Selling CFCs—
The Consequences of a Blended Territorial and Worldwide Regime

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Agenda

• **Introduction**
  • Squaring the Circle—Using a Corporate Framework to Tax Income on a Flow-Through Basis

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  • Example 1—When is Gain Treated as Tested Income?

• **Question #2—Should Treasury Regulations Require the Taxable Year of a CFC to Actually Close Upon an External Sale of the CFC and Treat the Selling U.S. Shareholder as the Owner Through the Closing?**
  • Example 2—Impact to USP Seller of Tested Income in the Year of Sale and the Identity of the Buyer

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Prior to the TCJA, Subpart F functioned more as an “anti-deferral” regime than a flow-through regime.

- The CFC rules retained (and operated within) the basic infrastructure of Subchapter C.
- Subpart F picked up only narrowly-defined categories of income (excluded most operating income).
- Used flow-through as a remedy.
- Included adjustments (e.g., PTI) intended to prevent a U.S. shareholder from being taxed twice.
  - Adjustments were complicated, did not work perfectly and were not fully developed.
  - Imperfections traditionally tolerable (or at least tolerated) as part of an “anti-deferral” regime.

Following enactment of TCJA, most taxable income recognized by a U.S. corporate shareholder in respect of a CFC will now be taxable to the corporate U.S. shareholder on a flow-through basis.

- Most notable exception to all of this relates to gain on the sale of stock of a CFC.

For corporate U.S. shareholders, the new CFC rules have the two hallmarks of a flow-through regime:

- Flow-through of income on a current basis.
- One level of tax.

There would have been some logic in the TCJA adopting a system that resembles a traditional flow-through regime (e.g., Subchapter K, Subchapter S or even the consolidated return regulations).
Squaring the Circle—Using a Corporate Framework to Tax Income on a Flow-Through Basis

• However, rather than adopting such an approach, the TCJA:
  • retained the basic subchapter C infrastructure applicable to CFCs,
  • expanded anti-deferral regime to cover most income realized by a CFC (i.e., GILTI and Subpart F),
  • applied a blend of “entity” level and “owner” level rules in calculating the flow through of GILTI, and
  • created new deductions for corporate U.S. shareholders of CFCs (and other non-U.S. companies)

• In doing so, the TCJA:
  • Increased the importance of the anti-deferral regime (and the adjustments) working properly, and
  • Exacerbated distortions when they do not (e.g., taxing income twice, not at all or at the wrong rate)

• Imperfections of system will tend to reveal themselves upon a sale of the CFC (if not before)
When compared to the relatively “simple” rules and principles of a traditional flow-through regime, the new CFC rules resemble the type of flow-through regime that Rube Goldberg would have designed.

Not surprising that early guidance has reflected a view that two wrongs can in fact make a right:

- If E&P is needed for Subpart F inclusion, Prop. Reg. § 1.951A-6(d) manufactures it.
- Since a tested loss from one CFC can cause the tested income of another CFC to be exempt income, the Proposed GILTI Regulations reduce the tax basis of the loss CFC to even things out.
One wonders if it is actually possible to make the current system work.

Expression "squaring the circle" is used as a metaphor for trying to do the impossible.*

Squaring the circle was a challenge proposed by ancient geometers to
- construct a square (that is, a corporation)
- with the same area as a given circle (that is, a partnership)
- using only a finite number of steps with a compass (i.e., regulatory authority) and a straightedge (i.e., technical corrections)

Literary references date back at least to 414 BC, when the play *The Birds* by Aristophanes was first performed.*

Dante*:  
- As the geometer his mind applies  
- To square the circle, nor for all his wit  
- Finds the right formula, howe'er he tries  
- Proved impossible in 1882*

* See Wikipedia
Whatever the challenges of making the current system work may be:

- System included in the TCJA was (as it turns out) something actually capable of getting adopted

- If U.S. tax system is to be truly competitive with other developed countries, it would seem that either
  - the U.S. will need to eliminate the new GILTI flow-through rules, or
  - the rest of the world will need to adopt them

For those hoping for the former rather than the latter, the movement to a true flow-through system for CFCs would only make it harder to reverse course
Thinking About What a Circle Would Look Like

- Flow-through regimes have certain features not currently applicable under the new CFC regime:
  - Rules conforming treatment of equity sales in an entity with asset sales by the entity
    - See Section 751(a)
  - Closing the taxable year upon a sale and treating the seller as the owner at the close of the year
    - See Treas. Reg. §§ 1.338-9(b)(2) and 1.1502-76(b)
  - Allowing all income and losses to flow through and adjusting stock basis accordingly
    - But see Section 704(d)
  - Taxing owner on distributions only to the extent they exceed tax basis in the stock of the entity
    - See Section 731
  - Upon a purchase, adjusting attributes to prevent use of built-in tax benefits or opportunities
    - See Section 743(d)
- Inclusion of some of these into new CFC rules would further some of the policy goals underlying TCJA
- Also helpful to go a step further and consider what a flow-through system for CFCs might look like.
  - More to come on that in a bit
Caveats

• Presentation will largely ignore foreign taxes and foreign tax credits
  • This is admittedly a material omission

• Presentation is focused on CFCs owned by a single U.S. multinational
  • Very different considerations apply when this is not the case
Overview of Elective* Treatment for Gain or Loss from the Sale of a Business Held by a CFC

**USP**
- **Sale of Stock of US Sub**
  - Creates “Regular” Gain or Loss
  - Taxed at 21% rate (no 1248 except Prop. Reg. § 1.1502-32(b)(3)(ii)(F))
  - No FTCs
  - Capital loss creates 21% tax benefit (but only if taxpayer has capital gain)

**US Sub**
- **Sale of Stock of First-Tier CFC**
  - Creates “Regular” Gain or Loss
  - Taxed at 21% rate (other than 1248 portion)
  - 1248 portion generally taxed at a 0% rate
  - No FTCs
  - Capital loss creates 21% tax benefit (but only if taxpayer has capital gain)

**CFC-1**
- **Sale of Stock of Second-Tier CFC**
  - Creates Subpart F income or loss
  - Income taxed at 21% rate (other than 964(e) portion)
  - Some FTCs available
  - 964(e) portion generally taxed at a 0% rate
  - Loss creates 21% tax benefit (but only if taxpayer has like Subpart F income)

**CFC-2**
- **Sale of DRE**
  - Creates tested income or loss
  - Income taxed at 0%, 10.5% or 21% (depending)
  - Some FTCs available (likely more than when stock is sold)
  - Loss creates a 0%, 10.5% or 21% tax benefit (depending) but may give rise to 21% tax cost due to basis reduction under Prop. Treas. Reg. § 1.951A-6(e)

**DRE**
- **Sale of Assets**
  - Like sale of DRE for U.S. purposes except for Section 901(m) and the like
  - May trigger local non-U.S. taxes but create local non-U.S. step-up
  - FTC rules critical

*Existence of other assets, liabilities and tax attributes limit electivity in practice*
Key Assumptions for Examples

<table>
<thead>
<tr>
<th>Except as noted, each example assumes (among other things) that:</th>
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<tbody>
<tr>
<td>• No corporation has any</td>
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<tr>
<td>• QBAI,</td>
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<td>• E&amp;P,</td>
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<tr>
<td>• Tested income (or loss), or</td>
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<td>• Subpart F income</td>
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<td>• There are no foreign taxes (or foreign tax credits)</td>
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<td>• There is no limit on the GILTI deduction under Section 250</td>
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<td>• Each taxpayer has the calendar year as its taxable year</td>
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<td>• Holding period is satisfied for purposes of Sections 245A,</td>
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<td>964(e)(4) and 1248(j)</td>
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<tr>
<td>• Use of DREs in the examples do not implicate the hybrid</td>
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<tr>
<td>dividend rules</td>
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<td>• Section 961 is self-effectuating prior to the issuance of</td>
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<tr>
<td>regulations as to GILTI and Subpart F</td>
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<tr>
<td>• References to</td>
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<tr>
<td>• USP mean the parent of a U.S. federal consolidated income</td>
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<td>tax group</td>
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<td>• US Sub mean a subsidiary member of a U.S. federal</td>
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<td>consolidated income tax group</td>
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<tr>
<td>• CFCs mean controlled foreign corporations while held by</td>
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<tr>
<td>USP (but not necessarily before or after)</td>
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<tr>
<td>• Non-U.S. Buyer mean a non-U.S. corporation that is not a</td>
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<td>CFC</td>
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<tr>
<td>• The new provisions otherwise apply as written</td>
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<tr>
<td>• Other stuff I forgot to write down</td>
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Question #1—Should Gain from the Sale of Stock of a CFC be Treated (in Part) as Tested Income?
Example 1—When is Gain Treated as Tested Income?

- **USP**
  - Tax Basis = $300
  - FMV = $400

- **US Sub**
  - Tax Basis = $300
  - FMV = $400

- **CFC-1**
  - Tax Basis = $300
  - FMV = $400

- **CFC-2**
  - Tax Basis = $300
  - FMV = $400

- **DRE**
  - Tax Basis = $300
  - FMV = $400
  - Non-U.S. Business
Example 1—When is Gain Treated as Tested Income?

**Example 1A—Sale of US Sub Stock with No 338(g) Election**
- $100 of “regular” gain
- $21 of U.S. tax (21% of $100)

**Example 1B—Sale of CFC-1 Stock with No 338(g) Election**
- $100 of “regular” gain
- $21 of U.S. tax (21% of $100)

**Example 1C—Sale of CFC-2 Stock with No 338(g) Election**
- $100 of Subpart F income
- $21 of U.S. tax (21% of $100)

**Example 1D—Sale of Interests in the DRE**
- $100 of GILTI inclusion
- ($50) GILTI deduction
- $50 net income
- $10.50 of tax (21% of $50). Would be $0 if enough QBAI.
How Should Gain from the Sale of GILTI-Producing Assets and Gain from the Sale of Stock of a CFC Owning Such Assets Be Treated?

• **Is the disparate tax treatment an accident of history or does it reflect a tax policy decision?**

  • **Consider a sale**
    • By CFC-2 of assets that produce tested income
    • By CFC-1 of stock of CFC-2
    • By US Sub of stock of CFC-1
    • By USP of stock of US Sub

  • **Summary of tax policy goals as reflected in the Preamble to the Proposed GILTI Regulations:**
    • To generally allow earnings of a foreign corporation to be repatriated to a corporate U.S. shareholder without U.S. tax;
    • To provide a protective measure against taxpayers being incentivized to allocate income that would otherwise be subject to full U.S. corporate tax to CFCs operating in low (or no) tax jurisdictions
      • Protective measure is to tax certain CFC income on a current basis under Section 951A; and
    • For the protective measures not to harm the competitive position of U.S. corporations relative to foreign peers.
How Should Gain from the Sale of GILTI-Producing Assets and Gain from the Sale of Stock of a CFC Owning Such Assets Be Treated?

- **Gain on assets sold by CFC-2 should be eligible for the 0% or 10.5% effective tax rates**
  - Allows the gain to be repatriated to USP without U.S. tax while providing some measure of protection against taxpayers being incentivized to allocate gain to CFCs operating in low tax (or no tax) jurisdictions.
  - Good argument that such gains should be entirely exempt from U.S. taxation.
  - But to the extent the U.S. is legitimately concerned with the inappropriate shifting of income from U.S. taxpayers to CFCs and addresses that concern by taxing a portion of the tested income of a CFC at a 10.5% rate, seems legitimate when that income stream is sold for the U.S. to tax a portion of the gain at the same 10.5% rate.
  - Since sale price is a multiple of earnings, should you apply a multiple of the QBAI return?

- **Above applies with similar force to gain on sale of stock of CFC-2 and CFC-1**
  - However, pretty complicated to actually do this (see later slides)
  - Treating loss on the sale of CFC stock as tested loss would raise additional issues (see later slides)

- **Above applies with somewhat less force to gain on the sale of stock of US Sub**
  - Except for built-up exempt income in US Sub’s lower-tier CFCs. More later.
How Does the Post-TCJA Regime Compare to the Rules in Other OECD Countries?*

• UK
  • If certain requirements are met, gain on the sale of shares by a UK company is exempt from taxation. The exemption requires a "substantial shareholding" (broadly, at least 10% of the ordinary share capital held in the company for at least 12 months) and that the company being sold meets certain criteria (including being a qualifying trading company or a qualifying holding company)
  • Non-exempt capital losses can generally be carried forward to be used against future non-exempt capital gains

• France
  • French companies may exclude 88% of gain on the shares of a French or non-French entity under the French participation exemption system if the selling French company has owned such shares for at least two years at the time of the sale and the shares meet certain requirements (e.g., by qualifying as “titres de participation” under French GAAP)
  • Capital losses on shares that qualify for the participation exemption system are not deductible

• Germany
  • Capital gains on a sale of shares by a German company are eligible for the general 95% German participation exemption, which is available if the German shareholder owns at least 10% of the share capital of the company being sold at the beginning of the year or if it acquired at least 10% during the calendar year; certain restrictions apply (e.g., for hybrid instruments and for short-term investments by financial institutions)
  • Capital losses on the sale of shares generally not deductible under the participation exemption regime

• Hong Kong
  • Capital gains are not taxable
  • Capital losses are not deductible

* Source: A document prepared by a very helpful big four accounting firm for internal purposes.
How Would You Do It?

- Exclude gain on the sale of CFC stock from income entirely
- Treat the gain entirely as tested income
- Treat the gain on the sale of stock of a CFC as tested income in part based on the nature of assets held by the CFC (see Section 751 or Section 954(c)(4))
  - May need to adjust attributes of the CFC to the buyer
  - Perfection is the enemy of the good
- Require Section 338 election
Question #2—Should Treasury Regulations Require the Taxable Year of a CFC to Actually Close Upon an External Sale of the CFC and Treat the Selling U.S. Shareholder as the Owner Through the Closing?
Example 2: Impact to USP of Tested Income in the Year of Sale and the Identity of the Buyer

Sale of CFC-1 Stock to Various Types of Buyers with No 338(g) Election

USP

CFC-1

Tax Basis = $300
FMV = $400

• Pre-Closing Tested Income = $60
• E&P Limited to Tested Income
Example 2A—Sale of CFC-1 Stock to a Non-U.S. Buyer that has No U.S. Subs (No 338(g) Election)

- Since USP is a U.S. shareholder on the last day of CFC-1’s taxable year on which it is a CFC, USP has GILTI on a portion of CFC-1’s tested income
- Application of GILTI (and Section 1248) to the sale depends on:
  - CFC-1’s E&P for the entire taxable year of the sale (not just through closing)
  - When during that taxable year the sale occurs
  - Whether CFC-1 makes distributions during that taxable year
- To illustrate the math, if taxable year of CFC-1 closed the next day (and there was no activity on that day or distributions during the year):
  - $60 of GILTI inclusion
  - ($30) GILTI deduction
  - Tax basis in CFC-1 increased by $60 to $360
  - $40 of gain (and $30 of net GILTI)
  - $14.70 of tax (21% of $70)
- If rules required the taxable year of CFC-1 to close on the sale date and treated USP as the owner of CFC-1 as of the closing of the taxable year, then USP would include the entire $60 under the GILTI rules (unless covered by QBAI return) but the calculation would not be impacted by post-closing activity.
Example 2B—Sale of CFC-1 Stock to U.S. Buyer (No 338(g) Election)

- Since USP is not a U.S. shareholder of CFC-1 on the last day of CFC-1’s taxable year on which it is a CFC, USP has no GILTI on account of CFC-1’s tested income for the year of sale.
- Application of Section 1248 to year of sale depends on same factors listed in Example 2A.
- If the taxable year of CFC-1 closed the day after the sale (and no activity or distributions on that day), USP has
  - $100 of gain, but $60 is exempt under Sections 1248 and 245A
  - $8.40 of Tax (21% of $40)
- As discussed in NYSBA Tax Section, “Report on the GILTI Provisions of the Code,” Report No. 1394, May 4, 2018, the $60 deemed dividend to the seller reduces U.S. Buyer’s share of the GILTI even if the $60 deemed dividend is tax exempt to USP by virtue of Section 245A.
- If the rules required the taxable year of CFC-1 to close on the sale date and treated USP as the owner of CFC-1 as of the closing of the taxable year, then the tax consequences of Examples 2A and 2B would be the same (i.e., USP would include the entire $60 under the GILTI rules (unless covered by QBAI return) and the calculation would not be impacted by post-closing activity).
Example 2C—Sale of CFC-1 Stock to Non-U.S. Buyer With a U.S. Subsidiary but No 338(g) Election

- In light of downward attribution of the CFC-1 stock from the Non-U.S. Buyer to the U.S. subsidiary of the Non-U.S. Buyer,
  - USP is not a U.S. shareholder of CFC-1 on the last day of CFC-1’s taxable year on which it is a CFC
  - USP has no GILTI on account of CFC-1’s tested income for the year of sale
  - Results to USP are the same as Example 2B (sale to U.S. Buyer)

- If the rules required the taxable year of CFC-1 to close on the sale date and treated USP as the owner of CFC-1 as of the closing of the taxable year, then the tax consequences of Examples 2A, 2B and 2C would be the same (i.e., USP would include the entire $60 under the GILTI rules (unless covered by QBAI return) and the calculation would not be impacted by post-closing activity).
Example 2: Discussion Points

• Basic questions
  • Why on Earth should the tax consequences to the seller depend on the identity of the buyer?
  • Why use a proration approach (rather than end of the day approach in Treas. Reg. § 1.1502-76(b))?

• Context
  • Has always been true with Subpart F income
  • Section 245A changes the significance to the seller
  • Tested income changes magnitude to a U.S. buyer
  • Tested losses raise new issues for U.S. corporate buyers

• Requires
  • Post-closing indemnity to protect U.S. buyer
  • Post-closing dividend covenants to protect U.S. seller

• Would think guidance under Sections 441, 898, 951 and 951A could:
  • Require the taxable year of a CFC to close upon a sale of 50% of the stock to an unrelated person
  • Treat the seller of CFC shares as the owner of the shares as of the end of the short taxable year

• Need to address foreign taxes and FTCs if force a closing of the taxable year for U.S. tax purposes
  • See Treas. Reg. § 1.338-9(d) (adopting principles of -76(b) for allocating taxes for foreign tax year)
  • See Treas. Reg. § 1.901-2(f)(4) (similar rule for Section 901 in case of Section 708(b) termination)
Question #3—Should the Tax Exemption Effected Through Section 245A Operate More Like Sections 199A, 250 and 731 in the CFC Context?

- At a high level the new CFC rules are designed to tax corporate U.S. shareholders at a:
  - 10.5% rate on the net tested income of its CFCs that exceeds the QBAI return (the “GILTI”), &
  - 0% rate on (i) net tested income of its CFCs (up to the QBAI return) and (ii) amounts excluded from both tested income and Subpart F income (collectively with (i), “Exempt Income”)*

- Two Different Approaches
  - The 10.5% tax rate is effected by allowing the income to flow through to the corporate U.S. shareholder in the year it is earned by the CFC and providing the corporate U.S. shareholder with a deduction equal to 50% of that flow-through income
  - By contrast, the 0% tax rate is effected through the creation of a deduction at the time the Exempt Income is paid as a dividend to the corporate U.S. shareholder (or treated as such).

- Why the Different Approaches?
  - GILTI is taxed currently and so need the flow through approach. Exempt Income is not.
  - Exempt Income treatment also applies to non-CFCs for which there is no infrastructure for flowing through income. *But see* Section 965 as applied to non-CFCs.
  - Section 245A is more about exempting dividends than exempting Exempt Income (though like effect)

* And a 21% tax rate on its Subpart F income
In the CFC context, the rules might work better under an “Exempt Income Approach” in which

- The Exempt Income also flowed up to the corporate U.S. shareholder
- A corporate U.S. shareholder received a current offsetting deduction in the same year
- Such amounts gave rise to PTI and tax basis (under Sections 959 and 961).

Alternatively, the Exempt Income could just create PTI and tax basis without actually flowing up.

Even if the Exempt Income Approach were adopted, there would still be instances in which a corporate U.S. shareholder received a dividend from a CFC, such as where

- the tested loss of one CFC offset the tested income of another CFC (see Example 5 below) or
- non-U.S. corporation had E&P when first acquired by the U.S. shareholder (see Example 6 below).

To address these cases, the rules might work better if revised to tax a corporate U.S. shareholder on distributions from a CFC only to the extent they exceed the corporate U.S. shareholder’s tax basis

- In effect, to provide that all distributions from a CFC are taxable first under Section 301(c)(2) and then under Section 301(c)(3) regardless of whether they are treated as dividends
- Would not really work for non-CFCs. And there are a lot more CFCs today than before the TCJA.
Example 3—Application of Section 245A Can Depend on the Level of Sale When Selling Stock

• **Basic Facts**
  - In year 1, CFC-1 has $100 of tested income but no GILTI income in light of available QBAI. There is no income in any prior or later year.
  - In year 3, USP wants to sell the business in a stock sale for $400
Example 3—Application of Section 245A Can Depend on the Level of Sale When Selling Stock

<table>
<thead>
<tr>
<th>USP</th>
<th>Tax Basis = $300</th>
<th>FMV = $400</th>
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<tr>
<td>US Sub</td>
<td>Tax Basis = $300</td>
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</tr>
<tr>
<td>CFC-1</td>
<td>$100 of Accumulated E&amp;P</td>
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</table>

- **Basic Facts**
  - In year 1, CFC-1 has $100 of tested income but no GILTI income in light of available QBAI. There is no income in any prior or later year.
  - In year 3, USP wants to sell the business in a stock sale for $400
- **Example 3A—US Sub Sells the Stock of CFC-1**
  - $100 of gain
  - Gain is effectively exempt dividend under Section 1248/245A
  - $0 tax
- **Example 3B—USP Sells the Stock of U.S. Subsidiary**
  - $100 of gain
  - $21 of tax
  - Although Proposed Treas. Reg. § 1.1502-32(b)(3)(ii)(F) may create a basis increase upon a sale of a member by reference to the amount of tax-exempt income the member would have recognized under Sections 1248 and 245A upon a sale of the stock of a CFC held by such member, that basis increase is available only to the extent the exempt income arose because tested income of the CFC was offset by a tested loss of another CFC.
Example 4—Application of Section 245A Can Depend on the Level of Sale in the Partnership Context

- **Example 4A—Partnership Sells Stock of CFC-1**
  - $200 of gain (all of which is treated as a dividend under Section 1248)
  - USP is allocated $100 of the dividend income
  - Dividend income should give rise to a DRD under 245A
  - $0 tax

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**Partnership**

- **U.S. Individual**
  - Tax Basis = $300
  - FMV = $400

- **USP**
  - Tax Basis = $600
  - FMV = $800

- **CFC-1**
  - $200 of Accumulated E&P

- **Example 4—Partnership Sells Stock of CFC-1**
  - $200 of gain (all of which is treated as a dividend under Section 1248)
  - USP is allocated $100 of the dividend income
  - Dividend income should give rise to a DRD under 245A
  - $0 tax
Example 4B—USP Sells Its Partnership Interest

- $100 of gain. Gain is ordinary income under Section 751(a)
- See the preamble to the final 1248 regulations:
  - “A commentator noted that §1.1248-1(a)(4) of the proposed regulations could be read to apply to the sale by a partner of its interest in a partnership holding the stock of a corporation. The Treasury Department and the IRS did not intend that interpretation because it would be contrary to section 1248(g)(2)(B). An amount that is received by a partner in exchange for all or part of its partnership interest is treated as ordinary income under section 751(a) and (c) to the extent attributable to stock in a foreign corporation as described in section 1248. Section 1248(g)(2)(B) provides that section 1248 will not apply if any other provision of the Code treats an amount as ordinary income. Accordingly, §1.1248-1(a)(4) in the final regulations is revised to clarify that a foreign partnership is treated as an aggregate for this purpose only when a foreign partnership sells or exchanges stock of a corporation.”

- But see, Kimberly S. Blanchard, “Section 751(c) and §1248: The Case of the Disappearing E&P,” Bloomberg BNA International Tax, September, 11, 2014.
- $21 of tax
Examples 3 & 4—Discussion Points

• USP is able to realize a 0% tax rate on the gain attributable to the exempt income of CFC-1 if the exit is effected as a sale of the stock of CFC-1 but not if the exit is a sale by USP of the entity owning the stock of CFC-1.

• If the Exempt Income Approach was adopted, USP would realize the full benefit of the 0% rate on the exempt income regardless of the level of exit.

• An alternative approach would be to extend the principles of Prop. Treas. Reg. § 1.1502-32(b)(3)(ii)(F) to any such a sale but without regard to whether the exempt income is attributable to a tested loss of a related CFC.
Example 5—Application of Section 245A Where Tested Loss of One CFC Offsets Tested Income of Another CFC

- **Example 5A**
  - In Year 1,
    - USP invests $100 into a newly formed CFC-1
    - CFC-1 buys DRE-1 and DRE-2 with the $100
    - DRE-1 generates $10 of tested income and DRE-2 generates $10 of tested loss
  - In Year 3, USP sells the stock of CFC-1 for $200
  - Assume no items of income or loss in years 2 and 3

- **Year 1—USP Tax Consequences**
  - $0 of GILTI inclusion
  - No change in tax basis, no E&P and no PTI

- **Year 3—USP Tax Consequences**
  - $100 of gain
  - No Section 1248 dividend (and thus no Section 245A DRD)
  - $21 of Tax
Example 5—Application of Section 245A Where Tested Loss of One CFC Offsets Tested Income of Another CFC

- **Example 5B**
  - Same as Example 5A but USP invests through two newly formed CFCs and both CFCs are sold for $200 in total (both at a gain)

  - **Year 1—USP Tax Consequences**
    - $0 of GILTI inclusion
    - No change in tax basis and no PTI
    - CFC-1 has $10 of E&P and CFC-2 has a $10 E&P deficit

  - **Year 3—USP Tax Consequences (Ignoring Prop. Treas. Reg. § 1.951A-6(e))**
    - $100 of gain
    - $10 of the gain is effectively exempt dividend income under Sections 1248 and 245A
    - $18.90 of tax (21% x $90) ($2.10 less than Example 5A)

- Tested loss in CFC-2 created exempt income in CFC-1. Oops!
Example 5—1.951A-6(e)

- Preamble to the Proposed GILTI Regulations
  - The Treasury Department and the IRS have determined that in certain cases the lack of adjustments to stock basis of a tested loss CFC can lead to inappropriate results.
  - For example, if the U.S. shareholder’s basis in the stock of the tested loss CFC is not reduced to reflect the use of the tested loss to offset tested income taken into account by the U.S. shareholder, the U.S. shareholder would recognize a second and duplicative benefit of the loss – either through the recognition of a loss or the reduction of gain – if the stock of the tested loss CFC is disposed of.
  - On the other hand, in the case of a corporate U.S. shareholder, but not in the case of an individual, gain recognized on the disposition of a CFC attributable to offset tested income would, in most cases, be eliminated as a result of the application of section 964(e) or section 1248(a) and (j), to the extent the gain is recharacterized as a dividend that is eligible for the dividends received deduction under section 245A.

- Prop. Treas. Reg. § 1.951A-6(e) generally provides that in the case of a corporate U.S. shareholder (here USP), for purposes of determining the gain, loss, or income on the direct or indirect disposition of stock of a CFC (here CFC-2), the basis of the stock is reduced by the amount of tested loss that has been used to offset tested income in calculating “net CFC tested income” of the U.S. shareholder (here there was an offset to CFC-1’s tested income)
  - Basis reduction is made only at the time of a “disposition” and does not affect the stock basis prior to a disposition
  - Lots of bells and whistles designed to make the rule operate better
  - Additional rules for application in the consolidated return context.
An Example Where Prop. Treas. Reg. § 1.951A-6(e) Arguably Results in the Right Amount of Tax

- **Example 5B (Applying Prop. Treas. Reg. § 1.951A-6(e))**
  - Year 1—USP Tax Consequences
    - $0 of GILTI inclusion
    - No change in tax basis and no PTI
    - CFC-1 has $10 of E&P
  - Year 2—USP Tax Consequences
    - USP has $10 of net used tested loss with respect to CFC-2 and upon the sale of the stock of CFC-2 the tax basis in the stock is reduced by the $10 of net used tested loss
    - $110 of gain
    - $10 of the gain in the stock of CFC-1 is effectively treated as exempt dividend income under Sections 1248 and 245A
    - $21 tax: $21 of tax is arguably the right amount of tax since (i) $100 of economic gain, (ii) no year with net tested income and (iii) no QBAI (assumed)
  - But that may not be right after all
Example 5—Discussion Points

• The $10 of tested loss in Example 5B creates two potential tax benefits

• First, the $10 of tested loss creates a potential timing benefit
  • Without the $10 of tested loss, USP would have $10 of GILTI but also $10 of additional stock basis
  • With the $10 of tested loss, the $10 of GILTI and the $10 tax basis increase both disappear
  • It seems clear that Congress intended to provide this tax benefit when it is available
  • If USP has enough QBAI that USP would not be taxable on the $10 of tested income in any case

• Second, the separation of the $10 of tested income and the $10 tested loss into two CFCs allows for the possibility that the tested income will be taxed at a 0% rate (by virtue of Section 245A).
  • The $10 DRD potentially available to USP under Section 245A in respect of the $10 of income earned by CFC-1 is similar to a $10 basis increase in the stock of CFC-1. However, there is no reduction in the tax basis in the stock of CFC-2 by reason of the $10 of tested loss.

• Importantly, the phenomenon creating this second potential benefit would also arise if USP owned 10% of stock of two (brother-sister) non-U.S. corporations that were not CFCs.
  • As a result, the phenomenon seems to have nothing to do with the GILTI rules applicable to CFCs.
Example 5—Discussion Points

• Not surprising that Treasury and IRS want to limit the second potential tax benefit in the CFC context.
  • But need to keep two points in mind

• First, this “second potential tax benefit” arises only if USP actually extracts the $10 of income from CFC-1 on tax free basis and this may not always be the case, such as where:
  • Stock of CFC-1 is sold at a loss because of an unrealized loss in its assets and no actual dividend
  • Section 245A requirements are not met (or are met but basis is reduced under 961(d) or 1059)
  • Also, even if can get full 245A benefit, result may not be better than GILTI with FTCs

• Second, this second potential tax benefit might disappear if the $10 of tested loss causes the portion of a subsequent distribution by CFC-1 to be taxed under Section 301(c)(2) rather than Section 301(c)(1)
  • Suppose (i) in year 1, CFC-1 has $10 of tested income and CFC-2 has $10 of tested loss, (ii) in year 2, CFC-1 has no income or loss and CFC-2 has $10 of tested income (but none of the $10 of tested income gives rise to GILTI because of available QBAI), and (iii) in year 3 CFC-2 pays a $10 distribution.  The Year 1 $10 tested loss may cause the $10 year 3 distribution to be a Section 301(c)(2) distribution that reduces tax basis rather than a Section 301(c)(1) dividend eligible for the Section 245A DRD.
Example 5—Discussion Points

• Alternative approaches
  • Reduce the DRD available in respect of CFC-1 to the extent it is attributable to the tested loss or
dee CFC-1 to have $10 of PTI (which would eliminate the DRD on the used tested income)
    • But need to increase accumulated E&P of CFC-1
  
• Provide an ability to “waive” a tested loss that would otherwise be subject to -6(e)

• Adopt the Exempt Income Approach and tax corporate U.S. shareholders on distributions from CFCs
  only to the extent they exceed the shareholder’s tax basis in its stock of the CFC
Example 6—Application of Sections 245A, 961(d) and 1059: to Pre-Acquisition E&P

- **Basic Facts (Pre-Acquisition E&P)**
  - In Year 1,
    - USP buys the stock of CFC-1 from an unrelated non-U.S. person in exchange for $100.
    - CFC-1 was not previously a CFC and had $10 of E&P and no PTI at the time USP acquired it.
   - CFC-1 does not generate any items of taxable income or loss thereafter
  - In Year 3, when there has been no change in the value of CFC-1’s assets, CFC-1 pays a $10 dividend and then USP sells the stock of CFC-1

USP

CFC-1

$10 of Pre-Acquisition E&P
Example 6—Application of Sections 245A, 961(d) and 1059: to Pre-Acquisition E&P

**Basic Facts (Pre-Acquisition E&P)**—In Year 1, USP buys the stock of CFC-1 from an unrelated non-U.S. person in exchange for $100. CFC-1 was not previously a CFC and had $10 of E&P and no PTI at the time USP acquired it. CFC-1 does not generate any items of taxable income or loss thereafter. In Year 3, when there has been no change in value of CFC-1’s assets, CFC-1 pays a $10 dividend and then USP sells the stock of CFC-1.

**Example 6A—Sale Price Is $90**
- USP has $10 of dividend income and a $10 DRD under Section 245A. No tax
  - Note the result would be different under Section 1248 (if no actual dividend)
- No gain or loss on sale of stock after application of Section 961(d). No tax
- $0 tax, $0 tax benefit and $0 economic income (so far, so good)

**Example 6B—Same, but Value of CFC-1’s Assets Increase by $10 and Sale Price Is $100**
- USP has $10 of dividend income and a $10 DRD under Section 245A. No tax.
  - Note the result would be different under Section 1248 (if no actual dividend)
- No gain or loss on sale of stock. No tax
- $0 tax even though $10 of economic income
- The E&P in existence at the time CFC-1 was acquired has converted what would have been gain taxable at a 21% rate into exempt income
Example 6—Application of Sections 245A, 961(d) and 1059: When No Pre-Acquisition E&P

- **Revised Facts (No Pre-Acquisition E&P but Value Declines)**—In Year 1, USP forms CFC-1 with $100 of equity. Over the next two years, CFC-1 earns (in total) $10 of tested income (none of which is treated as GILTI due to amount of QBAI). In Year 3 (during which CFC-1 has no taxable income or loss), CFC-1 pays a $10 dividend. CFC-1 declines in value and USP sells the stock of CFC-1 for $90.

- **Example 6C—Sale Price Is $90 (Assume Assets Declined in Value)**
  - USP has $10 of dividend income and a $10 DRD under Section 245A. No tax
  - Absent Section 961(d), USP would have a taxable loss on the sale. Under Section 961(d), USP’s basis in CFC-1 is reduced by $10 and USP has no gain or loss
  - **$0 in total taxes**
  - Why shouldn’t USP be allowed a loss on these facts?
  - Would it matter if the income was generated in the ordinary course of business vs. a transaction designed to manufacture E&P?

- **Example 6D—Same as Example 6C but with GILTI**
  - $5 of net tested income ($1.05)
  - $10 of capital loss on the sale (no reduction of tax basis under Section 961(d))
  - **Net tax saving of $1.05 if can use the capital loss**
  - USP is worse off with exempt income than GILTI
Example 6—Discussion Points

- Section 961(d) could be viewed as
  - under-inclusive (and should also apply to gain following a dividend of pre-acquisition E&P), and
  - over-inclusive (and should not apply to dividends of post-acquisition E&P).
- Since Section 245A also applies to non-CFCs, it is not surprising the rules take a rough justice approach pursuant to which:
  - Section 245A does not distinguish between pre-acquisition E&P and post-acquisition E&P,
  - Section 961(d) applies to loss but not gain.
- However, one could imagine a more refined approach for CFCs in which
  - Pre-acquisition E&P was treated as PTI under Section 959 (so that it did not give rise to a DRD),
  - Section 961(d) did not apply at all.
- Alternatively, the rules could be revised to adopt the Exempt Income Approach and to tax corporate U.S. shareholders of CFCs on distributions only to the extent they exceed the tax basis in the stock
Question #4—Is Pre-Acquisition Built-In-Gain Like Pre-Acquisition E&P?
**Example 7—Impact of Level of Sale Where There Is an Inside-Outside Basis Disparity**

- **Basic Facts**—
  - USP purchased the stock of CFC-1 in a transaction without a 338(g) election at a time when CFC-1 had $300 of built-in gain in its assets, no E&P and no PTI.
  - The value of CFC-1’s assets subsequently increases by $100.
  - Alternatively, USP sells the stock of CFC-1 (without a Section 338(g) election), the DRE or the stock of CFC-1 (with a Section 338(g) election).
Example 7—Impact of Level of Sale Where There Is an Inside-Outside Basis Disparity

- **Basic Facts**—USP purchased the stock of CFC-1 in a transaction without a 338(g) election at a time when CFC-1 had $300 of built-in gain in its assets, no E&P and no PTI. The value of CFC-1’s assets subsequently increases by $100.

- **Example 7A—Sale of CFC-1 Stock with no 338(g) Election**
  - $100 of gain
  - No Section 1248
  - $21 of U.S. tax (21% of $100)

- **Example 7B—Sale of Interests in the DRE**
  - $400 of GILTI inclusion
  - ($200) GILTI deduction
  - $42 of tax on the net GILTI income (21% of $200)
  - $400 increase in USP’s tax basis in the CFC-1 stock
  - $300 built-in loss in CFC-1 stock
  - May create a tax benefit when triggered
Example 7—Impact of Level of Sale Where There Is an Inside-Outside Basis Disparity

**Example 7C—Sale of CFC-1 Stock With 338(g) Election**
- $400 of GILTI inclusion
- ($200) GILTI deduction
- $42 of tax on the net GILTI income (21% of $200)
- $400 increase in USP’s tax basis in the CFC-1 stock
- $300 capital loss
- $42 tax if cannot use the $300 capital loss (21% of $200)
- ($21) net tax “credit” if can use the loss (21% of ($100))

The $300 capital loss seems to raise issues similar to those raised in Examples 6A and 6B relating to the 100% deduction under Section 245A when a CFC pays a dividend out of pre-acquisition E&P and the role of Section 961(d) when the stock is sold.

Here, however, the issue is raised by the 50% deduction under Section 250 in respect of pre-acquisition built-in gain.
How Should the Capital Loss in Example 7C Be Treated as a Tax Policy Matter?

• Section 961(d)
  • To the extent the stock of a non-U.S. corporation is sold at a loss by a 10% U.S. shareholder, the 10% U.S. shareholder’s tax basis in its stock is reduced by the “non-taxed portion” of any dividends received from such non-U.S. corporation by such 10% U.S. shareholder
  • No application to Example 7 because the example does not involve a dividend

• Should a rule like Section 961(d) apply to reduce (solely for purposes of determining loss) the tax basis in the stock of a CFC by the “nontaxed portion” of the GILTI income arising from a CFC (i.e., the GILTI income reduced by the deduction under Section 250 on that income)? As applied to Example 7C, under this approach:
  • USP’s tax basis in CFC-1 would be reduced by $200 from $700 to $500
  • USP would have a $100 capital loss (rather than a $300 capital loss)
  • USP would owe $42 of tax if it could not use the loss and $21 of tax if it could use the loss
  • However, since all of the gain is in fact tested income, USP should not owe more than $10.50 of tax
How Should the Capital Loss in Example 7C Be Treated as a Tax Policy Matter?

- For the same reason that Section 961(d) should arguably apply only to the DRD attributable to pre-acquisition E&P, a rule like Section 961(d) could be adopted that reduces the tax basis in the stock of a CFC to the extent of the nontaxed portion of any GILTI income attributable to pre-acquisition built-in gain in the assets of the CFC. As applied to Example 7C, under this approach:
  - USP’s tax basis in CFC-1 would be reduced by $150 from $700 to $550
  - USP would have a $150 capital loss
  - USP would owe $42 of tax if it could not use the loss, and $10.50 of tax if it could use the loss
How Should the Capital Loss in Example 7C Be Treated as a Tax Policy Matter?

- A different approach would be to treat the loss as a tested loss (which might seem justifiable if gains on CFC stock were treated as tested income). As applied to Example 7C, under this approach:
  - USP would seem to have $400 of tested income (from CFC-1) and $300 of tested loss (from the sale of the CFC-1 stock).
  - However, a circularity would arise since the tested loss would reduce the amount of the tested income of CFC-1 that is treated as GILTI income and included in income and this (in turn) would reduce the amount of the loss.
- Significant issues would arise if the loss on the sale of stock of a CFC were treated as a tested loss.
  - Given the lumpiness with which businesses are sold, the fact that tested losses are allowed only against tested income that arises in the same taxable year would mean that in many cases a large portion of such a tested loss would go unused and provide no benefit whatsoever.
  - Moreover, in light of the limitation on the availability of a GILTI deduction under Section 250 (i.e., capped at taxable income), tested income may be taxed at a 10.5% or 21% effective tax rate. Extending that variability to the tax benefit arising from a loss on the sale of stock of CFC might create an illusion of balance, but may well operate to the benefit of some taxpayers and the detriment of others. Also, other rules already limit the use of capital losses.
  - Finally, if (as discussed above) a look-through rule were applied to determine the extent to which gain on the sale of stock of a CFC is treated as tested income, a similar look-through rule would presumably apply to a loss on the sale of stock of a CFC. Yikes.
Do Other Tax Policy Concerns Require a Disallowance of the Loss and/or a Limit on the Amount of the Step-Up in the Assets?

- What about Sections 337(d), 338(i) and 951A(d)(4)?

- In a sense, the question boils down to whether a CFC is more like an S corporation or a member of a U.S. consolidated group.

- A sale of the stock of an S corporation with a Section 338(h)(10) election results in a step-up in the tax basis of the assets of the S corporation. Where the tax basis in the stock of the S corporation before the sale exceeds the tax basis of the S corporation in its assets,
  - the gain recognized at the S corporation level will be partially offset by a loss at the shareholder level, and
  - the amount of the step-up will exceed the net gain recognized by the selling shareholder.

This has (rightfully) never been viewed as problematic. It is very similar to what is going on in Example 7C in terms of the step up.
Do Other Tax Policy Concerns Require a Disallowance of the Loss and/or a Limit on the Amount of the Step-Up in the Assets?

- Different concerns apply where the consolidated return rules are used to step up the assets of a domestic C corporation.
  - Unlike the case with a CFC or S corporation, the corporation holding the assets in the consolidated return context is itself subject to tax on the gain inherent in its assets.
  - In the CFC and S corporation context, the measure of gain subject to U.S. federal income tax is the gain in the stock rather than gain in the assets.