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July 8, 2019

Treasury and IRS Release Final Regulations on Global Intangible Low-Taxed Income Regime

Final Regulations Provide Additional Detail While Leaving Certain Issues Open to Future Guidance

SUMMARY

On June 21, 2019, the Department of the Treasury (the "Treasury Department") and the Internal Revenue Service (the "IRS") published final regulations (the "Final Regulations") in the Federal Register addressing how United States shareholders of foreign corporations should include global intangible low-taxed income ("GILTI") in gross income.[1] The Final Regulations follow proposed regulations that were published on October 10, 2018 in the Federal Register (the "Proposed Regulations").[2]

The GILTI regime is intended to prevent taxpayers from avoiding U.S. taxation by shifting profits from intangible assets into low-tax foreign jurisdictions. Its rules are drafted to accomplish this intent through a series of formulae designed to approximate a taxpayer's income that is due to such intangible assets. The technical nature of these rules is reflected in the extensive guidance provided in the Final Regulations. In this memorandum, we focus on several significant items set forth in the Final Regulations, including: (1) the expansive definition of "interest", which is used in the GILTI regime as an input in formulae to derive a taxpayer's GILTI inclusion; (2) the anticipation of further guidance on how a controlled foreign corporation ("CFC") should calculate its gross income and allowable deductions against that gross income for GILTI purposes; (3) a potentially broad anti-abuse rule that applies in determining a taxpayer's pro rata share of CFC income and (4) the effect of property transfers to related parties by certain CFCs that are fiscal year taxpayers.

The Final Regulations form part of a broader regulatory package that was published in the Federal Register, which includes temporary regulations on the new Section 245A "participation exemption"[3], proposed regulations on a GILTI exclusion for high-taxed income (the "High Tax Exclusion")[4], and guidance on the treatment of domestic partnerships under the subpart F and GILTI rules.[5] However, this memorandum reserves comment on these aspects of the Final Regulations and the temporary regulations under Section 245A, which we address in separate publications.

The Final Regulations were effective upon publication in the Federal Register and, with exception for the Pro Rata Share Anti-Abuse Rule (as defined below), apply to the taxable years of foreign corporations beginning after December 31, 2017 and to the taxable years of United States shareholders in which such taxable years of those corporations end. The Pro Rata Share Anti-Abuse Rule, however, is applicable to the taxable years of United States shareholders ending on or after October 3, 2018.

BACKGROUND

The GILTI regime, enacted as part of the Tax Cuts and Jobs Act of 2017 (the "TCJA"), functions as a minimum tax on United States shareholders of CFCs[6] by subjecting those shareholders to current taxation on their GILTI inclusion. As part of the comprehensive tax reform enacted under the TCJA, Congress enacted the Section 245A "participation exemption", which allows United States shareholders a 100% dividends received deduction for the foreign-sourced portion of dividends from a CFC, thereby exempting certain foreign earnings from U.S. taxation.[7] The GILTI rules are intended to address concerns that this deduction would incentivize U.S. taxpayers to shift profits offshore by imposing a 10.5%[8] minimum tax on a United States shareholder's GILTI inclusion. The rules for calculating a United States shareholder's GILTI inclusion are summarized below.

The GILTI inclusion is meant to approximate income from highly mobile intangible assets. More specifically, the inclusion is the excess of a United States shareholder's "net CFC tested income" for a taxable year over that shareholder's "net deemed tangible income return" ("net DTIR") for that year. Net CFC tested income is computed as the excess of a United States shareholder's aggregate pro rata share of "tested income" from each of its "tested income CFCs" over that shareholder's aggregate pro rata share of "tested loss" from each of its "tested loss CFCs". Tested income excludes certain enumerated items of income that are already subject to U.S. tax or substantial foreign tax. Net DTIR is equal to the excess of 10% of a United States shareholder's pro rata share of each tested income CFC's "qualified business asset investment" ("QBAI") (such 10% figure, the "deemed tangible income return" or "DTIR") over the shareholder's "specified interest expense", which generally is the CFC's net interest expense that reduced tested income.[9] A CFC's QBAI is the average of its aggregate adjusted bases, as determined under Section 951A and the Final Regulations, of depreciable tangible property used in its trade or business to produce tested income.[10] This net DTIR amount reduces the amount otherwise includible in a United States shareholder's income as a GILTI inclusion.

The Final Regulations provide guidance on almost all aspects of this regime. We discuss several significant points of guidance in the Final Regulations, their deviation from the Proposed Regulations and their effect on the calculations summarized above.

DISCUSSION

In this memorandum, we focus on four significant aspects of the Final Regulations and then discuss more briefly several other points from the Final Regulations.

A. THE ROLE OF INTEREST EXPENSE IN THE GILTI REGIME

Under Section 951A(b)(2), a United States shareholder's tax-exempt return on certain tangible property, referred to as its DTIR, is decreased by net interest expense that reduced the shareholder's net CFC tested income.[11] The result of this rule is that net interest expense produces no benefit for GILTI purposes, since the beneficial reduction in tested income is exactly offset by a detrimental reduction in DTIR. Unlike the Proposed Regulations, the Final Regulations cross-reference Section 163(j) to adopt an expansive definition of interest expense for purposes of this determination. The effect of this expansive definition may upset the balance of the corresponding benefit and detriment of net interest expense on tested income and DTIR, respectively, and leave United States shareholders worse off under the Final Regulations.

1. Determining Net DTIR under the Final Regulations

The Final Regulations generally maintain the mechanics set forth in the Proposed Regulations for determining the amount of interest expense subtracted from DTIR. Therefore, the Final Regulations provide that a United States shareholder will determine its "specified interest expense" as equal to the excess of its pro rata share of "tested interest expense" of each CFC over its pro rata share of "tested interest income" of each CFC, and this specified interest expense will be subtracted from DTIR.[12] Tested interest expense and tested interest income reflect interest expense and income allocable to a CFC's gross tested income, but both the Proposed Regulations and Final Regulations exclude any interest paid/accrued or earned, respectively, in the conduct of an active financing or insurance business.[13] In response to a comment that suggested the burden of tracking interest that would qualify as paid or accrued in an active financing or insurance business for these purposes would not merit the benefits of a relatively greater net DTIR for certain United States shareholders, the Final Regulations provide that this amount of interest expense is only excluded to the extent established by the CFC such that the CFC can assume the amount is zero.[14]

Additionally, unlike the Proposed Regulations, the Final Regulations further reduce a tested loss CFC's tested interest expense by its "tested loss QBAI amount", an amount equal to 10% of the CFC's QBAI if that CFC had been a tested income CFC, in order to ameliorate particularly harsh effects to tested loss CFCs under the Proposed Regulations.[15] A tested loss CFC cannot have QBAI, and thus the QBAI of tested loss CFCs is not taken into account in determining DTIR. This results in tested loss CFCs losing the benefit of QBAI and, in addition, the interest expense of tested loss CFCs further depletes the DTIR of tested income CFCs.[16]

2. Defining Interest

The Proposed Regulations defined interest expense as expense or loss "treated as interest expense by reason of the Internal Revenue Code or the regulations thereunder, and any other expense or loss incurred in a transaction . . . in which the use of funds is secured for a period of time if such expense or loss is predominantly incurred in consideration of the time value of money."[17] Interest income was similarly defined as income "predominantly derived from consideration of the time value of money."[18] The Treasury Department and the IRS received comments that this time-value-of-money standard was a new standard that would create confusion and complexity for taxpayers.[19] In response, the Treasury Department and the IRS revised the Final Regulations to define interest expense and interest income as amounts treated as such under Section 163(j) of the Code, which generally limits a taxpayer's ability to deduct net business interest expense.[20] The revision was justified by reason of the similar policy goals of both Section 163(j) and Section 951A(b)(2) (namely, limiting the tax benefits of interest expense) and for fostering consistent definitions of interest in the Code.[21]

Section 163(j) itself does not include a definition of interest. However, the Treasury Department and the IRS released proposed regulations under Section 163(j) defining interest to include a variety of interest-equivalent amounts, including substitute interest payments and certain commitment fees, as well as a general anti-avoidance rule to capture any other amounts "predominantly incurred in consideration of the time value of money." [22]

Because the Final Regulations adopt this expansive definition of interest used in Section 163(j), United States shareholders will need to be mindful of amounts that could be considered interest under Section 163(j) and its regulations. Under both the Proposed Regulations and Final Regulations, it is likely that most expenses allocable to gross tested income give rise to a beneficial reduction in gross tested income. However, under the Proposed Regulations' more limited definition of interest expense, it was unlikely that such expenses which were not clearly interest expense would give rise to a detrimental reduction in DTIR. Therefore, United States shareholders are marginally worse off under the Final Regulations because the broader definition of interest expense and interest income results in more expenses being treated as interest expense, resulting in a lower net DTIR than would otherwise result under the Proposed Regulations.[23]

A number of comments to the Section 163(j) proposed regulations have stated that the proposed definition of interest is overly broad and unwarranted and that certain rules, such as those applicable to derivatives, are likely to cause additional and unnecessary complexity and confusion; other comments also question the basis of the Treasury Department's and the IRS's authority to adopt this expansive definition of interest in those proposed regulations. The Treasury Department and the IRS are continuing to review the proposed regulations under Section 163(j) and comments thereon. Adoption of Section 163(j)'s definitions of interest income and interest expense for purposes of the GILTI regime will place additional importance on the resolution of these questions.

B. A CFC'S GROSS INCOME AND ALLOWABLE DEDUCTIONS

To determine a United States shareholder's net CFC tested income, each CFC in which that United States shareholder holds an interest must determine its gross tested income. Both the Proposed Regulations and Final Regulations mirror the Code in providing that gross tested income is equal to the CFC's gross income calculated without regard to: (1) items of income subject to U.S. taxation as income effectively connected with a U.S. trade or business, (2) items of income included in subpart F income, (3) gross income subject to a high rate of tax in a foreign jurisdiction under the High Tax Exclusion, (4) dividends received from a related person and (5) foreign oil and gas extraction income.[24] Deductions against this gross tested income are then allowed to the extent allocable to such income. If these deductions exceed the gross tested income, this results in tested loss and the CFC is a tested loss CFC. Conversely, if the gross tested income exceeds deductions, this results in tested income and the CFC is a tested income CFC.[25]

The Proposed Regulations provided that a CFC should be guided by Treasury Regulation Section 1.952-2 in determining its gross income and allowable deductions.[26] Treasury Regulation Section 1.952-2 essentially provides that foreign corporations shall be treated as domestic corporations, subject to certain exceptions, for purposes of determining the foreign corporation's gross income and taxable income. The Treasury Department and the IRS had requested comments on whether this approach was appropriate in determining a CFC's subpart F income and calculating its tested income or tested loss.

Comments were generally supportive of the use of Treasury Regulation Section 1.952-2, but several comments proposed modifications to how Treasury Regulation Section 1.952-2 would apply in this context. Comments generally sought clarification on what deductions would be allowed in determining tested income and tested loss and how parties should interpret the breadth of deductions allowed to CFCs. Commenters specifically requested modifications to Treasury Regulation Section 1.952-2 in order to allow CFCs to deduct net operating loss carryforwards and capital loss carryforwards, both of which are disallowed to foreign corporations under Treasury Regulation Section 1.952-2, and requested clarification that business interest expense which is disallowed under Section 163(j) may be carried forward by a CFC in this context without limitation.[27] The Treasury Department and the IRS did not express any opinion on these comments.

However, the Treasury Department and the IRS did provide that further guidance on the application of Treasury Regulation Section 1.952-2 in calculating a CFC's subpart F income, tested loss and tested income under the GILTI regime will be provided in the future. Specifically, they noted that future guidance would address at least two items which commenters highlighted. First, the Treasury Department and the IRS stated that they do anticipate this future guidance will clarify that any deduction which is expressly limited to domestic corporations is not intended to be made available to CFCs by way of cross-reference to Treasury Regulation Section 1.952-2. For example, Section 250, which provides a deduction for domestic corporations that provide goods and/or services to foreign markets, is not intended to be made available to CFCs for GILTI purposes. Second, as part of this future guidance, the Treasury Department and the IRS will consider the extent to which the 100% dividends received deduction enacted in Section 245A should be taken into account in determining a CFC's subpart F income, tested income and tested loss under the rules of Treasury Regulation Section 1.952-2.

The Treasury Department and the IRS also noted that any CFCs engaged in an insurance or reinsurance business should determine their tested income or tested loss in accordance with the rules applicable to determining insurance income under Sections 953 and 954(i) of the Code. The Final Regulations reflect this modification, but the Treasury Department and the IRS expressed an intent to issue further guidance for these CFCs.

C. DETERMINING AND RE-DETERMINING A PRO RATA SHARE

A United States shareholder's GILTI inclusion is determined on an aggregate basis to reflect its interest in each of its CFCs. Net CFC tested income therefore reflects the United States shareholder's pro rata share of tested income and tested loss for all of its CFCs, and net DTIR likewise reflects such shareholder's pro rata share of QBAI, tested interest expense and tested interest income. Each of these items (tested income, tested loss, QBAI, tested interest expense and tested interest income) is defined as a "tested item" in the Final Regulations and is subject to special rules in the Final Regulations to determine the appropriate pro rata share of a United States shareholder of each of these items.[28]

1. Determining a United States Shareholder's Pro Rata Share of a Tested Item

In general, a United States shareholder's pro rata share of these tested items is determined on the basis of a hypothetical distribution of the CFC's earnings and profits on the last day of the foreign corporation's year in which it is a CFC, using the same mechanics by which a United States shareholder would determine its pro rata share of subpart F income (the "hypothetical distribution date").[29] Specific rules and guidance are given for each tested item. Both tested income and tested loss follow this hypothetical distribution model, but the Final Regulations add special recapture rules.[30] A United States shareholder's pro rata share of QBAI of a tested income CFC bears the same ratio to that tested income CFC's total QBAI for that year as its pro rata share of tested income bears to the total tested income of that CFC in that year, subject to certain special rules.[31] A determination of a United States shareholder's pro rata share of tested interest expense and tested interest income likewise keys off of the hypothetical distributions concept by providing that a pro rata share of tested interest expense equals the amount by which the total tested interest expense for that CFC decreases the shareholder's pro rata share of tested income and/or increases its pro rata share of tested loss and vice versa.[32]

2. Re-Determining a United States Shareholder's Pro Rata Share: The Pro Rata Share Anti-Abuse Rule

In addition to these detailed rules on determining a United States shareholder's pro rata share for each tested item, the Proposed Regulations included an anti-abuse rule providing that any transaction or arrangement that is part of a plan that has a principal purpose of avoiding federal income tax, "including . . . a transaction or arrangement to reduce a United States shareholder's pro rata share of the subpart F income of a controlled foreign corporation", is disregarded for purposes of determining the shareholder's pro rata share of subpart F income of the CFC, and this rule applies for purposes of determining a United States shareholder's pro rata share of each tested item under the GILTI regime (the "Pro Rata Share Anti-Abuse Rule").[33]

Comments received by the Treasury Department and the IRS argued that this Pro Rata Share Anti-Abuse Rule was overly broad and, at its most extreme interpretation, could require a United States shareholder who disposes of stock of a CFC to include its "pro rata share" of that CFC's subpart F income and GILTI tested items for an indefinite period of time.[34] Comments suggested this rule be clarified to apply only as of a hypothetical distribution date among the persons owning stock, directly or indirectly, of the CFC at that time.[35]

The Treasury Department and the IRS agreed with these comments. The Final Regulations therefore retain the Pro Rata Share Anti-Abuse Rule, but the rule has been revised such that, where there is a transaction or arrangement that has a principal purpose of avoiding federal income tax by altering the allocation of items in a hypothetical distribution, the rule only makes adjustments with respect to "any share of stock outstanding as of the hypothetical distribution date".[36] Thus, a shareholder that has divested itself of all of its stock in a CFC prior to the hypothetical distribution date should not be allocated any tested items due to this divested stock. Ultimately, the Pro Rata Share Anti-Abuse Rule continues to have very broad application, and the Treasury Department and the IRS declined to include a list of transactions intended to be captured by this rule and likewise declined to include any examples to illustrate the rule's reach.[37]

For example, some United States shareholders have been able to benefit from so-called "freeze transactions" in which the shareholder restructures its interests so that it holds preferred shares in its CFCs (or a foreign holding company which holds its CFCs) while the common shares are typically held by a non-U.S. parent of the United States shareholder. Because the United States shareholder's interest is then restricted to the preferred share's specified yield, its interest in the earnings and profits of CFCs will be restricted, with any earnings in excess of that yield allocable to shareholders other than that United States shareholder. Since a United States shareholder is not fully exiting in a freeze transaction, but merely restricting its share of earnings, that shareholder would remain subject to the Pro Rata Share Anti-Abuse Rule upon the hypothetical distribution date. The Treasury Department and the IRS did not specifically target freeze transactions when describing the scope of the rule, but did clarify that "the rule will not apply to adjust the allocable [earnings and profits] allocated to a shareholder by reason of a transfer of CFC stock, except by reason of a change to the distribution rights with respect to stock in connection with such transfer (for example, an issuance of new stock, including by recapitalization)."[38] Where the United States shareholder holds common stock, a recapitalization of that common stock for preferred stock may be a means of carrying out such a freeze transaction. Careful scrutiny is required to determine whether the Pro Rata Share Anti-Abuse Rule would cause a freeze transaction to be ignored in determining a United States shareholder's pro rata share of subpart F income and tested items.

D. THE EFFECTS OF DISQUALIFIED BASIS

Disqualified Basis (defined below) potentially applies to ensure that fiscal year CFCs do not take advantage of the period between December 31, 2017, when earnings and profits were calculated for purposes of the repatriation tax enacted under the TCJA, and the later date on which their income is subject to the GILTI regime, which would be the first day of the following taxable year, to increase basis in assets that could later be used to decrease U.S. tax liability.[39]

The Final Regulations define Disqualified Basis to mean the amount by which the adjusted basis in transferred property (other than inventory) immediately after a transfer from the transferor-CFC to a related party during the so-called "disqualified period" exceeds the adjusted basis in the transferred property immediately before the transfer to the extent the transferor is not subject to U.S. tax (such excess, the "Disqualified Basis"). The transferor-CFC must recognize gain in order to have any Disqualified Basis.[40] The disqualified period begins on January 1, 2018 and ends on the transferor-CFC's fiscal year end prior to December 31, 2018. This is substantially similar to the Proposed Regulations, but the Final Regulations include more fulsome guidance on adjustments to Disqualified Basis. Among other guidance on Disqualified Basis, the Final Regulations provide that Disqualified Basis includes any adjustments to basis in partnership property under Section 734 or 743 of the Code.[41] Clarification was also provided that Disqualified Basis may be reduced once a deduction or loss attributable to that Disqualified Basis reduces taxable income; the Preamble confirms that any deduction or loss attributable to Disqualified Basis which is allocated to Residual CFC Gross Income (as defined below and discussed under "Effect on Tested Income and Tested Loss") can reduce Disqualified Basis.[42] However, a special anti-abuse rule disallows any reduction to Disqualified Basis upon transfer to a related party, except to the extent of any recognized loss on the transfer or the Disqualified Basis that is eliminated in certain nonrecognition transactions.[43] Furthermore, the Final Regulations also provide that when the adjusted basis in property increases due to a nonrecognition transaction, the Disqualified Basis in that property is proportionally increased, such that taxpayers cannot reduce or eliminate Disqualified Basis.[44] Lastly, the Final Regulations provide an opportunity for United States shareholders who hold, together, more than

50% of the voting power of a CFC to elect to eliminate any Disqualified Basis by reducing the adjusted basis in property by the amount of Disqualified Basis. This election may also be made for a partnership that holds property with Disqualified Basis.[45]

1. Effect on QBAI

Both the Proposed Regulations and Final Regulations provide that Disqualified Basis is not basis for purposes of determining the QBAI of a tested income CFC. Thus, in general, the greater the amount of Disqualified Basis a CFC has in its property, the lower its QBAI will be, which can lead to a greater GILTI inclusion.

However, not all specified tangible property is used exclusively in the production of gross tested income. Unlike the Proposed Regulations, the Final Regulations provide rules for determining how Disqualified Basis affects the adjusted basis with regard to such "dual use property". The Final Regulations provide that only the portion of the adjusted basis in that dual use property that generates DTIR is reduced by the amount of Disqualified Basis. Notably, the Final Regulations are clear that Disqualified Basis will not cause property to be dual use property simply because deductions or losses related to Disqualified Basis are not allocated to gross tested income (as discussed below under "Effect on Tested Income and Tested Loss").[46]

The Final Regulations also provide further guidance on how Disqualified Basis affects property held by partnerships in which a tested income CFC holds a partnership interest, providing that the CFC's share of the Disqualified Basis in the partnership property decreases its partner adjusted basis, as determined under the Final Regulations.[47]

2. Effect on Tested Income and Tested Loss

In the Proposed Regulations, the Treasury Department and the IRS provided that any deduction or loss attributable to Disqualified Basis which is allocated to gross tested income is "disregarded for purposes of determining tested income or tested loss" of a CFC.[48] The Final Regulations' approach essentially maintained the same end goal of disregarding Disqualified Basis for purposes of tested income and tested loss, but arrived there in a different way. The Final Regulations provide that any "deduction or loss attributable to disqualified basis is allocated and apportioned solely to residual CFC gross income". The concept of "residual CFC gross income" is a new feature of the Final Regulations and is defined as gross income of the CFC other than gross tested income, gross income accounted for in subpart F income or gross income that is subject to U.S. tax as income effectively connected with a U.S. trade or business.[49] The Treasury Department's and the IRS's revisions to this provision reflect both substantive comments as well as questions regarding their authority to adopt such a rule. Each is considered in turn.

a. The Authority To Adopt the Rule

Several comments attacked the Treasury Department's and the IRS's authority to promulgate the rule described in the preceding paragraph. Most argued that the rule did not involve the determination of QBAI, and rulemaking authority was limited to providing rules that would prevent misdetermination of QBAI. Others argued that the rule was inapposite to the statutory text of the GILTI regime, which requires that deductions be allocable to a CFC's gross income under principles analogous to subpart F.[50]

The Treasury Department and the IRS believe their authority to promulgate the revised rule is on sounder footing. The Treasury Department and the IRS do have general rulemaking authority under the Code to promulgate "needful rules" and may rely on their authority under several related Code provisions to provide for proper allocations of deductions in determining subpart F income, income that is effectively connected with a U.S. trade or business and, due to the GILTI regime's reference to subpart F income rules, tested income and tested loss as relate to GILTI inclusions.[51]

Furthermore, the Treasury Department and the IRS believe that disregarding deductions or losses attributable to Disqualified Basis is consistent with Congressional intent. Congress intended the repatriation tax and GILTI to apply to CFCs as a consistent whole, such that all earnings of a CFC would potentially face U.S. taxation under one of these two regimes. As mentioned earlier in this section, Disqualified Basis serves as a measure to ensure that CFCs not subject to GILTI in an interim period cannot increase their basis in property without a corresponding tax cost.[52] Additionally, the rule in the Final Regulations provides better symmetry than the Proposed Regulations: when a transferor-CFC transfers property during the disqualified period and recognizes gain, this gain will be treated as residual CFC gross income, such that it is logical to allocate deductions or losses attributable to the corresponding basis to the same category of income.[53]

b. Other Substantive Revisions to the Rule

Other comments raised additional issues with the Proposed Regulations. Some comments requested clarification on whether Disqualified Basis is disregarded for purposes of determining the CFC's gain upon the disposition of property. The Treasury Department and the IRS provided that Disqualified Basis is not disregarded for purposes of determining such CFC's gain. These comments did prompt the Treasury Department and the IRS to revise the Final Regulations to provide that any depreciation, amortization or cost recovery allowances that are attributable to Disqualified Basis should not be allocated to other property produced or acquired for resale.[54]

Another comment observed that a transfer during the disqualified period which gives rise to Disqualified Basis may also be a covered asset acquisition, which could result in a loss of otherwise applicable foreign tax credits where deduction or loss that is not accounted for in determining tested income or tested loss is still taken into account for purposes of determining whether some portion of a taxpayer's foreign tax credits are disallowed. The Treasury Department and the IRS declined to alter the rule, but did include an election (noted above) pursuant to which a taxpayer may elect to eliminate the Disqualified Basis.[55]

E. OTHER SIGNIFICANT GUIDANCE UNDER THE FINAL REGULATIONS

While not exhaustive, the Final Regulations include extensive rules, not all of which are discussed here. Selective additional guidance included in the Final Regulations are discussed below.

1. Temporary Ownership Rule

Because a taxpayer could, transitionally, acquire specified tangible property in an effort to increase its net DTIR and thereby decrease its GILTI inclusion, the GILTI regime provided authority to the Treasury Department and the IRS to promulgate rules to address this potential abuse.[56] The Proposed Regulations provided that where a tested income CFC acquired specified tangible property "with a principal purpose of reducing the GILTI inclusion amount of a United States shareholder" and this CFC holds the property temporarily (but for at least one quarter), this specified tangible property is disregarded for purposes of determining that CFC's QBAI during any taxable year in which that property is held. Additionally, where this CFC holds the property for less than twelve months and the acquisition of the property would, ignoring the temporary ownership rule, result in a reduction to a United States shareholder's GILTI inclusion, then that property is "per se" treated as temporarily held and acquired with a principal purpose of reducing a shareholder's GILTI inclusion.[57]

Many comments asserted this temporary ownership rule in the Proposed Regulations was overly broad, particularly with regard to the twelve-month per se rule. In addition, commenters expressed concerns about compliance burdens and uncertain filing positions under the twelve-month per se rule.[58] In response, the Treasury Department and the IRS narrowed the temporary ownership rule.

Among several technical corrections, the Final Regulations tailor the temporary ownership rule in several ways. First, the twelve-month per se rule from the Proposed Regulations is replaced by a presumption rule; where the CFC holds the acquired property for less than twelve months and the acquisition of that property would, ignoring the temporary ownership rule, result in increasing the DTIR of the applicable United States shareholder, then that property is treated as temporarily held and acquired subject to the temporary ownership rules. This presumption may be rebutted by facts and circumstances which "clearly establish" that the subsequent transfer of the property was not planned when first acquired by the CFC and that there was not a principal purpose of increasing DTIR of the applicable United States shareholder.[59]

In addition, the Final Regulations provide that there is a presumption that property acquired by a CFC is not subject to these temporary ownership rules where that CFC has held the property for more than 36 months. This presumption is likewise rebuttable by facts and circumstances which clearly establish that the subsequent transfer of that property was planned and that there was a principal purpose of increasing DTIR of the applicable United States shareholder.[60]

The Final Regulations also provide a safe harbor for certain transfers by CFCs. The safe harbor provides that holding the specified tangible property as of the close of a quarter will not be considered to decrease the DTIR of the applicable United States shareholder if several conditions are satisfied involving the transfer of that property.[61] In general, the safe harbor may apply to transfers between CFCs that (i) are both tested income CFCs, (ii) have the same taxable years and (iii) are owned by the United States shareholder in the same proportion.[62]

2. Section 952(c) Coordination Rule

Under Section 952(c) of the Code, a CFC's subpart F income cannot exceed its earnings and profits for the relevant taxable year, and special rules apply to address how CFCs with a deficit of earnings and profits in prior years may re-characterize income as subpart F income in the current taxable year. The GILTI regime, as enacted under the TCJA, did not explicitly address how Section 952(c) works with the GILTI regime in determining tested gross income, which excludes subpart F income.[63] The Proposed Regulations adopted a straightforward rule in which gross tested income (and the deductions allocable thereto) are determined without regard to Section 952(c).[64]

The Final Regulations retain the rule, but provide additional detail on its application. Specifically, the coordination rule in the Final Regulations includes rules specific to the limitation on subpart F income by reference to a CFC's earnings and profits and rules specific to re-characterization of income as subpart F income.[65] Section 952(c)(1) excludes income as subpart F income when a CFC's subpart F income exceeds its earnings and profits. While Section 951A simply provides that gross tested income is gross income other than subpart F income (and certain other items of income), the Final Regulations clarify that gross tested income excludes amounts that would be subpart F income notwithstanding that the amounts are not treated as subpart F income under Section 952(c)(1). Furthermore, any income that is re-characterized as subpart F income is nonetheless not taken into account as subpart F income in determining a CFC's gross tested income. On applying this rule then, a CFC may be subject to both the GILTI and subpart F regimes with regard to the same amount of income when (i) that income is re-characterized as subpart F income under Section 952(c)(2) and (ii) that income is nonetheless still included as gross tested income because it is not treated as subpart F income for purposes of the GILTI regime.

In addition, the Final Regulations include a coordination rule with certain other Code sections that may alter the treatment of income as subpart F income. Section 954(b) can include all gross income as subpart F income if the percentage of subpart F income exceeds a certain threshold (the "Full Inclusion Rule").[66] In the Final Regulations, the Treasury Department and the IRS clarified that income which is re-characterized as subpart F income under the Full Inclusion Rule is taken into account as such in determining a CFC's gross tested income. If the Full Inclusion Rule subjects income to tax in a high-tax jurisdiction such that it may not be treated as subpart F income, the Final Regulations further clarify that this income is not exempt from inclusion as gross tested income under either the subpart F exception to gross tested income or the High Tax Exclusion.[67]

3. Future Guidance on Basis Adjustments to Stock of Tested Loss CFCs

The Proposed Regulations included rules intended to foreclose a taxpayer's ability to receive a double-benefit by preserving basis in a tested loss CFC while also using that tested loss to offset the tested income of another CFC held by the United States shareholder. In general, rules in the Proposed Regulations would therefore adjust downward a United States shareholder's basis in stock of the tested loss CFC upon a disposition of the stock.[68]

The Treasury Department and the IRS have withdrawn these rules from the Final Regulations, but provided that they remain concerned about the potential benefits taxpayers could derive from possible duplicative losses. Therefore, the Treasury Department and the IRS have stated that they anticipate future guidance on basis adjustments to be made to the stock of tested loss CFCs.[69]

F. EFFECTIVE DATE

The Final Regulations became effective upon publication in the Federal Register and, with exception for the Pro Rata Share Anti-Abuse Rule, apply to the taxable years of foreign corporations beginning after December 31, 2017 and to the taxable years of United States shareholders in which such taxable years of those corporations end. The Pro Rata Share Anti-Abuse Rule, however, is applicable to the taxable years of United States shareholders ending on or after October 3, 2018.[70]

Questions regarding the Final Regulations may be directed to any member of the Tax Group.

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ENDNOTES

[1] 84 Federal Register 29,288 (June 21, 2019).

[2] 83 Federal Register 51,702 (October 10, 2018).

[3] For additional information on the new Section 245A "participation exemption", see our Client Memorandum, *Treasury and IRS Release Temporary Regulations Limiting Section 245A Dividends Received Deduction*, dated June 28, 2019, *available at* https://www.sullcrom.com/files/upload/SC-Publication-New-IRS-Guidance-Limits-Section-245A-Dividends-Received-Deduction.pdf.

[4] For additional information on the High Tax Exclusion, see our Client Memorandum, *Treasury and IRS Release Regulations on the GILTI High Tax Exclusion*, dated July 1, 2019, *available at* https://www.sullcrom.com/files/upload/SC-Publication-New-IRS-Guidance-on-GILTI-High-Tax-Exclusion.pdf.

[5] For additional information on the treatment of domestic partnerships, see our Client Memorandum, *Treasury and IRS Release Final and Proposed Regulations on the GILTI and Subpart F Treatment of Domestic Partnerships*, dated June 24, 2019, *available at* https://www.sullcrom.com/files/upload/SC-Publication-New-IRS-Guidance-Treats-Domestic-Partnerships-as-Aggregates-for-Many-Subpart-F-and-GILTI-Purposes.pdf.

[6] A United States shareholder is any U.S. person that owns, by vote or value, 10% or more of a foreign corporation. Section 951(b). A controlled foreign corporation is a foreign corporation that is more than 50%-owned, by vote or value, by United States shareholders on any day in its taxable year. Section 957(a).

[7] Section 245A.

[8] The applicable rate is 10.5% until 2025 due to a deduction provided under Section 250 of the Code that was also enacted under the TCJA. After 2025, this deduction will decrease such that the applicable rate will be 13.25%.

[9] Section 951A(b)(2); Treas. Reg. Sections 1.951A-1(c)(3), 1.951A-4(b).

[10] Section 951A(d)(1)-(2); Treas. Reg. Section 1.951A-3(b)-(c).

[11] Section 951A(b)(2)(B).

[12] Treas. Reg. Section 1.951A-1(c)(3)(i), (iii).

[13] Treas. Reg. Section 1.951A-4(b)(1)-(2); Preamble at 95-101.

[14] Treas. Reg. Section 1.951A-4(b)(1)(iii)(A); Preamble at 98-99.

[15] Treas. Reg. Section 1.951A-4(b)(1)(iv); Preamble at 103.

[16] The Proposed Regulations at Section 1.951A-3(b)(2) were explicit that a tested loss CFC could not have QBAI. Certain commenters argued that this tested loss CFC QBAI exclusion rule should be struck because the statute was not clear as to whether tested loss CFCs could never have QBAI. The Treasury Department and the IRS rejected these comments, pointing to excerpts in the legislative history that made the drafting and intent of Congress clear that tested loss CFCs should not have QBAI. *See* Preamble at 60 ("The Senate amendment to the House bill struck the reference to 'tested loss' in the definition of specified tangible property, and the Conference Report explains that the term 'used in the production of tested income' means that '[s]pecified tangible property does not include property used in the production of a tested loss, so that a CFC that has a tested loss in a taxable year does not have QBAI for the taxable year.'") (quoting Conf. Rpt. 115-466, 642 n.1536).

[17] Prop. Treas. Reg. Section 1.951A-4(b)(1)(ii).

[18] Prop. Treas. Reg. Section 1.951A-4(b)(2)(ii).

ENDNOTES (CONTINUED)

19 Preamble at 93.

20 Treas. Reg. Section 1.951A-4(b)(1)(ii), (b)(2)(ii).

21 Preamble at 94.

22 Prop. Treas. Reg. Section 1.163(j)-1(b)(20)-(22). For additional information on the proposed regulations under Section 163(j), see our Client Memorandum, *IRS Issues Proposed Regulations on Section 163(j) Interest Deduction Limitation*, dated December 31, 2018, *available at* https://www.sullcrom.com/files/upload/SC-Publication-Proposed-Section-163j-Regulations.pdf.

23 The text describes the most likely scenario. It is also possible that an item of expense could be considered interest expense under the Final Regulations and therefore reduce DTIR, but the item is not considered deductible for purposes of lowering tested income. In such a case, the United States shareholder would face both higher tested income and lower net DTIR, resulting in a greater GILTI inclusion.

24 Section 951A(c)(2)(A)(i); Treas. Reg. Section 1.951A-2(c)(1).

25 Section 951A(c)(2); Treas. Reg. Section 1.951A-2(b)-(c).

26 Prop. Treas. Reg. Section 1.951A-2(c)(2).

27 Preamble at 22-24.

28 Treas. Reg. Section1.951A-1(d).

29 Treas. Reg. Sections 1.951-1(e), 1.951A-1(d).

30 Treas. Reg. Section 1.951A-1(d)(2), (4).

31 Treas. Reg. Section 1.951A-1(d)(3).

32 Treas. Reg. Section 1.951A-1(d)(5)-(6).

33 Prop. Treas. Reg. Section 1.951-1(e)(6).

34 Preamble at 5-6.

35 Preamble at 6.

36 Treas. Reg. Section 1.951-1(e)(6).

37 Preamble at 7-8.

38 Preamble at 6.

39 Preamble at 46-47.

40 Treas. Reg. Section 1.951A-3(h)(2)(ii)(A), (C).

41 Treas. Reg. Section 1.951A-3(h)(2)(ii)(A).

42 Treas. Reg. Section 1.951A-3(h)(2)(ii)(B)(1)(i); Preamble at 87.

43 Treas. Reg. Section 1.951A-3(h)(2)(ii)(B)(ii); Preamble at 53.

44 Treas. Reg. Section 1.951A-3(h)(2)(ii)(B)(2); Preamble at 89.

45 Treas. Reg. Section 1.951A-3(h)(2)(ii)(B)(3).

46 Treas. Reg. Section 1.951A-3(h)(2)(i)(B).

47 Treas. Reg. Section 1.951A-3(h)(2)(i)(C).

48 Treas. Reg. Section 1.951A-2(c)(5).

49 Treas. Reg. Section 1.951A-2(c)(5).

ENDNOTES (CONTINUED)

50 Preamble at 44-45.

51 Preamble at 45-46.

52 Preamble at 46-47. The Preamble quotes the Conference Report for the TCJA as follows: "The conferees intend that non-economic transactions intended to affect tax attributes of CFCs and their U.S. shareholders (including amounts of tested income and tested loss, tested foreign income taxes, net deemed tangible income return, and QBAI) to minimize tax under this provision be disregarded. For example, the conferees expect the Secretary to prescribe regulations to address transactions that occur after the measurement date of post-1986 earnings and profits under amended section 965, but before the first taxable year for which new section 951A applies, if such transactions are undertaken to increase a CFC's QBAI." Conf. Rpt. 115-466, 645.

53 Preamble at 48-49.

54 Treas. Reg. Section 1.951A-2(c)(5)(i); Preamble at 52.

55 Treas. Reg. Section 1.951A-3(h)(2)(ii)(B)(3); Preamble at 55-56.

56 Section 951A(d)(4).

57 Prop. Treas. Reg. Section 1.951A-3(h)(1).

58 Preamble at 80-81.

59 Treas. Reg. Section 1.951A-3(h)(1)(iv)(A).

60 Treas. Reg. Section 1.951A-1(h)(1)(iv)(B).

61 Treas. Reg. Section 1.951A-1(h)(1)(iii).

62 Preamble at 84.

63 Section 951A(c)(2)(A)(i)(II).

64 Prop. Treas. Reg. Section 1.951-2(c)(4)(i).

65 Treas. Reg. 1.951A-2(c)(4)(iii)(A)-(B).

66 Section 954(b)(3).

67 Section 1.951A-2(c)(4)(iii)(C).

68 Prop. Treas. Reg. Section 1.951A-6(e).

69 Preamble at 121.

70 Treas. Reg. Sections 1.951-1(i), 1.951A-7.

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