deducts $60x of S2's current year BIE and none of P and S1's.

Analysis:

- Allocations of the group's foreign related current year BIE deduction status (simplified)
  - The amount of domestic related current year BIE deduction status allocable to S2 is $36x
  - The amount of foreign related current year BIE deduction status allocable to S2 is $24x
- Application of the allocation rule in §1.1502-59A(c)(5) (simplified)
  - The percentage of disallowed BIE carryforward allocable to P is 50%.
  - The percentage of disallowed BIE carryforward allocable to S1 is 33.33%.
  - The percentage of disallowed BIE carryforward allocable to S2 is 16.67%.

Example - BEAT in Consolidation: Coordination with §163(j)



Analysis (cont.):

- Application of the allocation rule in §1.1502-59A(c)(5) (simplified) (cont.)

	P	S1	S2
Domestic Related BIE Carryforward	$12x ($24x * 50%)	$8x ($24x * 33.33%)	$4x ($24x * 16.67%)
Foreign Related BIE Carryforward	$8x ($16x * 50%)	$5.33x ($16x * 33.33%)	$2.66x ($16x * 16.67%)
Unrelated BIE Carryforward	$40x (($60x - ($12x + $8x))	$26.67x (($40x - ($8x + $5.33x))	$13.34x ($20x - ($4x + $2.66x))

Selected Issues in 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).
  - Applies to earnings of a CFC at least 10 percent owned by a U.S. corporation, that has positive accumulated post-1986 deferred foreign income (a “DFIC”).
  - Inclusion may be reduced by E&P deficits (“specified E&P deficits”) of certain other foreign corporations (an “EDFC”).
- A taxpayer may make an election under section 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 sections 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 section 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).

Transition Tax – In General

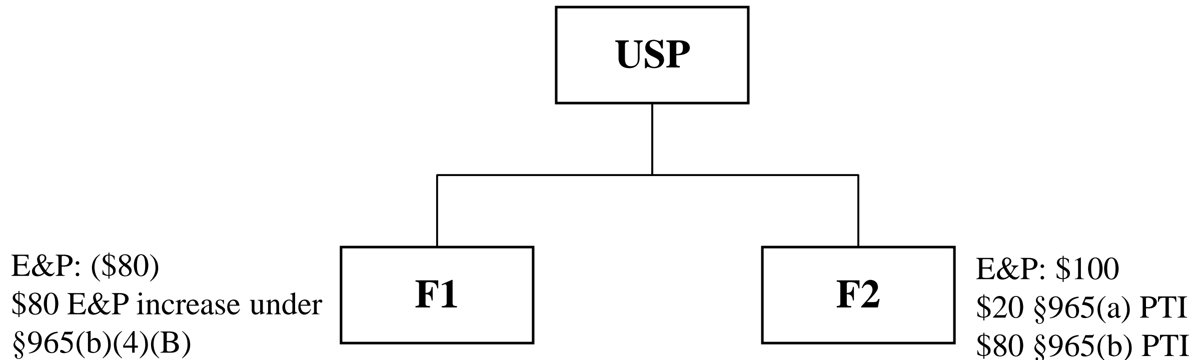
Allocation of aggregate foreign E&P deficit

- 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).
- 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 – 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 section 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.
- **Additional Elective Basis Adjustments – Treas. Reg. §1.965-2(f)(2)**
  - 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).

Transition Tax Inclusion and Stock Basis Adjustments – Example



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.

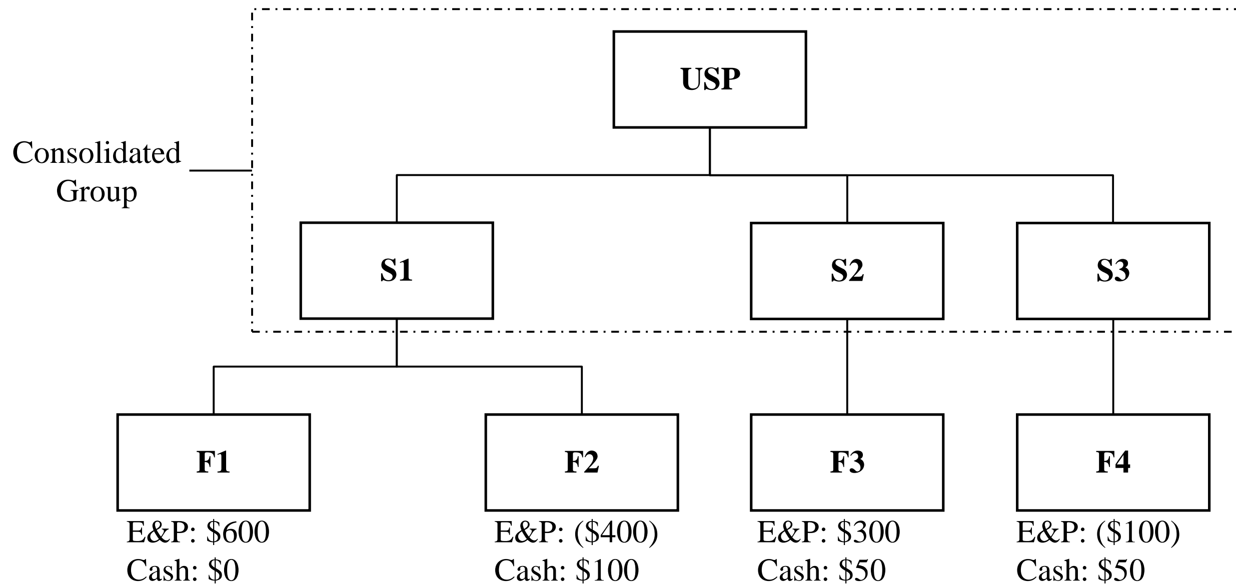
Transition Tax – Rules for Consolidated Groups

- **General Approach**: The section 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 section 958(a) U.S. shareholders of an SFC are treated as a single §958(a) U.S. shareholder for purposes of sections 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 section 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 section 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 section 965(a) inclusion) and foreign taxes deemed paid. See Prop. Treas. Reg. §1.965-8(e)(2).

Transition Tax – Rules for Consolidated Groups

- For purposes of determining the section 965(c) deduction amount of any section 958(a) U.S. shareholder that is a member of a consolidated group, the aggregate foreign cash position of the section 958(a) U.S. shareholder is equal to that member's section 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 section 958(a) U.S. shareholder as a single section 958(a) U.S. shareholder) to (ii) the sum of the aggregate section 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).

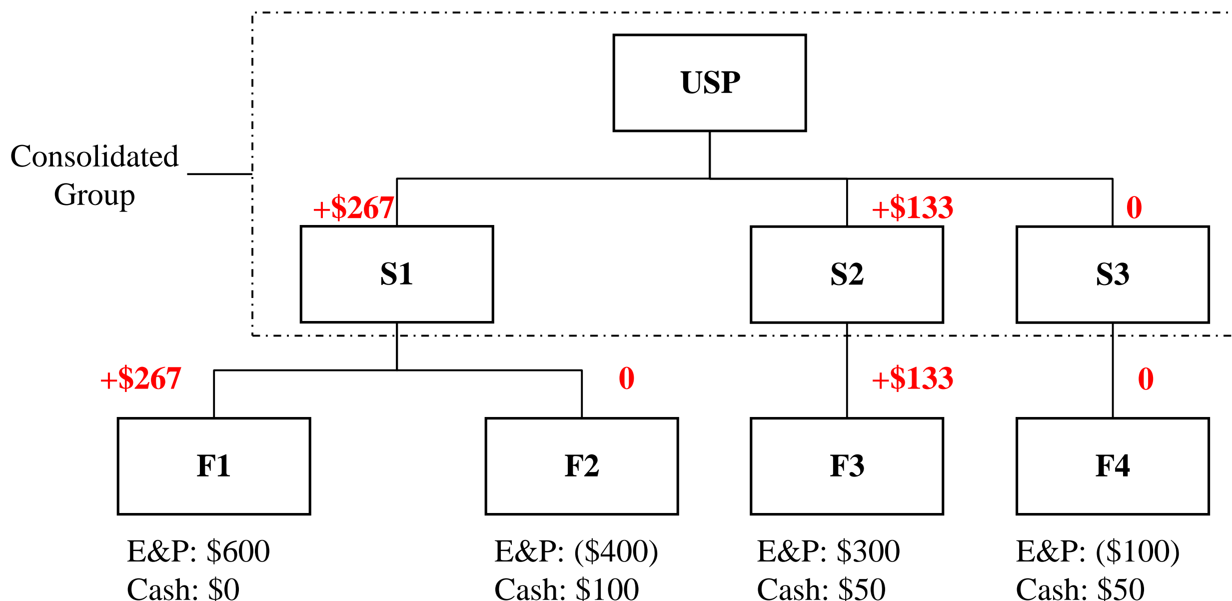
Section 965(a) Consolidated Group: Example 2 (Treas. Reg. §1.965-8(g)(2), Example 2)



<u>Facts:</u>

- 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)



Analysis:

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

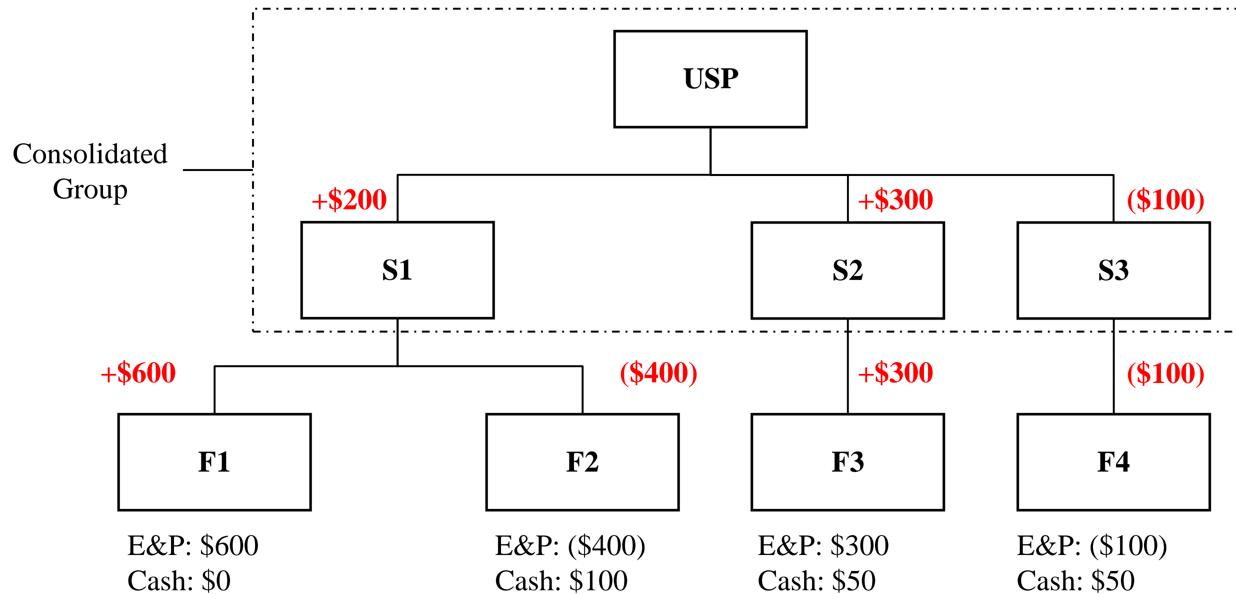
* $177.14 = ($133.33 x (19.5/35)) + ($133.33 x (27/35))

** $88.56 = ($66.67 x (19.5/35)) + ($66.67 x (27/35))

*** Group Cash Ratio: $200/$400 = 50%

- 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.

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.

Deferred Payment of Section 965(h) Net Tax Liability

- **<u>Context:</u>**
  - 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.

- **<u>Key Considerations:</u>**
  - Acceleration events in regulations that trigger total, unpaid transition tax are broader than statutory language and differ from approach in § 108(i).
  - 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.

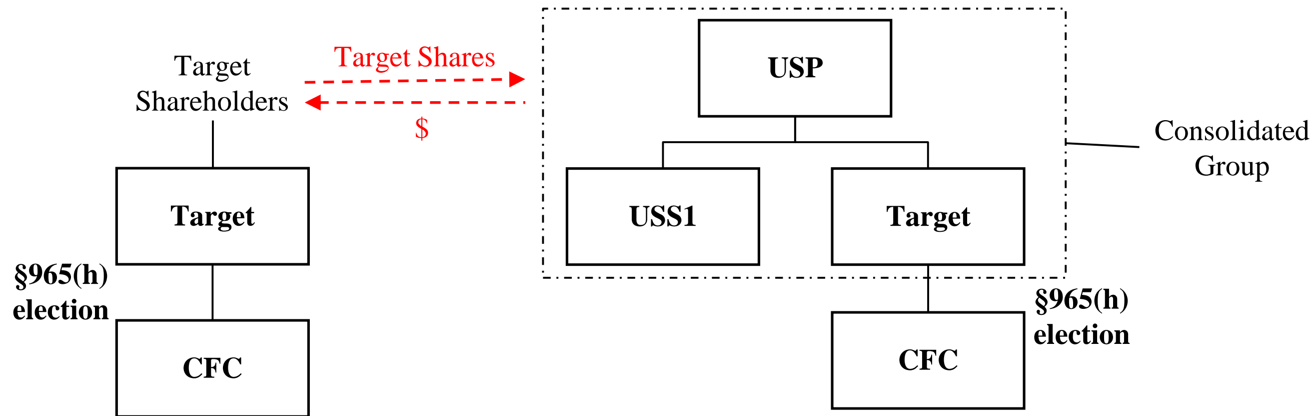
Acceleration Events

- **<u>Acceleration rule:</u>** 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).

- **<u>"Person":</u>** The event is with respect to **(i)** a U.S. shareholder or **(ii)** the U.S. owner of a domestic passthrough entity.

- **<u>Acceleration events</u>**: 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 ("**<u>Failure to Pay Event</u>**");
  - The person liquidating, selling, exchanging, or otherwise disposing of substantially all of its assets ("**<u>Sub All Event</u>**");
    - *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 ("**<u>Business Cessation Event</u>**");
  - The person becoming a non-U.S. person ("**<u>Non-U.S. Event</u>**");
  - A person that is not a member of a consolidated group becoming a consolidated group member ("**<u>Consolidation Event</u>**");
  - For a consolidated group, the group ceasing to exist or otherwise discontinuing filing consolidated returns ("**<u>Termination Event</u>**"); **<u>or</u>**
  - The Commissioner determines that the transfer agreement includes a material misrepresentation or material omission.

Acceleration by Joining Consolidated Group: Example 1



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.

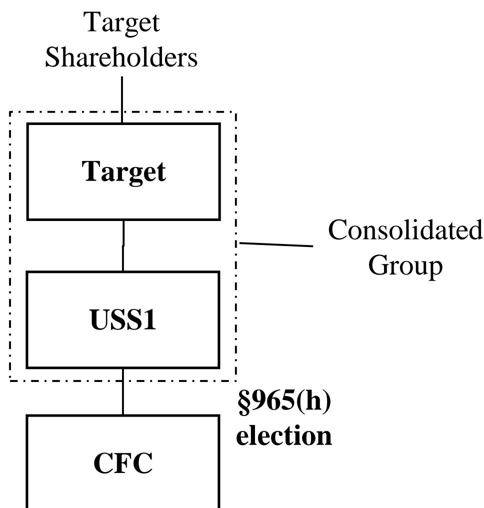
Analysis:

- 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 2



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:

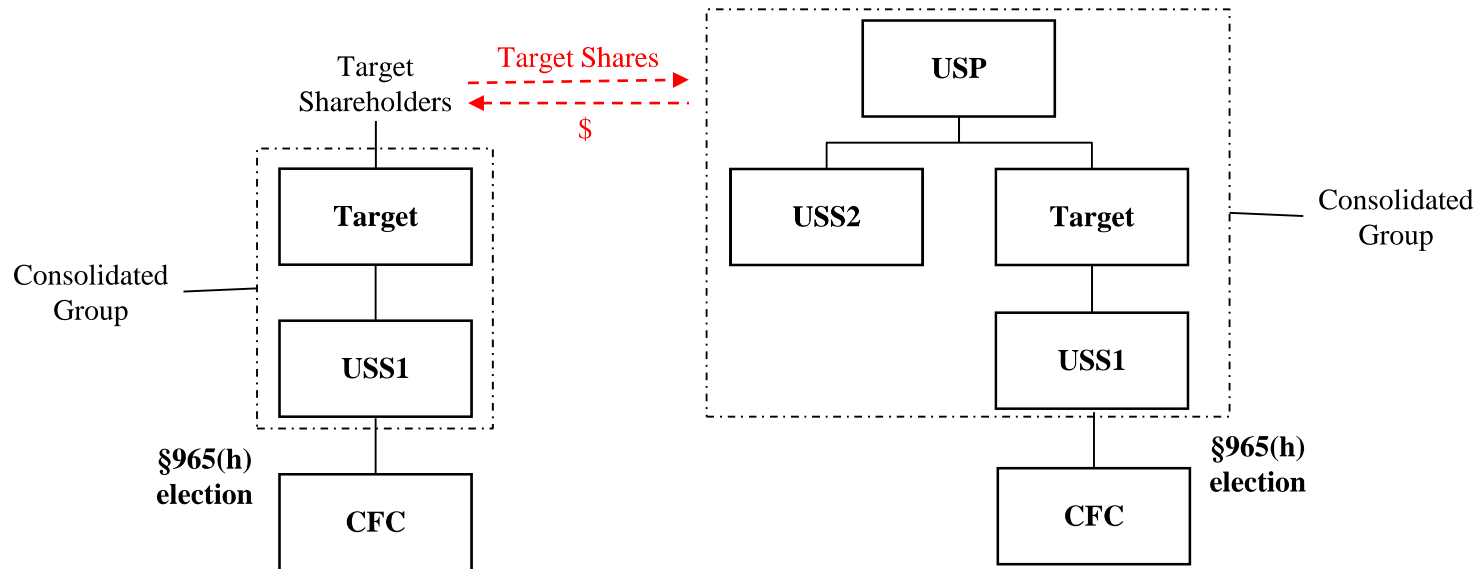
- The termination of the Target consolidated group for **any** reason is an acceleration event.
- This transaction also constitutes a covered acceleration event; thus, the transfer agreement exception may apply (discussed below). *See* Treas. Reg. §1.965-7(b)(3)(iii)(A)(*1*)(*v*).

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 3



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.

Changes to Transfer Agreement Requirements (per Final Regulations)

- The transferee must waive the right to a notice of liability and consent to an immediate assessment as a term of the transfer agreement.

- **The transfer agreement must include a statement as to whether the leverage ratio of the transferee exceeds 3:1.**

  - IRS may use the ratio when assessing the accuracy of the transferee's representation that it is able to pay the outstanding payments.

  - The ability to pay depends on all facts and circumstances.

  - What is the consequence if this statement is not able to be made or, based upon the government's methodology, the ratio is higher than 3:1?

- The Commissioner may require the transfer agreement to include any additional information, representation, or certification as indicated in publications, forms, instructions, or other guidance.

Rejected Comments Related to Transfer Agreements

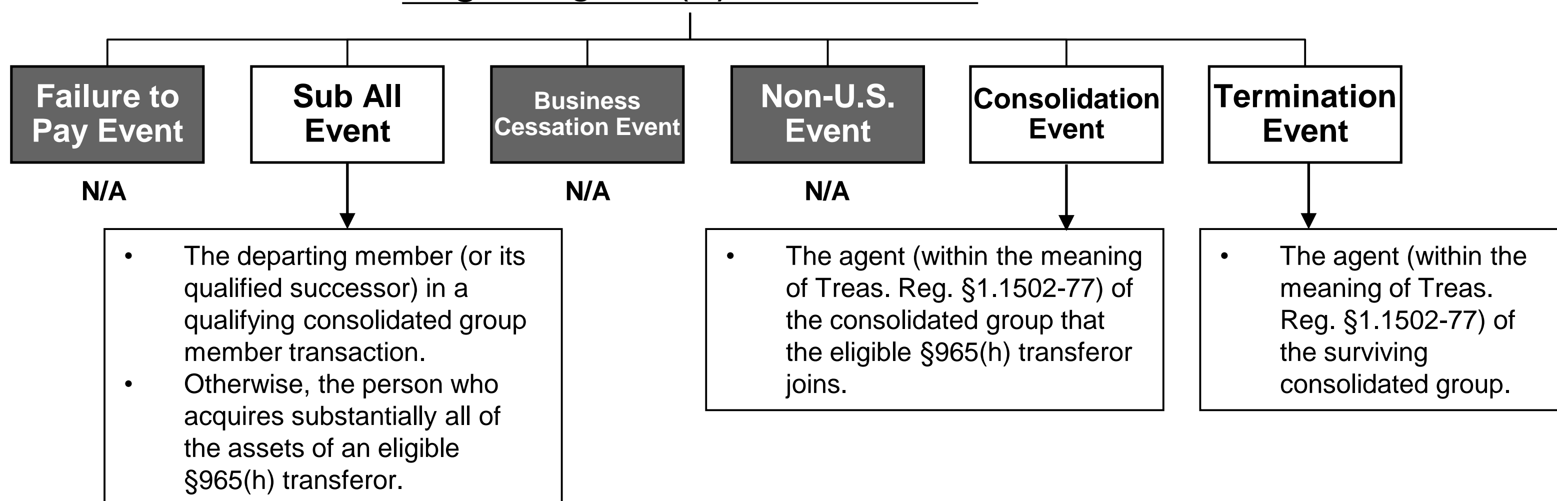
- Section 351 and 721 exchanges and F reorganizations should not be treated as acceleration events.
  - Viewed as a risk to the IRS's ability to collect.
- Clarification of the meaning of "substantially all."
  - Intended to be a facts and circumstances inquiry; no bright line definition.
- Treating "death" as a covered acceleration event.
  - Viewed as administratively difficult to execute such a transfer agreement.
- Allowing multiple transferees to be eligible to enter into multiple transfer agreements.
  - Rejected because considered akin to allowing partial transfers of the section 965(h) tax liability.
- Not to require the transferor who remains in existence to be jointly and severally liable for any unpaid instalments.
  - Viewed as IRS protection on its ability to collect as well as a safeguard against abusive transactions.

Due Date for Transfer Agreements

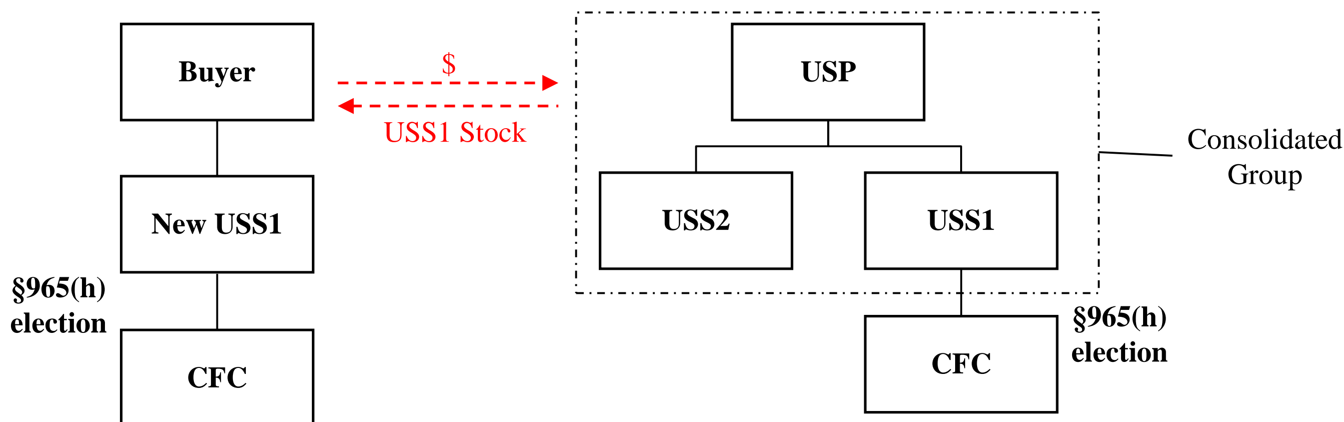
- The transfer agreement must be filed within 30 days of the date that the acceleration event occurs.
- Under the proposed regulations, if an acceleration event occurs before September 10, 2018, a transfer agreement is due by October 9, 2018.
- Under the final regulations, if an acceleration event occurs on or before December 31, 2018, the transfer agreement is due by March 7, 2019.

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). ***Query whether a merger into a DRE is eligible to enter into a transfer agreement?***
- 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. §.1502–77) of the relevant consolidated group.



Sale of Substantially All Assets, Eligible §965(h) Transferor, Eligible §965(h) Transferee: Example 4



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?

A "Substantially All" Acceleration Event (Revisited)

- An acceleration event includes the liquidation, sale, *exchange*, or other disposition of substantially all of the taxpayer's assets
- How should practitioners interpret "substantially all" for purposes of section 965(h)? *Cf.* Treas. Reg. § 1.108(i)-2(b)(6)(i)(B) (substantially all for purposes of section 108(i)(5)(D)(i) is at least 90% of FMV of net assets and 70% of gross assets).
- Is it appropriate to add "exchanges" of substantially all the assets in the regulations when excluded in section 965(h)(3)?

Eligible Section 965(h) Transferee Exception and "Sub All" Transactions

- A liquidation, sale, exchange or other disposition of substantially all of a taxpayer's assets will not result in the acceleration of the remaining installment payments if:
  - The acceleration event is either a qualifying consolidated group member transaction or a "sub all" event without a qualifying consolidated group member transaction (collectively with previous bullet, "Sub All Acceleration Events"); **and**
  - The eligible section 965(h) transferor and the "eligible section 965(h) transferee enter into a transfer agreement.
- As discussed previously, an "eligible section 965(h) transferee" is a single ***U.S. person*** (other than a passthrough).
- Open Question:
  - Is it possible for an eligible section 965(h) transferor to also be an eligible section 965(h) transferee in the same transaction (*e.g.*, an inbound section 332 liquidation)?

Eligible Section 965(h) Transferee Exception and "Sub All" Transactions (cont.)

- Sub All Acceleration Events appear to include, among other transactions, several commonplace internal restructuring transactions including:
  - Inbound section 332 liquidations;
  - Inbound F reorganizations;
  - Foreign-to-foreign reorganizations where the target corporation is a first-tier subsidiary (including foreign-to-foreign F reorganizations).
- Each of the above described transactions appear to be acceleration events that are ineligible to enter into a transfer agreement, because the section 965(h) transferee is not a U.S. person.
- Open Questions:
  - What is the government's concern with the transactions described above? Is the government's creditor position diminished or compromised in any material way?
  - Provided transfer agreements are entered into, would the government consider certain limited exceptions?