University of Chicago Law School

Federal Tax Conference

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

David H. Schnabel

November 9, 2018

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I. Introduction: Squaring the Circle—Using a Corporate Framework to Tax Income on a Flow-Through Basis

Prior\textsuperscript{1} to the enactment of the tax legislation commonly referred to as the “Tax Cuts and Jobs Act” (the “TCJA”\textsuperscript{2}), the tax rules under Subpart F of the Code\textsuperscript{3} functioned more as an “anti-deferral regime” than a “flow-through” regime.\textsuperscript{4} Income of a “controlled foreign corporation” (a “CFC”) was generally subject to the Subpart F regime only if the income fell within certain narrowly defined categories of income\textsuperscript{5} (“Subpart F income”), and Subpart F income generally did not include the normal operating income of a CFC.\textsuperscript{6}

\textsuperscript{1} I would like to thank Rachel Lerner and Karen Li for their help in preparing this paper, Aliza Slansky for her help on the slides for the May 2018 ABA panel at which some of the issues addressed in this paper were discussed, and Lindsey Bristow, Ronald Dabrowski and Jose Murillo (my co-panelists at the 2018 University of Chicago Law School Federal Tax Conference). Each of you provided invaluable comments and insights.

\textsuperscript{2} The TCJA is formally known as “An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018,” P.L. 115-97.

\textsuperscript{3} Except as noted, references to the “Code” are to the Internal Revenue Code of 1986, as amended, and references to “Sections” are to sections of the Code.

\textsuperscript{4} As explained in the Preamble to the recently proposed regulations under Section 956 relating to the application of Section 245A:

“Subpart F was enacted in order to limit the use of low-tax jurisdictions for the purposes of obtaining indefinite deferral of U.S. tax on certain earnings that would otherwise be subject to U.S. federal income tax. Congress enacted subpart F in part to address taxpayers who had ‘taken advantage of the multiplicity of foreign tax systems to avoid taxation by the United States on what could ordinarily be expected to be U.S. source income…The subpart F regime eliminated deferral for certain – generally passive or highly mobile – earnings of CFCs by subjecting those earnings to immediate U.S. taxation regardless of whether there was an actual distribution. Earnings that were not subject to immediate U.S. taxation under the subpart F regime were generally taxable only upon repatriation, as those earnings did not present the same concerns regarding indefinite tax deferral compared to earnings subject to subpart F.” REG-114540-18 at preamble (citations omitted).

\textsuperscript{5} Section 952 (defining Subpart F income to include foreign base company income, insurance income, certain income relating to countries under boycott or sanction and the amounts of illegal bribes, kickbacks and other payments). Under Section 956, a U.S. shareholder owning stock of a CFC (within the meaning of Section 958(a)) is also taxed on the earnings and profits (“E&P”) if the CFC makes certain investments in U.S. property.

\textsuperscript{6} Subpart F income primarily consists of “foreign base company income,” which is defined in Section 954. Foreign base company income is the sum of a CFC’s “foreign personal holding company income” (generally, consisting of certain types of passive income), “foreign base company sales income” (….continued)
The rules applicable to CFCs retained (with some adjustments) the basic U.S. federal income concepts that generally apply to C corporations under the Code, including those relating to “dividends” and “earnings & profits.”

Although the Subpart F income of a CFC would in effect “flow through” to the U.S. shareholders of the CFC, the income did not flow through in the traditional sense (e.g., the character of the income generally did not flow through). Rather, when a CFC earned Subpart F income, the U.S. shareholders of the CFC were (in general) simply required to include a corresponding amount in ordinary income.

The rules also included a series of adjustments (found primarily in Sections 959 and 961) that were designed to prevent the U.S. shareholder from being taxed twice on the same income. Those adjustments were complicated, did not work perfectly and were not fully developed. However, in light of the somewhat limited role played by the Subpart F regime, those imperfections were tolerable (or at least tolerated) as part of what was an “anti-deferral” (or anti-abuse) regime. In the case of a typical CFC that operated a business, most of the income was not taxable under the anti-deferral regime at all and would be taxable to the U.S. shareholder only when distributed as a dividend.

Following the enactment of the TCJA, most of the income recognized by a corporate U.S. shareholder in respect of a CFC will now be taxable to the U.S. shareholder on a flow-through basis. While the new CFC rules do not require all CFC income to flow through, the rules are generally designed to allow the income that does not flow through to be tax-exempt to a corporate U.S. shareholder by reason of the new 100% dividends received deduction (“DRD”) under Section 245A. While there are a number of exceptions to all of this, the most notable exception relates to gain (and loss) arising from the sale of stock of a CFC.

(continued....)

7 See, e.g., 952(c) (limiting Subpart F income to current earnings and profits) and Section 951(a)(2)(B) (reducing the amount of Subpart F income that must be included by a U.S. shareholder by the amount of dividends received by any other person with respect to such stock).

8 Except as noted, references to U.S. shareholders are to U.S. shareholders of a CFC (within the meaning of Section 951(b)) that own stock of the CFC under Section 958(a).

9 See NYSBA Tax Section, “Report on Previously Taxed Earnings under Section 959,” Report No. 1402, October 11, 2018 (discussing issues relating to PTI newly raised by the TCJA and existing issues exacerbated by the TCJA) and NYSBA Tax Section, “Report on 2006 Proposed Regulations Regarding the Exclusion from Income of Previously Taxed Earnings under Section 959 and Related Basis Adjustments under Section 961,” Report No. 1321, Mar. 20, 2015 (discussing issues with adjustments to E&P and PTI, some of which were addressed by proposed regulations and some of which remained unaddressed).

10 References to corporate U.S. shareholders of a CFC are to U.S. shareholders of the CFC that (in general) are eligible for deductions in respect of the CFC under Sections 245A and 250.
As a substantive matter, the new tax rules applicable to corporate U.S. shareholders of CFCs now possess the two primary hallmarks of a flow-through regime: most income that will be recognized by a corporate U.S. shareholder flows through to the shareholder on a current basis and that income is subject to one level of tax (if any).\(^{11}\) In light of this, there would have been some logic in the TCJA adopting a system that more closely resembles a traditional flow-through system, such as Subchapter K, Subchapter S or the consolidated return rules.

However, rather than adopting such an approach, the TCJA:

- retained the basic subchapter C infrastructure generally applicable to CFCs;

- expanded the Subpart F anti-deferral regime to cover “tested income” (which includes most income of a CFC that is not Subpart F income), but only to the extent a U.S. shareholder has net tested income and only to the extent that net tested income exceeds an annual threshold;

- applied a blend of entity-level and shareholder-level rules in calculating the amount of net tested income and the annual threshold; and

- created new deductions for corporate U.S. shareholders generally equal to the sum of:
  
  - 50% of the net tested income that actually flows up and
  
  - 100% of the taxable “dividends” distributed (or deemed to have been distributed) by the CFC.

In doing so, the TCJA greatly increased the importance of the anti-deferral regime (and the assortment of adjustments required under that regime) working properly and exacerbated the distortions caused when they do not work properly (e.g., taxing income twice, not at all or at the wrong rate). As illustrated by the examples discussed below, the imperfections of the new regime tend to reveal themselves upon a sale of a CFC (if not before).

When compared to the relatively “simple” rules and principles of a traditional flow-through regime, the new CFC rules seem to resemble the type of flow-through regime that Rube Goldberg would have designed.

\(^{11}\) The “aggregate” aspects of the GILTI rules to calculating the GILTI inclusion (i.e., the netting of tested income and tested losses across CFCs and the aggregation of QBAI across CFCs with positive tested income) also resemble in some respects what would happen under a traditional flow-through regime (see treatment of losses under Section 199A and rules for calculating the wage and qualified property caps under Section 199A in the case of aggregated trades or businesses).
Given the inherent difficulty in using a Subchapter C framework to tax income on a flow-through basis, it is not surprising that in implementing the new rules some of the early guidance has reflected a view that “two wrongs” can in fact make a “right.” For example, since E&P is needed for a Subpart F inclusion, the proposed GILTI regulations (the “Proposed GILTI Regulations”)\(^\text{12}\) simply manufacture E&P in certain cases where it is needed to allow Subpart F income to flow up.\(^\text{13}\) Similarly, since a tested loss from one CFC can cause the tested income of another CFC to be treated as exempt income by reason of the Section 245A deduction, the Proposed GILTI regulations reduce the tax basis of the CFC that generated the tested loss in an attempt to even things out.\(^\text{14}\) Rough justice is better than no justice.

However, one wonders if it is actually possible to make the current rules work in a way that is good enough. The expression “squaring the circle” is sometimes used as a metaphor for trying to do the impossible. Squaring the circle refers to a challenge by ancient geometers to:

- construct a square (that is, a corporation),\(^\text{15}\)

\(^\text{12}\) See REG-104390-18; Prop. Reg. §§ 1.951A-1 through -7 (2018), and related rules.

\(^\text{13}\) Prop. Reg. § 1.951A-6(d).

\(^\text{14}\) Prop. Reg. § 1.951A-6(e).

\(^\text{15}\) Admittedly, corporations are normally depicted as rectangles rather than squares, but give me a little room.
• with the same area as a circle (that is, a partnership).\textsuperscript{16}

• using only a finite number of steps with a compass (that is, regulatory authority) and a straightedge (that is, technical corrections).\textsuperscript{17}

Whatever the challenges of making the current system work properly may be, the inclusion of the current system in the TCJA was (as it turns out) something that was actually capable of getting adopted. There is some reason to doubt that this would have been true (at least on the same timetable) if Congress had sought to adopt a traditional flow-through system for taxing the income of CFC.

Moreover, in order for the U.S. tax system to be truly competitive with other developed countries, there is reason to believe 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, a movement to a true flow-through system for CFCs would only make it harder to reverse course.

Nevertheless, in considering how to implement (or perhaps revise) the CFC rules adopted by the TCJA, it is helpful to examine features common to traditional flow-through systems and to consider whether certain aspects should be imported into the new

\textsuperscript{16} Back in the day, when I was growing up as a young tax lawyer, partnerships were drawn as circles rather than triangles. See, e.g., Lee A. Sheppard, “The Fairies, The Magic Circle, and Partnership Options,” 90 Tax Notes 721 (Feb. 5, 2001). I’m not sure when the change to triangles occurred (I was late to the party), but I think it was the check-the-box elections and the resulting increase in the use of hybrid entities.

\textsuperscript{17} See Wikipedia, “Squaring the Circle.” Literary references date back at least to 414 BC, when the play The Birds by Aristophanes was first performed. In 1882, the task was proven to be impossible as a consequence of the Lindemann-Weierstrass theorem, which proved that pi (\(\pi\)) is a transcendental number rather than an algebraic irrational number. \textit{Id.} Illustration below: Original PNG by Plynn9; SVG by Alexei Kouprianov (Pd-self-image by Plynn9) [Public domain], via Wikimedia Commons.
rules governing CFCs. For example, the various flow-through regimes that operate under the Code generally share certain features that do not apply under the Subpart F and GILTI regimes, such as:

- Rules designed to conform the treatment of selling equity in the flow-through entity to the treatment of the flow-through entity selling assets (see, e.g., Section 751(a)).

- Closing the taxable year of an entity upon a sale and treating the seller as the owner of the entity through the date of the sale (see Treas. Reg. §§ 1.338-9(b)(2) and 1.1502-76(b)).

- Allowing all income and losses (rather than just “net” income) to flow up and adjusting the outside basis for both accordingly (see all flow-through systems).

- Taxing the owner of a flow-through entity on distributions received from the entity only to the extent the distributions exceed the owner’s tax basis in its equity in the entity.

- Upon the purchase of a flow-through, adjusting certain tax attributes to prevent the purchaser from benefiting from certain built-in tax benefits or opportunities (see Section 743(d)).

It is also helpful to go a step further and consider (for a moment) what a flow-through system for CFCs might actually look like. But let’s get to that in a bit.

Most of the remainder of this paper considers a variety of simplified examples designed to illustrate some of the issues arising under the new rules applicable to CFCs held by U.S. corporations and various alternatives for addressing those issues.

Three meaningful caveats before going further:

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18 The collapsible corporation rules were repealed on a temporary basis in 2003 and on a permanent basis in 2013.

19 In the S corporation and partnership context, the amount of losses that flow up are limited by outside basis. See Section 704(d) and Section 1366(d).

20 Except as noted, each example assumes (among other things) that (i) no corporation has any QBAI, E&P, tested income (or loss) or Subpart F income, (ii) there are no foreign taxes (or foreign tax credits), (iii) there is no limit on the GILTI deduction, (iv) each taxpayer has the calendar year as its taxable year, (v) all holding periods are (and remain) satisfied for purposes of Sections 245A, 964(e)(4) and 1248(j), (vi) the use of disregarded entities (“DREs”) in the examples does not implicate the hybrid dividend rules, (vii) Section 961 is self-effectuating prior to the issuance of regulations as to GILTI and Subpart F, (viii) references to a Non-U.S. Buyer are to a non-U.S. corporation that is not a CFC, references to USP are to the parent of a U.S. federal consolidated tax group, references to US Sub are to a member of a U.S. federal consolidated group and references to CFC-1 and CFC-2 are (except as noted) to CFCs and (ix) the new provisions otherwise apply as written.
First, this paper largely ignores foreign taxes and foreign tax credits (“FTCs”). This is admittedly a material omission and it may well be that some (or all) of the considerations and suggested approaches discussed in this paper would change significantly if they were considered more fully.

Second, with a few exceptions, this paper is focused on CFCs that are owned 100% by a single U.S. consolidated group. I am certain that different considerations apply to CFCs owned in other contexts.

Third, if you skipped over the assumptions related to the examples in the footnote above, please go back and read them.

II. Disparate Treatment Depending upon the Level of the Sale—In General

Before delving into the examples, it is helpful to consider at a high level various ways in which the tax consequences arising from the sale of a business held by a CFC may differ depending upon the corporate level at which the sale takes place. Assume, for example, that (as depicted below) USP owns US Sub, US Sub owns CFC-1, CFC-1 owns CFC-2, and CFC-2 owns a non-U.S. entity that is disregarded as an entity separate from CFC-2 for U.S. federal income tax purposes (a “DRE”) and that operates a non-U.S. business.

It is neither surprising nor new that the tax consequences of a sale of the non-U.S. business depend on the level at which the sale takes place. In some cases, the range of possible outcomes represents an opportunity for taxpayers to elect among various possible outcomes. For example, if there is an available tax loss, USP may choose to sell US Sub or CFC-1 and realize a tax benefit equal to 21% of the loss. If there is a gain, USP may choose to sell the assets of the business or sell the stock of either CFC with a
Section 338(g) election and pay tax based on a 10.5% or 0% rate (depending on available QBAI). Depending upon available FTCs or other factors, the taxpayer might also choose to effect the sale in a manner that generates Subpart F income by selling the stock of CFC-2 or as a sale that gives rise to a local law step-up (and local law taxes) by having the DRE sell assets for local purposes.

In other cases, however, this electivity will instead operate as a trap for the unwary, the unlucky or the poorly advised. For example, if US Sub owns appreciated assets and the “inside basis” of US Sub in those assets is significantly less than USP’s tax basis in the stock of US Sub, it may be necessary (as a practical matter) to effect the sale of the business as a sale of the stock of US Sub and this will (in general) prevent USP from receiving the benefit of Section 245A in respect of CFC-2’s built-up E&P. It may also prevent (or at least complicate) USP’s ability to structure the transaction in a manner that allows USP to be taxed on the gain of the business operated by the DRE at GILTI rates (10.5% or 0%) and deliver a step-up to the buyer.

One can guess, however, that the disparate treatment will inure to the benefit of taxpayers far more than the IRS.

III. Question #1—Should Gain from the Sale of Stock of a CFC be Treated (in Part) as Tested Income?

A. Treatment of Gain from Sale of a CFC

1. 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.

B. Policy behind Treatment of CFCs under the TCJA
As illustrated above, although a sale of the operating assets of the business will give rise to tested income eligible for the 10.5% rate (or a 0% rate up to the return on QBAI), a sale of the stock of the entities owning those assets will generally be subject to full 21% corporate tax rates unless a Section 338(g) election is made.

Is this varying tax treatment an accident of history or does it reflect a tax policy at work? The preamble to the Proposed GILTI Regulations notes that:

The Act established a participation exemption system under which certain earnings of a foreign corporation can be repatriated to a corporate U.S. shareholder without U.S. tax. See section 14101(a) of the Act and section 245A). However, Congress recognized that, without any base protection measures, the participation exemption system could incentivize taxpayers to allocate income—in particular, mobile income from intangible property—that would otherwise be subject to the full U.S. corporate tax rate to CFCs operating in low- or zero-tax jurisdictions. See Senate Committee on Finance, Explanation of the Bill, at 365 (November 22, 2017). Therefore, Congress enacted section 951A in order to subject intangible income earned by a CFC to U.S. tax on a current basis, similar to the treatment of a CFC’s Subpart F income under section 951(a)(1)(A).

However, in order to not harm the competitive position of U.S. corporations relative to their foreign peers, GILTI of a corporate U.S. shareholder is taxed at a reduced rate by reason of the deduction under section 250 (with the resulting U.S. tax further reduced by a portion of foreign tax credits under section 960(d)).

* * * *

In summary, the goals of the new tax rules applicable to CFCs thus appear to be:

1) To generally allow earnings of a foreign corporation to be repatriated to a corporate U.S. shareholder without U.S. tax;

2) To provide a protective measure against taxpayers being incentivized to allocate income that would otherwise be subject to full U.S. corporate tax in the U.S. to CFCs operating in low (or no) tax jurisdictions; and

3) For the protective measures not to harm the competitive position of U.S. corporations relative to their foreign peers.

**C. Application of GILTI to Gains on the Sale of CFC Stock**

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21 See REG-104390-18 at preamble.
Sale of Assets that Produce Tested Income. As an initial matter, putting to one side the point about not harming the competitive position of U.S. corporations relative to their foreign peers, it seems clear that the gain in Example 1A (sale of tested income operating assets by CFC-2) should be eligible for the 0% or 10.5% effective tax rates adopted by the TCJA (depending upon the QBAI return of the selling corporate U.S. shareholder). This would generally allow the earnings of the CFC to be repatriated to USP without U.S. tax, but provide some measure of protection against taxpayers being incentivized to allocate income that would otherwise be subject to full U.S. tax rates to CFCs operating in low tax (or no tax) jurisdictions.

An argument could also be made that such gains should be entirely exempt from U.S. taxation. However, to the extent the U.S. is legitimately concerned with the inappropriate shifting of income from U.S. taxpayers subject to full U.S. tax rates to CFCs (e.g., by shifting intellectual property) and addresses that concern by taxing a portion of the tested income of a CFC at a 10.5% rate (with limited FTCs), it seems legitimate when that income stream is sold for the U.S. to tax a portion of the gain from the sale at the same 10.5% rate.

However, since the sale price of the business will generally be based on a multiple of the earnings of the business, one wonders whether some sort of multiple of the QBAI return would also be appropriate in determining the portion of the gain eligible for a 0% rate.

Gain on the Sale of Stock of a CFC. Assuming that is all correct, one wonders why the tax treatment to USP should be any different if the sale of the business is effected as a sale of the stock (with no Section 338(g) elections) of CFC-2 or CFC-1. The application of the Subpart F rules to such a sale (in the case of a sale of stock of CFC-2) and the application of full U.S. corporate tax rates (in the case of a sale of stock of CFC-1) could be viewed as at odds with the first two tax policy considerations noted above.

However (i) as discussed in Part III.E., in cases where a CFC owns both tested-income producing assets and other assets, it is not clear how one would determine the portion of the gain on a sale of stock of the CFC that is treated as tested income and (ii) as discussed in Part VI.B., the treatment of loss on the sale of CFC as tested loss would raise additional issues.

Gain the Sale of Stock of US Sub. If gain on the sale of stock of a CFC were treated (in part) as tested income, one might wonder whether a similar rule should apply to gain on the sale of stock of a U.S. subsidiary that owns a CFC with tested-income producing assets. This, however, would seem like a bridge too far given the separate

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22 Alternatively, it might make sense to provide that the gain on the tangible assets is entirely exempt and the gain on the intangible assets is tested income taxable at 10.5% without regard to the QBAI.
entity treatment generally applicable to U.S. corporations and to the sale of such corporations, including under the consolidated return regulations.\textsuperscript{23}

D. **Taxation of Sales of Foreign Stock by Select Other Countries**

Although a full examination of the tax rules applicable in other developed countries is well beyond the scope of this paper, a glimpse at the tax rules in certain countries suggests that the competitive position of U.S. corporations relative to their foreign peers could well be harmed if gains on sales of stock of first-tier (and lower-tier) CFCs continue to be taxed at full corporate rates.\textsuperscript{24}

- **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.

E. **How Would You Do It?**

Although a discussion of how to extend the TCJA’s favorable tax rates to sales of stock of CFCs is also well beyond the scope of this paper, a few points come to mind.

First, since a CFC may own some assets that produce tested income and own other assets that produce Subpart F income, it may be appropriate to tax gain on the sale of stock of a CFC in part at the favorable rates adopted by the TCJA and in part based on the regular rates applicable to Subpart F income. Special rules may also be needed if the CFC owns ECI-producing assets or other assets that produce income excluded from both tested income and Subpart F income.

\textsuperscript{23} However, as discussed in Part V.B.3 below, I do think Prop. Treas. Reg. § 1.1502-32(b)(3)(ii)(F) should be expanded to apply more generally to such a sale.

\textsuperscript{24} This summary is based on a document prepared by a very helpful big four accounting firm for internal purposes.
Second, those rules could well be incredibly complicated to get right. *See, e.g.*, Sections 751(a) and 954(c)(4).

Third, the treatment of losses upon a sale of a CFC might be given similar treatment, but (as discussed in Part V.D.3) that may raise other issues.

Fourth, as in all things, perfection is the enemy of the good.

**IV. 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?**

**A. In General**

This point has a simple aspect and a complicated aspect.

This simple aspect is that when a U.S. corporation buys a CFC from another U.S. corporation without a Section 338(g) election, the parties often (i) agree to a tax indemnity pursuant to which the seller indemnifies the buyer if the buyer ends up with excess Subpart F income under Section 951 (and now excess tested income or tested loss under Section 951A) for the CFC’s taxable year in which the sale takes place and (ii) agree to covenants designed to allow the seller to get its full Section 1248 amount (which has become even more important today than under pre-TCJA law given the application of Section 245A to the amount triggered by Section 1248).

In light of the broad definition of tested income and tested loss, the amount at issue for the buyer will frequently be far larger today than was typically true prior to the enactment of the TCJA. Moreover, in light of Prop. Treas. Reg. § 1.951A-6(e) (discussed below in Part V.C.2), buyers today may be even more concerned with an excess allocation of tested loss than an excess allocation of tested income.

This is silly, is made even more complicated by Prop. Treas. Reg. § 1.951A-6(e) and would be avoided if the principles of Treas. Reg. § 1.1502-76(b) applied to sales of significant (e.g., 50% or greater) interests in a CFC outside the seller’s group. This would allow the seller to be taxed on income earned by the CFC while it was held by the seller and allow the buyer to be taxed on income earned by the CFC while it was held by the buyer.

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25 Under Section 951(a)(1), a U.S. shareholder is required to include in income its “pro rata share” of Subpart F income for CFCs with respect to which it is a U.S. shareholder. Section 951(a)(2) defines a U.S. shareholder’s pro rata share of Subpart F income as the amount the U.S. shareholder would receive if the CFC made a pro rata distribution “on the last day, in its taxable year, on which the corporation is a controlled foreign corporation,” reduced by “the amount of distributions received by any other person during such year as a dividend with respect to such stock.” This reduction for distributions is capped such that the U.S. shareholder with the end-of-year inclusion cannot reduce its inclusion by more than an amount representing the portion of the year in which it did not own such stock in the CFC. Section 951(a)(2) also clarifies that “any gain included in the gross income of any person as a dividend under section 1248 shall be treated as a distribution received by such person with respect to the stock involved.”
B. Impact of to USP Seller of Tested Income in the Year of Sale and the Identity of the Buyer

The complicated aspect is discussed at length in a recent NYSBA report on GILTI and can be illustrated by the following examples (in particular, Examples 2B and 2C).

1. Example 2A—Sale to Non-U.S. Buyer with No US Subs

- 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.

2. Example 2B—Sale to U.S. Buyer with No US Subs

3. Example 2C—Sale to Non-U.S. Buyer with a US Sub

- 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 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).

C. Discussion

The seller’s share of the tested income of the CFC in the year of the sale (i) may be taxed at a 0% rate (rather than the 10.5% rate generally applicable to GILTI) if the CFC is sold to a U.S. buyer or to a Non-U.S. buyer with a U.S. subsidiary and (ii) may be taxed at a 10.5% rate if the CFC is sold to a Non-U.S. buyer that does not have a U.S. subsidiary.

Why on Earth should the tax consequences to a U.S. shareholder selling a CFC depend on the identity of the buyer? While this has always been true in the case of Subpart F income, in practice this often did not matter as much to the seller because the deemed dividend under Section 1248 was generally still taxable to the seller (albeit with
potentially valuable FTCs). With the adoption of Section 245A, the stakes matter a lot more to the seller.

All of these issues would be avoided if, upon a sale of a significant interest in a CFC outside the seller’s group, the taxable year of the CFC closed and the seller was treated as owning the stock through the end of the sale date.²⁷

Section 898 generally governs the taxable year of a CFC if the CFC has a United States shareholder (within the meaning of Section 951(b)) that owns (within the meaning of Section 958(a) or (b)) on each “specified day” more than 50% of the stock of the CFC. The basic purpose of Section 898 is to line up the taxable year of such a CFC with the taxable year of its U.S. shareholders to limit the ability of such U.S. shareholders to defer by one year the income of the CFC. Accordingly, such a CFC is generally required to adopt as its taxable year (i) the so-called “majority U.S. shareholder year” (if there is one) or (ii) the taxable year prescribed regulations under Section 898 (if there is not one). In the latter case, the legislative history of Section 898 and the proposed regulations under Section 898 contemplate that the CFC will be required to adopt the taxable year that results in the least aggregate deferral of income to the U.S. shareholders.

Section 898(c)(3)(B) generally provides that the testing days shall be (i) the first day of the CFC’s taxable year (determined without regard to Section 898) and (ii) the days during such representative period as the Secretary may prescribe. The legislative history indicates that:

The committee contemplates that such additional testing days may include days on which a substantial change in U.S. ownership of the stock of a controlled foreign corporation or a foreign personal holding company occurs. For example, in the case of a controlled foreign corporation, the committee anticipates that the regulations might provide that a testing day will include any day on which either a person obtains a sufficient amount of the stock of such corporation to cause such person to qualify as a U.S. shareholder for purposes of applying the applicable Subpart F income rules, or when a current U.S. shareholder acquires or disposes of any stock of the controlled foreign corporation.

As an initial matter, given the basic purpose of Section 898, it could fairly be interpreted to allow for an early closing of the required taxable year of the CFC upon a transfer of 50% or more of the stock of the CFC. Moreover, although not entirely clear, it appears that if 50% or more of the stock of a CFC is sold to an unrelated person, the Secretary could (under Section 898(c)(3)(B)) treat the day after such a sale as a “testing day” and treat the CFC as not governed by Section 898 since a single shareholder would

²⁷ See, e.g., Treas. Reg. § 1.1502-76(b) and Treas. Reg. § 1.338-9(b)(2). But does current law provide a statutory basis for the issuance of guidance to that effect? It would appear that Sections 441, 898 and 951A could provide the authority for such a rule.
not own more than 50% of the stock of the CFC on each tested day. In this event, the taxable year of the CFC would be determined under the more general rules of 441 and 442. Section 441(b) defines a taxable year as “the period for which a return is made, if a return is made for a period of less than 12 months,” and Sections 6001 and 6011(a) require a person to make returns as required by regulations prescribed by the Secretary.

If the rules were revised to provide for a closing of the taxable year of a CFC for U.S. tax purposes, additional rules would be needed to allocate the foreign taxes of the CFC (assuming that the taxable year of the CFC did not similarly close for purposes of those foreign taxes). See Treas. Reg. § 1.338-9(d) (adopting principles of -76(b) for allocating taxes for foreign tax year) and Treas. Reg. § 1.901-2(f)(4) (similar rule for Section 901 in case of Section 708(b) termination).

V. Question #3—Should the Tax Exemption Effected Through Section 245A Operate More Like Sections 199A, 250 and 731 in the CFC Context?

A. In General

At a high level, the new CFC rules are generally designed to tax corporate U.S. shareholders of CFCs at a:

- 10.5% rate on the net tested income of a CFC that exceeds the QBAI return (the “GILTI”); and
- 0% rate on (i) net tested income up to the return on QBAI and (ii) amounts excluded from both tested income and Subpart F income (collectively with (i), “Exempt Income”).

The TCJA adopted two different approaches to achieving these reduced rates. 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

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28 But see Example in Prop. Treas. Reg. § 1.898-3(a)(5)(iv). (In this example, a U.S. shareholder that owns 51% of foreign corporation sells an interest in such CFC to an unrelated party such that the seller falls below 51% and the buyer ultimately owns more than 51% of the CFC. The seller and the CFC both have tax years ending on June 30, and the buyer has a tax year ending on April 30. With the sale occurring on May 1, 1994, the example concludes that the CFC has a taxable year ending on June 30, 1994 and then short taxable year ending on April 30, 1995.)

29 See also Section 951(a)(1) and Section 951A(e)(2) (which look to the last day (rather than the last moment) of the taxable year of a CFC on which the CFC is a CFC). The preamble to the Proposed GILTI Regulations indicates that the shareholder owning Section 958(a) stock “as of the close of the CFC’s taxable year” is the U.S. shareholder with the Section 951A inclusion.

30 The rules also tax a corporate U.S. shareholder at a 21% rate on subpart F income of a CFC.
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).\textsuperscript{31}

The different approaches seem to reflect the fact that (i) GILTI is taxed currently and so needs the flow-through approach whereas Exempt Income is not, (ii) Exempt Income treatment also applies to non-CFCs for which there is no infrastructure for flowing up income (\textit{but see} Section 965 as applied to non-CFCs) and (iii) Section 245A seems more about exempting dividends than exempting Exempt Income (though it has a like effect\textsuperscript{32}).

In the CFC context, the interplay between these rules gives rise to a number of complexities that are illustrated in Examples 3 through 6 in the sections that follow. The rules might work better under an “Exempt Income Approach” in which

- The Exempt Income also flowed up to the corporate U.S. shareholders.
- The corporate U.S. shareholders 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 was adopted, there would still be instances in which a corporate U.S. shareholder received a dividend from a CFC, such as where (i)

\textsuperscript{31} To elaborate, Sections 245A and 250 are each designed to reduce the tax rate applicable on certain income by allowing the owner of a business a deduction based on a percentage of that income. Section 199A (as alluded to in the header to this discussion) has a similar function. In the case of Sections 199A and 250, the income of the business flows through to the owner-taxpayer in the year it is earned, the owner-taxpayer is allowed a deduction at the time, and adjustments are made so that the owner-taxpayer will not be taxed again when the income is distributed (\textit{e.g.}, in the case of Section 250 and CFCs, the income that flows through creates PTI under Section 959 and (presumably) tax basis under Section 961). By contrast, Section 245A creates a deduction in the taxable year the income is distributed to the owner (that is, distributed by the CFC to the corporate U.S. shareholder) rather than at the time the income is earned by the CFC. This was not a surprising choice. First, the use of a dividends-received deduction in Section 245A reflects the more general retention of a corporate framework for taxing CFCs. Second, and more fundamentally, Section 245A applies (more generally) to any U.S. corporation that owns 10\% (or more) of the stock of a non-U.S. corporation even if the non-U.S. corporation is not a CFC.

\textsuperscript{32} Presumably, the drafters of the TCJA intended for Section 245A to have this effect. The reports of the House Ways and Means Committee and the Senate Finance Committee both indicate that the motivation for the enactment of 245A is to create a “territorial system” that will make U.S. corporations more competitive with foreign multinationals and that Section 245A accomplishes this goal by establishing a “participation exemption system” for foreign income whereby certain foreign-source dividends are exempt from tax. H.R. Rep. 114-409 at 370-371 and S. Rep. 115-20 at 358-359. The Conference Report simply restates the intention of Congress to create a participation exemption system. H.R. Rep. No. 115-466 at 595.
the tested loss of one CFC offset the tested income of another CFC (see Example 5 below) and (ii) a 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 they were 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 the stock of a CFC—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.\(^{33}\)

But I’m getting ahead of myself.

### B. Application of Section 245A Can Depend on the Level of Sale

1. 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 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.

\(^{33}\) This would not really work for non-CFCs. Unfortunately, as a result of the changes to the downward attribution rules, there are a lot more CFCs today than there were before the TCJA was adopted.
2. 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

- Example 4B—USP Sells its Partnership Interest
  - $100 of gain. Gain is treated as ordinary income but not a dividend (see discussion below).
  - $21 of taxes.

Under Section 751(a), gain on the sale of a partnership interest is treated as ordinary income and will not give rise to a deemed dividend under Section 1248. The preamble to the final 1248 regulations states Treasury and the IRS’s position on the matter:

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.\(^{34}\)

3. Discussion

In Example 3, 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 by US Sub of the stock of CFC-1, but (in general) not if the sale is effected as a sale by USP of the stock of US Sub.\(^{35}\)


\(^{35}\) \textit{But see} Prop. Treas. Reg. § 1.1502-32(b)(3)(ii)(E) (but relief applies only to the extent the exempt income arose because tested income of the CFC was offset by a tested loss of another CFC).
Similarly, in Example 4, the corporate partner is able to realize a 0% tax rate on the gain attributable to the exempt income of the CFC if the exit is effected as a sale by the partnership of the stock of the CFC, but not if the exit is effected as a sale by the corporate partner of its interest in the partnership.

In both cases, the Exempt Income Approach would allow the taxpayer to realize the full benefit of a 0% rate on the exempt income of the CFC regardless of the level at which the sale took place.

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.

C. Issues Arising When a Tested Loss of One CFC Offsets Tested Income of Another CFC

1. 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
The preamble to the Proposed GILTI regulations explains that:

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. See Charles Ilfeld Co. v. Hernandez, 292 U.S. 62 (1934) (denying the loss on stock of subsidiaries upon liquidation when operating losses were previously claimed from the subsidiaries’ operations because “if allowed, this would be the practical equivalent of double deduction”); U.S. v. Skelly Oil Co., 394 U.S. 678 (1969) (“the Code should not be interpreted to allow respondent “the practical equivalent of a double deduction”’’ (citing Charles Ilfeld Co.)); § 1.161-1. 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.  

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!

2. Prop. Treas. Reg. § 1.951A-6(e)

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36 See REG-104390-18 at preamble.
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). The basis reduction is made only at the time of the disposition and, therefore, does not affect the stock basis prior to a disposition. There are lots of bells and whistles designed to make the rule operate better and an expanded set of regulations applying the rules in the consolidated group context.

3. Example 5B Revisited

**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

4. Discussion

The taxpayer (USP) in Example 5B could be viewed as receiving two tax benefits as a result of the tested loss. First, the $10 tested loss in CFC-2 reduces the GILTI that USP otherwise would have had as a result of the $10 of tested income of CFC-1. However, putting Section 245A to one side for a moment, since that additional $10 of GILTI would have increased USP’s tax basis in the stock of CFC-1 by $10, the reduction in USP’s GILTI (and the corresponding reduction in the associated increase in USP’s tax basis in the stock of CFC-1) is (in reality) merely a timing benefit. Moreover, depending upon the facts, it is possible that the tested loss will not, in fact, give rise to a timing benefit, e.g., where USP has sufficient QBAI, the tested income would not give rise to GILTI even in the absence of the tested loss. Finally, it seems quite clear that, in the cases where a timing benefit would arise, Congress intended to allow it.
Second, the separation of the tested income and the tested loss into two CFCs allows for the possibility that the tested income will be taxed at a 0% rate (by virtue of the DRD under Section 245A). Although 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, there is no reduction in the tax basis in the stock of CFC-2 by reason of the $10 of tested loss.

Importantly, however, the same potential second benefit would arise if USP owned 10% of the stock of two (brother-sister) non-U.S. corporations that were not CFCs. In such a case, the $10 of income earned by one of the non-U.S. corporations would similarly increase the amount of exempt dividend that could be paid whereas the $10 of loss by the other corporation would not reduce the tax basis in the stock of the corporation with the loss. This suggests that the increased DRD available when income and loss are separated into two non-U.S. corporations has nothing at all to do with the GILTI rules.

Nevertheless, it is not surprising that Treasury and the IRS would want to limit the potential benefit in the CFC context. In doing so, however, it is important to keep two further things in mind.

First, the benefit arises only if USP is actually able to realize a 0% tax rate on the $10 of income generated by CFC-2. For a variety of reasons, this may not turn out to be the case. For example:

- The stock of CFC-1 may be sold at a loss (due to an unrealized loss in its assets) before CFC-1 pays an actual dividend.
- CFC-1 may pay an actual dividend but the requirements for Section 245A may not be met.
- CFC-1 may pay an actual dividend and the requirements for Section 245A may be met, but tax basis in the stock of CFC-1 may be reduced under Section 961(d) or 1059.
- CFC-1 may make an investment in U.S. property under Section 956 prior to the time it pays (or is deemed to pay) an actual dividend. But see Prop. Treas. Reg. § 1.956-1(a)(2).

Second, the “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). For example, suppose that (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. In this event, it seems wholly inappropriate
to reduce the tax basis of the stock of CFC-2 a second time under Prop. Treas. Reg. § 1.951A-6(e).

Assuming that there is an actual problem here to be solved, rather than reducing the tax basis of CFC-1 by the $10 “net used tested loss amount,” it would be better to:

- reduce the DRD available in respect of CFC-1 to the extent it is attributable to the tested loss or deem CFC-1 to have $10 of PTI (which would eliminate the DRD on the used tested income) and increase the accumulated E&P of CFC-1;

- 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; or

- Allow a corporate U.S. shareholder of a CFC to “waive” a tested loss of a CFC to the extent that such loss would be taken into account under Prop. Treas. Reg. § 1.951A-6(e) (and do not reduce the E&P of the CFC by the tested loss).

D. Pre-Acquisition E&P and Sections 245A, 961(d) and 1059

1. Examples 6A and 6B—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

2. Examples 6C and 6D—Application of Sections 245A, 961(d) and 1059 to E&P Arising after Corporate U.S. Shareholder Acquires a CFC
3. Discussion

In Example 6A, it seems right for the rules to prevent USP from receiving a tax benefit from the pre-acquisition E&P and, if that is true, one wonders whether the same principles should require a basis reduction in Example 6B.

In contrast, it seems that Congress intended USP in Example 6C to be able to realize $10 of tax-exempt income. Assuming that the $10 of income was generated in the ordinary course and not manufactured in a transaction to create tax-exempt income and an offsetting loss, it is hard to understand why a later loss on the sale of stock of CFC-1 that is attributable to a loss in value of CFC-1 assets should result in a basis reduction that effectively reverses the 0% tax rate that applied to the $10 of income earned by CFC-1 after it was acquired by USP.

Thus, one might say that Section 961(d) is under-inclusive (and should also apply to gain) but also over-inclusive (and should apply only to dividends of pre-acquisition E&P).

Since Section 245A applies to U.S. corporations that own 10% or more of the stock of a non-U.S. corporation regardless of whether the non-U.S. corporation is a CFC, it is not surprising (for administrative convenience reasons alone) that Section 245A does not distinguish between E&P arising before the shareholder acquired an interest in the non-U.S. corporation and E&P arising thereafter. Given this, it is similarly not

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37 But see Section 1248 (which does look at the time E&P was generated in relation to a U.S. shareholder’s ownership).
surprising that Section 961(d) adopts a rough justice approach that applies to loss but not gain.

The concept of pre-acquisition earnings (or E&P) does not really exist under a pure flow regime (except for limited purposes\(^{38}\) in the S corporation context). Even in the consolidated group context, the rules operate to limit eliminate the E&P of a member joining the group. As explained by Blanchard, Sloan, Kramer and Wolfe:\(^{39}\)

If \(P\) buys all of the stock of \(S\) and \(S\) later distributes preaffiliation (SRLY) E&P, the distribution does not increase \(P\) ’s E&P. \(S\) ’s E&P, however, is reduced by the amount of the distribution. From a single entity viewpoint, \(P\) has received a return of capital, and has a basis reduction in the \(S\) stock under Treas. Reg 1.1502-32.***

The result is comparable to the treatment of a nondividend distribution under [Section 301(c)(2)]. This treatment of E&P is apparently based on the assumption that preaffiliation E&P is not the E&P of the group. It is in contrast to the Code rules, under which the purchaser of a corporation can receive its E&P from before the purchase, either when the E&P is distributed to the purchaser, or when the corporation is liquidated into the purchaser in a [Section 332] liquidation.

Consistent the consolidated group rules, one could imagine a more refined approach in cases where the non-U.S. corporation is a CFC, particularly where 100% of the stock of the CFC is owned (within the meaning of Section 958(a)) by a single corporate group. In such a case, the rules might well work better if pre-acquisition E&P were treated as PTI under Section 959\(^{40}\) (so that it did not give rise to a DRD) and Section 961(d) did not apply at all.

Alternatively, similar results could be achieved if (i) the Exempt Income Approach was adopted and (ii) corporate U.S. shareholders were taxed on distributions from CFCs only to the extent they exceed the shareholders’ tax basis in the stock of the CFC.

For a far more exhaustive analysis of the issues raised by Section 245A, see the NYSBA report on 245A.\(^{41}\)

\(^{38}\) See, e.g., Section 1317(c).


\(^{40}\) Notably, Section 959 seems to tilt in favor of saying that E&P in existence at the time a non-U.S. company is acquired is not PTI (meaning it may give rise to a DRD). One wonders if this continues to make sense.

VI. Question #4—Is Pre-Acquisition Built-In-Gain Like Pre-Acquisition E&P?

A. Sale of CFC Where There Is an Inside-Outside Basis Disparity

1. Example 7—Losses on the Stock of a CFC Attributable to the Recognition of Built-in-Gain in Existence When the CFC Was First Acquired

- **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 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

B. Discussion

The fact pattern presented in Example 7 provides yet another illustration of the disparate tax treatment potentially applicable to USP under the new rules depending on the structure of the sale as well as some of the (likely) unintended consequences of
building the GILTI regime onto the infrastructure that was already in place under subpart F. The discussion below focuses on the issues raised by Example 7C in particular, exploring three different approaches for potentially addressing that example.

1. Section 961(d)-Type Rules

The $300 capital loss in Example 7C seems to raise issues similar to those raised in Examples 6A and 6B relating to the 100% DRD available 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 of the CFC is sold. In Example 7C, the issue is the 50% deduction under Section 250 in respect of pre-acquisition built-in gain.

Section 961(d) generally provides that, 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. Section 961(d) has no application to Example 7 because the example does not involve a dividend (or a Section 245A DRD).

Although Section 961(d) does not apply to Example 7C, one wonders whether a rule like Section 961(d) should apply to reduce (solely for purposes of determining loss) the tax basis in the stock of a CFC-1 by the “non-taxed portion” of the GILTI arising from CFC-1 (i.e., the $400 of GILTI reduced by the $200 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 (i) $42 of tax if it could not use the loss and (ii) $21 of tax if it could use the loss.

However, since all of the underlying gain is in fact tested income, it would seem that USP should owe no more than $10.50 of tax.

For the same reason that Section 961(d) should arguably apply only to a DRD attributable to pre-acquisition E&P, any basis reduction in the stock of a CFC by reason of the non-taxed portion of the GILTI from the CFC should be limited to GILTI 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 (i) $42 of tax if it could not use the loss and (i) $10.50 of tax if it could use the loss.
2. Treat Stock Loss as Tested Loss

A different approach would be to treat the loss on the sale of stock of a CFC as a tested loss (which might seem justifiable if gains on the sale of stock of a CFC were treated as tested income). As applied to Example 7C, under this approach:

- USP would seem to have $400 of tested income (from sale by CFC-1 of its assets) and $300 of tested loss (from the sale by USP of its 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 and included in income; this (in turn) would reduce the resulting increase in the tax basis in the stock of CFC-1, and this in turn would reduce the amount of the loss on the stock of CFC-1.

- If, however, the rules operated to allow for $100 of net tested income from CFC-1, there would be $100 of GILTI from CFC-1, a $50 deduction under Section 250, no gain or loss in the stock of CFC-1 and USP would owe $10.50 of tax.

However, significant issues (apart from the circularity point) would arise if the loss on the sale of stock of a CFC were treated as a tested loss. First, given the lumpiness with which businesses are sold (including at a loss), 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 in many cases be taxed at the full 21% U.S. corporate tax rate (in whole or in part). Extending that variability to the tax benefit arising from the sale of stock of CFC might create an illusion of balance but would likely operate to the great benefit of some taxpayers and the great detriment of others. Finally, if (as discussed in Part III 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.

3. Other Rules and Doctrines

(a) Sections 337(d), 338(i) and 951A(d)(4)

Section 337(d) provides that:

The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of the amendments made by subtitle D of title VI of the Tax Reform Act of 1986, including—

(1) regulations to ensure that such purposes may not be circumvented through the use of any provision of law or regulations (including the consolidated return regulations and part III of this subchapter) or through the use of a regulated investment company, real estate investment trust, or tax-exempt entity, and
(2) regulations providing for appropriate coordination of the provisions of this section with the provisions of this title relating to taxation of foreign corporations and their shareholders.


Section 338(i) provides that:

The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including—

(1) regulations to ensure that the purpose of this section to require consistency of treatment of stock and asset sales and purchases may not be circumvented through the use of any provision of law or regulations (including the consolidated return regulations) and

(2) regulations providing for the coordination of the provisions of this section with the provisions of this title relating to foreign corporations and their shareholders.

See Treas. Reg. § 1.338-8 (asset consistency rules) and 1.336-1(a)(2) (applying asset consistency rules to transactions with Section 336(e) elections).

Section 951A provides that:

The Secretary shall issue such regulations or other guidance as the Secretary determines appropriate to prevent the avoidance of the purposes of this subsection, including regulations or other guidance which provide for the treatment of property if—

(A) such property is transferred, or held, temporarily, or

(B) the avoidance of the purposes of this paragraph is a factor in the transfer or holding of such property.

(b) Discussion

In considering whether Sections 337(d), 338(i) or 951A(d)(4) have a role to play here, it is worth asking 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, (i) the gain recognized at the S corporation level will be partially offset by a loss at the shareholder level and (ii) 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.

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.