SULLIVAN & CROMWELL LLP

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Treasury and IRS Release Temporary Regulations Limiting Section 245A Dividends Received Deduction

The Temporary Regulations apply retroactively to limit the Section 245A dividends received deduction and the Section 954(c)(6) exception for distributions attributable to certain transactions.

SUMMARY

On June 14, 2019, the Treasury Department and IRS released temporary regulations (the "Temporary Regulations") that limit the Section 245A dividends received deduction and the Section 954(c)(6) look-through exception with respect to specified distributions received from controlled foreign corporations ("CFCs"). The specified distributions are intended to capture distributions of earnings from specified transactions that would have allowed certain types of income to permanently escape U.S. taxation. The targeted transactions include certain dispositions made before the CFC became subject to Section 951A, as well as certain ownership reduction transactions as described below. These Temporary Regulations were issued without a notice and comment period and are immediately effective and apply retroactively.

These Temporary Regulations form part of a broader regulatory package published in the Federal Register on June 21, which also includes additional guidance on Global Intangible Low-Taxed Income ("GILTI").

Although our other publications address key features of the guidance published on June 21, this memorandum is limited to our observations in respect of the Temporary Regulations.[1]

BACKGROUND

As part of the comprehensive tax reform bill passed in December 2017 (the "Tax Reform Act"),[2] Congress enacted Section 245A, which allows a 100% dividends received deduction for the foreign-source portion of certain dividends received by a domestic corporation from a specified 10%-owned foreign corporation (an "SFC"). This deduction generally applies only to dividends received after December 31, 2017.

Before the Tax Reform Act, the subpart F regime subjected certain passive or highly mobile income to immediate taxation in the hands of 10% United States shareholders ("U.S. Shareholders"), but deferred U.S. income tax on other CFC income until the income was repatriated to U.S. Shareholders. Under the subpart F provisions, U.S. Shareholders of CFCs were taxed currently on their pro rata share of passive and mobile income such as dividends, interest, rents, and royalties, even if the U.S. Shareholder did not receive any distributions from the CFC. However, U.S. shareholders did not recognize income in respect of the CFC's remaining earnings until those earnings were repatriated.

The Tax Reform Act significantly changed this regime by introducing a modified territorial framework (layered on top of the subpart F regime, which was largely retained) that includes (i) the 100% dividends received deduction for the foreign portion of dividends received from an SFC (under Section 245A) and (ii) the GILTI regime. GILTI imposes immediate taxation on additional types of income in a manner similar to subpart F.[3] For income that escapes immediate U.S. taxation under both subpart F and GILTI, Section 245A allows a 100% dividends received deduction when such earnings are distributed to U.S. Shareholders. To transition to this new system, Section 965 imposed a reduced tax on certain post-1986 deferred earnings and profits ("E&P") of CFCs (*i.e.*, income that would have been subject to full U.S. taxation upon distribution to shareholders).

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[1] *See* our Client Memorandum entitled *Treasury and IRS Release Final and Proposed Regulations on the GILTI and Subpart F Treatment of Domestic Partnerships*, dated June 24, 2019.

[2] The formal name for the Tax Reform Act is "An act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018." *See* S&C publication of December 20, 2017, U.S. Tax Reform, for a description of the key provisions included in the legislation.

[3] In general, a U.S. Shareholder's GILTI is the excess of the U.S. Shareholder's net CFC tested income (computed by aggregating a U.S. Shareholder's pro rata shares of its CFCs' tested income, which is the excess of its CFCs' gross income (with exceptions) over allocable deductions) over a deemed 10% return on the aggregate CFCs' bases in hard assets. A 50% deduction for GILTI under Section 250 reduces the effective tax rate to 10.5% on such income. After taking into account the exceptions to tested income, in many cases, the GILTI regime covered most CFC income that was not subject to subpart F.

The preamble to the Temporary Regulations stresses that Section 245A should be read as part of an integrated framework with GILTI, subpart F, and the transition tax. Prior to the Tax Reform Act, all income of CFCs was eventually subject to U.S. tax (either under subpart F or upon repatriation). However, after the Tax Reform Act, only certain types of income—subpart F and "tested income" under the GILTI regime—are subject to U.S. tax at all, with the transition tax capturing pre-Tax Reform Act income that had not yet been repatriated. Thus, Treasury and the IRS believe that all income and earnings of foreign corporations should either be subject to the pre-Tax Reform Act framework (including the transition tax) or the post-Tax Reform Act framework (and be tested under both the GILTI and subpart F regimes). Accordingly, Treasury and the IRS believe that Section 245A is intended to exempt only income that has been tested under the GILTI and subpart F regimes but was not included under those regimes. However, it should be noted that Congress did exempt some income from both the transition tax and the new GILTI regime—that is, pre-1987 earnings of CFCs.

The preamble notes that certain atypical situations could give rise to consequences that would be inconsistent with Treasury's residual view of Section 245A and the integrated framework. In these situations, Section 245A read in isolation could allow certain earnings arising after the application of the transition tax (*i.e.*, not subject to the transition tax) to be exempt under Section 245A without being tested under GILTI or subpart F. This result is possible because the text of Section 245A states that all foreign-sourced income is eligible for the dividends received deduction, regardless of whether the income was first tested under GILTI or subpart F. To resolve this inconsistency, the Temporary Regulations limit the availability of Section 245A with respect to amounts attributable to two general categories of transactions, disqualified period dispositions and extraordinary reductions in CFC ownership, in which subpart F or tested income earned by a CFC would otherwise escape U.S. taxation.

THE TEMPORARY REGULATIONS

A. DISQUALIFIED PERIOD DISPOSITIONS

The first type of transaction identified by the Temporary Regulations as inconsistent with the integrated international regime arises from an inconsistency between the effective date of the GILTI regime and the last date that E&P was measured for purposes of the Section 965 transition tax. The Temporary Regulations generally limit the availability of Section 245A to distributions of earnings attributable to such transactions.

The preamble notes that there is a gap between GILTI's effective date for certain fiscal-year CFCs (such as CFCs with taxable years ending November 30) and December 31, 2017, the last date on which the CFC's Section 965 E&P is measured (the "disqualified period"). The preamble notes that during this disqualified period, CFCs may have engaged in transactions to take advantage of the timing gap. For example, CFCs that sold assets to a related foreign party during the disqualified period—and outside the

ordinary course of business—would have created a stepped-up tax basis for the buyer,[4] while also generating E&P for the seller that would have been tested income had the GILTI regime been effective. However, because of the effective date discrepancy, that tested income was not subject to GILTI and distributions of those earnings to U.S. Shareholders may have been eligible for the Section 245A deduction. Based on the views described above, the Treasury Department and the IRS determined that it would be inconsistent with the closely interdependent set of international tax rules for earnings attributable to such "extraordinary dispositions" to be eligible for the Section 245A deduction.

To prevent this result, the Temporary Regulations limit the amount of the Section 245A deduction with respect to a distribution received from an SFC to 50% of the "extraordinary disposition amount." Limiting the restriction to 50% of the extraordinary disposition amount approximates the GILTI deduction, which generally operates to reduce the effective U.S. tax rate on tested income by half. The extraordinary disposition amount generally reflects distributions attributable to E&P generated from certain related-party dispositions made during the SFC's disqualified period, but it is tracked shareholder-by-shareholder rather than by actual earnings. In general, under the Temporary Regulations, the extraordinary disposition amount is defined as the portion of a dividend received by a Section 245A shareholder[5] from an SFC that is paid out of the Section 245A shareholder's "extraordinary disposition account." A U.S. Shareholder's extraordinary disposition account represents the U.S. Shareholder's pro rata portion (determined by value of the U.S. Shareholder's shares in the CFC rather than based on hypothetical distributions) of the SFC's "extraordinary distribution E&P," and is reduced by distributions from this account. "Extraordinary disposition E&P" is E&P recognized in an "extraordinary disposition," which is, generally, a related-party disposition of certain specified property made during the SFC's disqualified period and outside of the ordinary course of the SFC's activities.

Under a *de minimis* exception, this rule applies only to gains in excess of the lesser of $50 million or 5% of the gross value of the SFC's property held immediately before its disqualified period. Additionally, a successor rule shifts the extraordinary disposition account to transferee U.S. Shareholders that acquire the SFC's stock in certain carry-over basis transactions. Distributions are attributed first to non-extraordinary disposition E&P (both current and accumulated) before they are attributed to the U.S. Shareholder's extraordinary disposition account balance.

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[4] The final GILTI regulations also include rules to address transactions intended to reduce GILTI inclusions due to a stepped-up basis in CFC assets attributable to related party transfers during a CFC's disqualified period, and allow taxpayers to make an election to eliminate their disqualified basis in CFC property by reducing their adjusted basis in the property by the amount of disqualified basis.

[5] Defined in the Temporary Regulations as a domestic corporation that is a U.S. Shareholder with respect to an SFC.

B. EXTRAORDINARY REDUCTIONS IN CFC OWNERSHIP

In addition to extraordinary disposition transactions, which were only possible during a particular window, the regulations also identify a second type of transaction that results in earnings that would otherwise be taxable as subpart F income or GILTI permanently escaping U.S. taxation. This second type of transaction relies on a reduction in the U.S. Shareholder's ownership percentage.

This result occurs primarily as a result of Section 951(a)(2)(B), a long-standing provision designed to prevent double inclusion of subpart F income under the pre-tax reform regime. Specifically, Section 951(a)(2)(B) reduces a U.S. Shareholder's pro rata share of subpart F income (and, following the Tax Reform Act, tested income) by the amount of dividends received by another U.S. Shareholder with respect to the same share of stock. Prior to the Tax Reform Act, such dividends would have been includible by the U.S. Shareholder receiving the dividends. Thus, under the old system, it was necessary to prevent a transferee U.S. Shareholder from including the same earnings a second time as Subpart F income.

Under the new regime, however, if the dividend received by the transferor U.S. Shareholder is eligible for Section 245A, a subsequent reduction in subpart F income to the transferee U.S. Shareholder would result in those earnings permanently escaping U.S. tax.

Similarly, because of the Tax Reform Act's changes to the rules for determining CFC status, the same result can be achieved through sales by a U.S. Shareholder that result in a deemed dividend from the CFC. For example, a U.S. Shareholder could sell 100% of a CFC to a related foreign party. Depending on the transferee's ownership, it is possible that the CFC would remain a CFC (due to "downward" attribution), but no longer have any U.S. Shareholders that would be required to include subpart F income or GILTI. In this scenario, Section 1248 would deem the selling U.S. Shareholder to receive a dividend equal to the gain on the sale to the extent of the U.S. Shareholder's share of the E&P of the CFC. If Section 245A applied to this deemed dividend, the transferring U.S. Shareholder would be entitled to a dividends received deduction, and no U.S. Shareholder would include subpart F income or GILTI in respect of the CFC.[6] Therefore, earnings of the CFC attributable to subpart F income or tested income would never be subject to U.S. tax.

To address these transactions, the Temporary Regulations generally treat distributions (or deemed distributions) that occur in the same year as an "extraordinary reduction" as ineligible for Section 245A to the extent of the U.S. Shareholder's pre-reduction, pro rata share of the CFC's subpart F income or tested income. An extraordinary reduction occurs when a shareholder's ownership is reduced by more than 10%, by value, of the amount of stock such shareholder owned at the beginning of the CFC's taxable year,

[6] Section 1248(j) treats Section 1248 dividends on gain from the sale or exchange of stock held for more than one year as eligible for Section 245A.

provided the reduction in ownership also represents at least 5%, by value, of the total stock of the CFC. This reduction can occur by transfer[7] or by dilution.

Notably, the extraordinary reduction restrictions only apply to shareholders controlling more than 50% of the vote or value of the CFC (or that are acting in concert with such controlling shareholders), and that are eligible for Section 245A. 50% ownership for this purpose includes ownership attributed from related parties under Sections 267(b) or 707(b). The restrictions also only apply if the amount subject to the limitation would exceed a *de minimis* threshold equal to the lesser of $50 million or 5% of the CFC's total taxable income for the year.

One consequence of the denial of a Section 245A deduction in respect of extraordinary reduction amounts is that U.S. Shareholders must include the full ineligible amounts in income, and will potentially be subject to 21% tax on these amounts. This is the case even though some or all of the underlying earnings may have been tested income, rather than subpart F income, and would therefore have been eligible for a GILTI deduction that would have reduced the effective tax rate. To mitigate this result, the Temporary Regulations permit taxpayers to make an election to close the taxable year of the CFC as of the end of the date of the extraordinary reduction. Closing the CFC's taxable year results in the U.S. Shareholders including their pro rata share of subpart F and GILTI for the CFCs taxable year; to the extent this inclusion is GILTI, the U.S. Shareholder would be entitled to the corresponding deduction, reducing the effective tax rate.

C. TIERED CFCS

In the case of tiered CFCs, Section 954(c)(6) can similarly cause earnings that would otherwise be subpart F income or tested income to permanently escape U.S. taxation.[8] That section generally provides that dividends received by an upper-tier CFC from a related lower-tier CFC are not treated as foreign personal holding company income (and therefore do not give rise to subpart F income to the upper-tier CFC) to the extent the dividend is attributable to income of the lower-tier CFC that is neither subpart F income nor effectively connected income. Similarly, dividends are excluded from tested income under Section 951A(c)(2). Accordingly, if a lower-tier CFC engages in an extraordinary distribution transaction or an extraordinary reduction transaction, the subpart F or tested income of the lower-tier CFC would not be

[7] Other than transfers pursuant to a recapitalization or an F reorganization (which is generally defined as a mere change in identity, form, or place of organization of a corporation).

[8] The preamble to the Temporary Regulations states that, while future guidance will clarify that any provision that is expressly limited in its application to domestic corporations does not apply to CFCs by reason of Treasury Regulations §1.952-2, the Treasury and IRS continue to study whether proposed regulations should be issued that allow dividends received by a CFC to be eligible for a Section 245A deduction. However, the preamble also explicitly states that even if Section 245A were to apply to CFCs, there would be no deduction for amounts not eligible for the Section 954(c)(6) exemption under the Temporary Regulations.

included by the U.S. shareholders, and the distribution of such earnings to an upper-tier CFC would not give rise to subpart F income or tested income at the upper-tier CFC.

Thus, to prevent earnings of a lower-tier CFC that would otherwise be subpart F income or tested income from permanently escaping U.S. taxation by way of a Section 245A deduction upon eventual distribution to the U.S. shareholder, the Temporary Regulations generally limit the application of Section 954(c)(6) in respect of dividends received by an upper-tier CFC that are attributable to extraordinary distribution accounts or that occur in a year in which an extraordinary reduction occurs. As with the general rule for extraordinary distributions under Section 245A, the limitation on Section 954(c)(6) applies only to 50% of dividends in respect of extraordinary distribution accounts; this provides a similar result as the GILTI deduction that would have been available to a U.S. Shareholder in respect of the tested income.

FURTHER CONSIDERATIONS

D. PLANNING CONSIDERATIONS

The preamble to the Temporary Regulations notes that distributions from a CFC are allocated to E&P attributable to extraordinary disposition accounts only after being allocated to all other E&P. Thus, careful monitoring and timing of distributions may permit significant deferral of any extraordinary disposition accounts from being recognized in income. In most cases, this is the intended result as the preamble explains that extraordinary distribution E&P generally are the last earnings and profits deemed distributed by a CFC in order to minimize the potential "lockout effect" that occurred in prior years where U.S. corporations were reluctant to incur the tax on distributions from foreign subsidiaries and therefore had large amounts of "trapped cash" offshore.

In contrast, the extraordinary reduction rules apply only to distributions (or deemed distributions) that occur in the year of an extraordinary reduction. Accordingly, any pre-reduction distributions (or deemed distributions) that occur in the same year as the reduction are subject to this rule, even if such distributions were not part of a plan that included the extraordinary reduction. Moreover, an extraordinary reduction can occur inadvertently, and the extraordinary reduction rules apply regardless of whether the relevant transactions were undertaken with a tax motivation. Accordingly, controlling U.S. Shareholders should monitor CFC transactions, and should review CFC transactions that occurred prior to the publication of the Temporary Regulations, for inadvertent reduction transactions. Where a reduction transaction has occurred, controlling U.S. Shareholders should consider whether to make the election to close the taxable year of the CFC.

As noted above, while the extraordinary disposition rules apply to all Section 245A shareholders, the extraordinary reduction rules apply only to controlling Section 245A shareholders. However, the tiered CFC rules for extraordinary reduction transactions are not limited to controlling Section 245A shareholders, but

instead apply to all shareholders. Thus, the tiered CFC rules expand the scope of the extraordinary reduction rules beyond the scope of shareholders the rules were intended to affect.

Finally, both the extraordinary disposition rules and the extraordinary reduction rules are subject to a broad anti-abuse rule. Thus, while the IRS helpfully provided a bright-line 10% test for extraordinary reductions, transactions that do not cross that bright line may nonetheless be adjusted by the IRS to the extent the transactions were undertaken with "a principal purpose of avoiding the purposes of" the Temporary Regulations.

E. IMMEDIATE EFFECT AND RETROACTIVITY

The Temporary Regulations were issued immediately without a notice and comment period, and apply retroactively to distributions occurring after December 31, 2017. The preamble to the Temporary Regulations explicitly addresses the IRS and Treasury's authority under the Administrative Procedure Act to issue regulations in this manner, concluding that the "public interest" prong of the good cause exception applies. Under that exception, rulemaking authorities may issue regulations without notice and comment if such notice and comment would hurt, rather than serve, public interest. The preamble states that a notice and comment period could give taxpayers time to enter into "aggressive tax planning" or "financial manipulation" before the Temporary Regulations became effective. The preamble also justifies the retroactive nature of the provisions under Section 7805(b)(2), which allows a retroactive regulation if issued within 18 months of the statutory provision. Since Sections 245A, 951A and 965 were enacted on December 22, 2017, the Temporary Regulations meet this deadline. Treasury and the IRS reasoned that retroactivity was required to prevent taxpayers that have already engaged in the transactions described above from having a comparative advantage. However, such taxpayers—which may have no ability to unwind those transactions and now face a significant and unexpected tax liability—might choose to challenge the IRS and Treasury's authority to issue these Temporary Regulations with retroactive effect. In this scenario, the litigation test for Treasury and the IRS will be (i) whether Section 245A's broad grant of regulatory authority can be used to resolve problems that are in essence outside of Section 245A and created by a failure of coordination among Sections 951, 951A and 965, and (ii) whether Treasury has the authority to fix such statutory inconsistencies, which would ordinarily be fixed by technical corrections legislation.

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