NEW YORK STATE BAR ASSOCIATION
One Elk Street, Albany, New York 12207 PH 518.463.3200 www.nysba.org

Report No. 1423
September 18, 2019

The Honorable David J. Kautter
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable Michael J. Desmond
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: *Report No. 1423 – Report on June 2019 GILTI and Subpart F Regulations*

Dear Messrs. Kautter, Rettig, and Desmond:

I am pleased to submit our Report No. 1423 commenting on final regulations and proposed regulations issued by the Internal Revenue Service and the Department of the Treasury to implement the so-called "GILTI" and Subpart F provisions of the Internal Revenue Code. We previously commented on the GILTI provisions of the Internal Revenue Code and on the proposed regulations that were finalized by the final regulations discussed in this Report. We commend the Internal Revenue Service and the Department of the Treasury for issuing thoughtful and timely guidance on these topics.

We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Deborah L. Paul
Chair

Enclosure

Cc:

Lafayette "Chip" G. Harter III
Deputy Assistant Secretary (International Tax Affairs)
Department of the Treasury

Douglas L. Poms
International Tax Counsel
Department of the Treasury

Erika W. Nijenhuis
Senior Counsel
Department of the Treasury

Peter Blessing
Associate Chief Counsel (International)
Internal Revenue Service

Daniel M. McCall
Deputy Associate Chief Counsel (International-Technical)
Internal Revenue Service

Margaret O'Connor
Deputy Associate Chief Counsel (International)
Internal Revenue Service

John J. Merrick
Senior Level Counsel, Office of Associate Chief Counsel (International)
Internal Revenue Service

Report No. 1423

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON JUNE 2019 GILTI AND SUBPART F REGULATIONS

September 18, 2019

Table of Contents

I. Introduction

This Report[1] comments on final regulations (the "**Final Regulations**")[2] and proposed regulations (the "**Proposed Regulations**")[3] issued by the Internal Revenue Service (the "**IRS**") and the Department of the Treasury (collectively with the IRS, the "**Treasury**") to implement the so-called "**GILTI**" and Subpart F provisions of the Code.[4] The GILTI provisions were added by the legislation informally known as the Tax Cuts and Jobs Act of 2017 (the "**Act**").[5] Treasury also recently issued temporary[6] and proposed[7] regulations under Section 245A (the "**Section 245A Regulations**"). An analysis of the Section 245A Regulations is beyond the scope of this Report.

We previously commented on the GILTI provisions of the Code[8] and on the proposed regulations that were finalized by the Final Regulations (the "**Original Proposed GILTI Regulations**").[9]

II. Summary of Principal Recommendations and Comments

All terms used in this Part II have the meanings as defined in this Report.

---

[1] The principal authors of this report are Kara L. Mungovan and Michael L. Schler. Helpful comments were received from Kimberly Blanchard, Andy Braiterman, Robert Cassanos, Peter Connors, Tim Devetski, Peter A. Furci, Kevin Glenn, Andrew M. Herman, John Lutz, Jeffrey Maddrey, Andrew Needham, Richard M. Nugent, Deborah L. Paul, Richard L. Reinhold, David R. Sicular, Ted Stotzer, Jonathan Talansky, Joseph Toce, Shun Tosaka, Dana L. Trier, Gordon E. Warnke and Sara B. Zablotney. This report reflects solely the views of the Tax Section of the New York State Bar Association ("**NYSBA**") and not those of the NYSBA Executive Committee or the House of Delegates.

[2] T.D. 9866, Federal Register Vol. 84, No. 120, June 21, 2019, at 29288-29370.

[3] REG-101828-19, Federal Register Vol. 84, No. 120, June 21, 2019, at 29114-29133.

[4] Unless otherwise stated, all "Code" and "Section" references are to the Internal Revenue Code of 1986, as amended.

[5] The Act 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.

[6] T.D. 9865, Federal Register Vol. 84, No. 117, June 18, 2019, at 28398-28424.

[7] REG-106282-18, Federal Register Vol. 84, No. 117, June 18, 2019, at 28426-28427.

[8] NYSBA Tax Section, Report on the GILTI Provisions of the Code, Report No. 1394, May 4, 2018 (the "**First Prior GILTI Report**").

[9] REG-104390-18, Federal Register Vol. 83, No. 196, Oct. 10, 2018, at 51072-51111. See NYSBA Tax Section, Report on Proposed GILTI Regulations, Report No. 1406, November 26, 2018 (the "**Second Prior GILTI Report**").

A. The Final Regulations

1. The adjustments to gross Subpart F and GILTI inclusions under Sections 951(a)(2)(A) and (B) should be modified to eliminate an uneconomic duplicative reduction in such inclusions under both provisions in some circumstances. Part III.A.1(b).

2. We discuss considerations involved in the decision whether to reduce Subpart F and GILTI inclusions under Section 951(a)(2)(A) in certain circumstances to avoid an overinclusion in income to a U.S. shareholder in respect of periods that the CFC is a CFC but does not have Section 958(a) U.S. shareholders. Reducing such overinclusions would increase the fairness of the rules to U.S. shareholders but would necessarily increase the complexity of the rules. We do not take a position on the appropriate way to balance these considerations. Part III.A.1(c).

3. To avoid overtaxation of a U.S. shareholder, in computing gain on the sale of stock of a second tier CFC, tested income of the second tier CFC should be taken into account under Section 961(c) in determining the first tier CFC's basis in the stock of the second tier CFC. To avoid undertaxation of the U.S. shareholder on the subsequent sale of the first tier CFC, certain adjustments to e&p of the first tier CFC should be made. Part III.A.2(b).

4. Disqualified basis of assets arises from certain transactions with related parties in the GILTI transition period. In the case of a taxable sale of property with disqualified basis to an unrelated party at a loss, regulations should clarify whether disqualified basis that exceeds taxable loss on the property carries over in the property. If this is the intent, we urge that serious reconsideration be given to this result. Part III.A.3(b)(ii).

5. In the case of a nontaxable transfer of property with disqualified basis to an unrelated party, regulations should clarify whether the disqualified basis carries over in the property. If that is the intent, we believe a preferable rule would be to not carry over disqualified basis in the property beyond some period of time and/or to adopt an anti-abuse rule. Part III.A.3(b)(iii).

6. In a nonrecognition transaction such as a Section 1031 transaction, regulations should (i) clarify that on a transaction with a related party when basis in property is reduced, qualified basis and disqualified basis are reduced proportionately, and (ii) provide a rule for determining disqualified basis for each party when the transaction involves the exchange of properties each of which has disqualified basis. Part III.A.3(b)(iv).

7. In the case of a nontaxable transfer of appreciated property in which all or part of the realized gain is recognized because of boot, in lieu of the rule in the Proposed Regulations that fully applies the rules for nonrecognition transfers, a pro rata portion of the disqualified basis to both transferor and transferee should be eliminated to reflect the portion of realized gain that is recognized. Parts III.A.3(b)(v)-(viii).

8. In a nontaxable transfer of loss property where boot is received, the results concerning disqualified basis to both the transferor and transferee should be clarified. Part III.A.3(b)(ix).

9. Just as domestic partnerships will soon be treated as aggregates for purposes of both GILTI and Subpart F inclusions, they should be treated as aggregates for purposes of Section 1248 on both a partnership's sale of CFC stock and a partner's sale of a partnership interest. The same rules should apply to foreign partnerships to the extent they are not already treated as aggregates. Part III.A.4(d).

10. Domestic partnerships should likewise be treated as aggregates for purposes of determining deemed Section 1248 dividends under Section 951(a)(2)(B). Part III.A.4(e).

11. If a domestic or foreign partnership owns a CFC, GILTI/Subpart F inclusions by a U.S. shareholder partner should be reflected in the partnership's basis in the stock of the CFC, and such basis increases should be allocated to the partner with the inclusions. Part III.A.5.

12. Regulations should clarify the method for determining whether the 10% vote and value tests for U.S. shareholder status are satisfied for a partner of a partnership that owns stock in a CFC. Part III.A.6.

13. Regulations should confirm several collateral consequences of the adoption of aggregate treatment for GILTI inclusions for CFC stock held through a domestic partnership. That approach (i) can result in an acceleration of the taxable year of the U.S. shareholder in which such inclusions occur in certain situations involving fiscal year taxpayers, (ii) can decrease the Section 163(j) limit on interest deductions for the partnership and increase the limit for its U.S. shareholder partners, and (iii) requires confirmation that the method of allocation of tested income to U.S. shareholder partners should be unchanged under the aggregate approach. Part III.A.7(a).

B. The Proposed Regulations: The Hybrid Approach to Partnerships

14. We strongly support the rule conforming the aggregate treatment of partnerships for Subpart F purposes to the same rule in the Final Regulations for GILTI purposes. Part III.B.1(c)(i).

15. Regulations should confirm whether the intent of the Proposed Regulations is to cause two years of Subpart F income to be included in a single taxable year of a U.S. shareholder, in the first year to which the final regulations will apply in situations involving a fiscal year partnership. If this result is intended, consideration should be given to granting Section 481 relief. Part III.B.1(c)(ii).

16. The retroactivity option for aggregate treatment for partnerships should be modified to allow a separate option to each partner of a partnership. If this proposal is not adopted, there should be a single election by the partnership that is binding on all partners. In any event, once the retroactivity option is effective for a party, it should be

binding for all future years in the retroactivity period subject to consent by the Secretary for a change. The regulations should also clarify whether the retroactivity option can be adopted or revoked by the filing of amended returns at any time within the statute of limitations. Relief should be provided for partners and partnerships filing 2018 tax returns under the then-current law, to account for the retroactivity option under the Proposed Regulations, in a manner similar to relief provided in Notice 2019-46 to account for the retroactive nature of the Final Regulations under GILTI. Part III.B.1(c)(iii).

17. Regulations should confirm the current private letter ruling position of the IRS that if a partnership is a U.S. shareholder of a CFC that is also a PFIC, a partner in the partnership is not treated as having a holding period in the PFIC during such period of time for purposes of making subsequent QEF and MTM elections without a purging election. Part III.B.1(c)(iv)(2).

18. If a partnership holds stock in a PFIC, QEF and MTM elections and income inclusions should be made directly at the partner level rather than at the partnership level. In addition, in appropriate cases, a partnership should be permitted to make QEF (and possibly MTM) elections on behalf of all its partners, with inclusions still at the partner level. Part III.B.1(c)(iv)(3).

19. If the retroactivity option applies and the CFC is also a PFIC, partners of a U.S. shareholder partnership that owns the CFC that are not themselves U.S. shareholders of the CFC will be retroactively treated as shareholders in a PFIC. They should be permitted to make retroactive QEF and MTM elections without purging elections. Part III.B.1(c)(iv)(4).

20. Aggregate treatment of partnerships would be appropriate for applying Section 958(a) to the ownership tests under Section 953(c)(2) (related party insurance income), but not for purposes of Section 163(j) (where the interest expense limitation is itself applied at the partnership level). Part III.B.1(c)(v).

21. Consistent with the rules in the Final Regulations for applying entity treatment to partnerships for the purpose of certain GILTI elections, the same rule should apply for purposes of Section 964. Part III.B.1(c)(vi)(1).

22. Domestic non-grantor trusts (or domestic estates) should not be treated as aggregates for purposes of the GILTI or Subpart F rules. Part III.B.1(c)(vi)(2).

23. We are not aware of any material issues relating to basis, capital accounts, or previously taxed earnings and profits in connection with the transition to treating partnerships as aggregates for Subpart F purposes. Part III.B.1(c)(vii).

C. The Proposed Regulations: Elective Exclusion of High-Taxed Income from GILTI

24. Since an election or revocation may require the consent of multiple U.S. shareholders of a CFC on their own tax returns, U.S. shareholders so consenting or

revoking should be required to notify the CFC, and the CFC should be required to inform all U.S. shareholders of such notices. Part III.B.2(b)(ii).

25. Regulations should clarify an issue concerning the application of the 60-month periods during which limits are imposed on the making or revoking of the election in certain circumstances. Part III.B.2(b)(iii).

26. Regulations should clarify a number of issues concerning the retroactive making or revoking of elections on amended tax returns, including interactions with the 60-month rules and the obligation of all affected U.S. shareholders to file amended tax returns. Part III.B.2(b)(iv).

27. For a U.S. shareholder partnership, aggregate rather than entity principles should apply in determining the U.S. shareholders that are eligible to make or revoke the election and the effectiveness of the election. Part III.B.2(b)(v).

28. The definition of a CFC Group (a group of CFCs for which a single election is made) should be clarified in respect of a rule that ownership of a CFC by related party shareholders is aggregated. Part III.B.2(b)(vi)(1).

29. Further consideration should be given to the rule that to satisfy one alternative test for a CFC Group, each U.S. shareholder must own each CFC in identical proportions. Part III.B.2(b)(vi)(2).

30. Aggregate rather than entity treatment of domestic partnerships should apply in determining whether a CFC Group exists. Part III.B.2(b)(vi)(3).

31. Clarification should be made to the rules for making and revoking future elections for a CFC when the CFC leaves an old CFC Group and/or joins a new CFC Group. Part III.B.2(b)(vii)(1).

32. Clarification should be made to the rules for making and revoking future elections for a CFC when a U.S. shareholder of the CFC is acquired by one or more other U.S. shareholders that own their own CFCs that are part of a CFC Group.
Part III.B.2(b)(vii)(2).

33. Regulations should clarify the extent to which "successor" rules apply to CFCs for purposes of the 60-month election rules. Part III.B.2(b)(vii)(3).

34. Further consideration should be given to the "change in control" exception that allows the IRS to waive the 60-month waiting periods for a change in election. The rationale for some of the limitations that apply to a change in control, and the application of the rule to a change in control of a U.S. shareholder of a CFC, are not clear. Clarification should also be provided about the standards the IRS will use to waive (or not waive) the waiting periods, and, if there are situations where a waiver is almost certain, consideration should be given to providing a safe harbor in the regulations rather than requiring a ruling request. Part III.B.2(b)(vii)(4).

35. Regulations should clarify the method of determining whether income is "high-taxed income" when a single foreign tax is levied on income of more than one QBU, the statutory foreign tax rate meets the 90% test, and the overall foreign tax liability is reduced because one of the QBUs has losses. A similar situation arises if a single QBU has businesses generating both tested income and nontested loss. Part III.B.2(b)(viii).

36. If a disregarded entity or U.S. tax partnership is treated as a separate taxable entity in its local jurisdiction, then for purposes of the election, the entity should be treated as an entity separate from its "parent" CFC and as having its own QBUs, income, and tax liability. If such an entity is not a separate taxable entity in the local jurisdiction, the rules should apply in the same manner as if the entity did not exist, including treating any QBU of the entity in the same manner as a QBU of the "parent" CFC. Part III.B.2(b)(ix).

III. Discussion and Recommendations

A. The Final Regulations

1. Calculation of Inclusions Under Sections 951(a)(2)(A) and (B)

(a) *Background*

Each person who is a United States shareholder (a "**U.S. shareholder**") of a controlled foreign corporation (a "**CFC**") and who owns stock in the CFC on the last day of the CFC's tax year on which it is a CFC (the "**Last CFC Date**") must:

(i) include in income its pro rata share of the CFC's Subpart F income for the year[10] and

(ii) include in its GILTI calculation its pro rata share of the CFC's tested income or tested loss, qualified business asset investment ("**QBAI**") and interest expense for the year (together, "**GILTI items**").[11]

---

[10] Section 951(a)(1).

[11] Section 951A.

A U.S. shareholder is a United States person who is considered to own under Section 958(a) or Section 958(b) 10% or more of the vote or value of the CFC. Section 951(b). Stock is considered owned under Section 958(a) if it is owned directly or indirectly through a foreign corporation, partnership, trust or estate. Stock is considered owned under Section 958(b) if it is considered owned under the constructive ownership rules of Section 318, with certain modifications.

A CFC is a foreign corporation if more than 50% of its vote or value is considered to be owned under Section 958(a) or Section 958(b) by U.S. shareholders on any day of its year. Section 957(a).

Subpart F income is defined in Section 952 and includes various types of passive and portable income.

The U.S. shareholder's pro rata share of Subpart F income and tested income for a tax year of the CFC is calculated in the following manner (the "**Inclusion Formula**"):

> (i) begin with the amount that would have been distributed to the U.S. shareholder if, on the Last CFC Date, the CFC had made a pro rata distribution to its shareholders equal to its Subpart F income or tested income (whichever is applicable) for the year (the "**Gross Inclusion Amount**");
>
> (ii) if the CFC was not a CFC for the entire year (a "**Partial Year CFC**"), the Gross Inclusion Amount is reduced by a proportionate amount based on the number of days during the year that the CFC was not a CFC (the "**Partial Year CFC Reduction Amount**");[12] and
>
> (iii) if the U.S. shareholder did not own its stock in the corporation for the entire tax year, the Gross Inclusion Amount (as reduced by the Partial Year CFC Reduction Amount, if applicable) is reduced by the lesser of (i) the amount of dividends received during the year, including deemed dividends under Section 1248(a), by other holders of the same stock of the CFC (including the holders of the stock for the period when the CFC was not a CFC) and (ii) the amount of Subpart F income or tested income allocable to the stock for the portion of the year that the U.S. shareholder did not own the stock (the "**Partial Year Ownership Reduction Amount**").[13]

Therefore, the Subpart F and tested income inclusions are equal to the respective Gross Inclusion Amounts, reduced by the respective Partial Year CFC Reduction Amounts and Partial Year Ownership Reduction Amounts.[14]

For ease of reference and clarity, the discussion that follows focuses on tested income but applies equally to Subpart F income. The requirement for including the Gross Inclusion Amount, net of the Partial Year CFC Reduction Amount, is contained in

---

While ownership of CFC stock under Section 958(b) counts for purposes of determining whether a U.S. person is a U.S. shareholder of a CFC, that U.S. shareholder's Subpart F or GILTI inclusion is determined by reference only to CFC stock owned under Section 958(a). Section 951(a).

[12] Section 951(a)(2)(A), Treas. Reg. § 1.951-1(b)(1)(i).

[13] Section 951(a)(2)(B), Treas. Reg. § 1.951-1(b)(1)(ii)(A) and (B). Any such dividends reduce Subpart F income and tested income proportionately. Treas. Reg. § 1.951-1(b)(1)(ii)(A).

It is anomalous that Section 951(a)(2)(B) reduces year-end tested income inclusions by dividends paid out of e&p, even though tested income is not limited to e&p and has no necessary relation to e&p. That issue is beyond the scope of this Report.

[14] Note that there is no reduction in Subpart F or tested income inclusions for dividends paid during the year to the U.S. shareholder that owns stock on the last CFC date. Instead, e&p that is attributable to Subpart F and tested income inclusions to that shareholder creates previously tax earnings and profits ("**PTEP**") for that shareholder. Dividends paid to that U.S. shareholder are considered to be paid first out of PTEP and are not subject to additional tax to that extent. Section 959(a) and (c).

Section 951(a)(2)(A), and the reduction for the Partial Year Ownership Reduction Amount is contained in Section 951(a)(2)(B).[15]

The preamble to the Final Regulations (the "**Final Regulations Preamble**") states that Treasury is studying situations where the application of Sections 951(a)(2)(A) and (B) may lead to inappropriate results, for example due to the concurrent application of the provisions. The Preamble then states that Treasury is studying the application of the Partial Year Ownership Reduction Amount to: (1) dividends paid to foreign persons, (2) dividends that give rise to a deduction under Section 245A(a) and (3) dividends paid on stock after the disposition of such stock by a U.S. shareholder.[16]

We discuss in Part III.A.1(b) and (c) two situations that, in the words of the Treasury, may lead to inappropriate results. It should be noted that the results in these situations are unrelated to Section 245A. They arise under the Inclusion Formula, which has been in the Code since 1962.[17] Moreover, regulations adopted in 1965 include two examples[18] that illustrate the first result that we discuss.

However, both results that we discuss have a greatly increased significance after the Act. The Inclusion Formula will now determine tested income as well as Subpart F inclusions, so any economic distortion in the formula is magnified. Moreover, the second fact pattern that we discuss arises when a foreign corporation is a CFC for part of the year when it has no Section 958(a) U.S. shareholders. This fact pattern is much more likely to arise after the Act's repeal of Section 958(b)(4).

(b) *Avoiding Uneconomic Underinclusions*

The Inclusion Formula, including the Partial Year Ownership Reduction Amount, was designed to work properly in simple situations. That is, it is designed to ensure that a U.S. shareholder holding stock in a CFC on the Last CFC Date for a year is taxed on its true economic share of the CFC's income for the year, including income allocable to former U.S. shareholders of the stock that did not pay tax on their share of the income because they were not shareholders on the Last CFC Date.

Assume in each example below that, unless stated otherwise, the CFC has $100 of tested income for the year, $100 current e&p and no Subpart F income, S owns 100% of

---

[15] These rules apply to tested income pursuant to Section 951A(e) and Treas. Reg. § 1.951A-1(d).

[16] T.D. 9866, Federal Register Vol. 84, No. 120, June 21, 2019, at 29290-29291. Page references hereinafter to the Final Regulations Preamble are to pages in this volume of the Federal Register.

[17] Section 951 was added to the Code as part of the Revenue Act of 1962, P.L. 87-834, which adopted Subpart F.

[18] Treas. Reg. § 1.951-1(b)(2), Ex. 3 and 5, included in T.D. 6795, January 28, 1965. These examples were modified by the Final Regulations but, as the Final Regulations Preamble notes at 29290, the modifications just illustrate the new proportionality rule described in footnote 13 and conform the terminology to the Final Regulations.

the stock of the CFC, and on August 7 of the year (after the passage of 60% of the year), S sells all the stock to unrelated buyer B.

One situation where the Inclusion Formula works correctly is the case where the CFC is a CFC for the entire year and all the shareholders are U.S. shareholders.

> Example 1. Full-year CFC, all U.S. shareholders. Assume S and B are both U.S. persons and therefore U.S. shareholders of the CFC, and S sells the stock at a gain of $60 or more. The gain results in a deemed dividend to S under Section 1248 of $60 or more. The tested income inclusion to B for the year is $40, calculated as $100 (the Gross Inclusion Amount) minus $60 (the Partial Year Ownership Reduction Amount). This is the correct result for B and represents the tested income of the CFC for B's period of ownership.

We note in this example that if S is eligible for the dividends received deduction under Section 245A, $60 of the tested income of the CFC would not be taxed to any U.S. shareholder. We discussed this problem in detail in a prior report.[19]

The Section 245A Regulations disallow the Section 245A deduction to S in certain situations of this type. However, as noted above, those Regulations are beyond the scope of this Report. We therefore assume, for purposes of this Report, that those regulations are sufficient, from a Treasury point of view, to prevent inappropriate results arising from the application of the Section 245A deduction to S.[20] We limit the discussion to other situations where the amount of the inclusion to B might not be considered appropriate.

Another case where the Inclusion Formula works correctly is where the CFC is a Partial Year CFC and no dividend is paid to S.

> Example 2. Partial Year CFC, non-U.S. seller, U.S. buyer, no dividend. Assume S is foreign, B is U.S., the CFC is not a CFC until the purchase by B, and no dividend is paid to S.[21] B's inclusion amount is $40, calculated as the Gross Inclusion Amount of $100 reduced by the Partial Year CFC Reduction Amount of $60.

---

[19] First Prior GILTI Report at 48-58.

[20] We note, however, that the enactment of Sections 245A and 250 in the Act introduced additional considerations relating to the effective tax rate applicable to various types of income inclusions. When a GILTI or Subpart F inclusion is reduced by a dividend to a U.S. shareholder, the gross amount included in income of the U.S. shareholder may remain constant, but the tax result to the U.S. shareholder may be very different depending on the effective rate at which the GILTI or Subpart F inclusion is taxed (which, in the case of the GILTI inclusion, will depend on the availability of a Section 250 deduction) and the availability of the Section 245A deduction. These considerations are beyond the scope of this Report.

[21] Any gain to S on the sale to B would not be a deemed dividend under Section 1248, because Section 1248 only applies to sales by U.S. shareholders. Section 1248(a).

In this case, B's inclusion is equal to the tested income attributable to B's period of ownership.

However, the Inclusion Formula results in an overall exclusion of tested income if there is *both* a Partial Year CFC and a dividend paid to a non-U.S. shareholder during the non-CFC portion of the year. The reason is that the Partial Year CFC Reduction Amount is a reduction in the Gross Inclusion Amount to reflect earnings during the period that the CFC is not a CFC during the year, and the Partial Year Ownership Reduction Amount is a reduction in the Gross Inclusion Amount that can reflect dividends paid to a non-U.S. shareholder out of earnings in the non-CFC period. Thus, the Gross Inclusion Amount for the year can be reduced twice by the earnings of the Partial Year CFC during the non-CFC period of the current tax year.[22] The legislative history of the Inclusion Formula does not discuss the interaction of the Partial Year Ownership Reduction Amount and the Partial Year CFC Reduction Amount.[23]

We note that a Partial Year Ownership Reduction Amount can arise for a Partial Year CFC regardless of whether the dividend to the non-U.S. person is paid before or after the sale transaction. The following two examples illustrate the doubling up of the reduction in Gross Inclusion Amount in these situations.[24]

> Example 3. Partial year CFC, non-U.S. seller, U.S. buyer, dividend to seller. Assume S is foreign, B is U.S., the CFC is not a CFC until the purchase by B, and a dividend of $40 or more is paid to S. B's inclusion amount is $0, determined as a Gross Inclusion Amount of $100, reduced by a Partial Year CFC Reduction Amount of $60 and a Partial Year

[22] Even though dividends may be paid out of accumulated e&p, the dividends taken into account in calculating the Partial Year Ownership Reduction Amount will almost always in practice be limited to the current e&p of the CFC for the year in question. The reason is that the Partial Year Ownership Reduction Amount is limited to tested income that is allocable to the stock owned by the U.S. shareholder on the Last CFC Date for the portion of the year that the U.S. shareholder did not own the stock, and current year tested income will normally approximate current year e&p. The Partial Year CFC Reduction Amount also only takes into account current year tested income, which again will normally approximate current year e&p. In unusual cases, a dividend taken into account under the Partial Year Ownership Reduction Amount might be paid out of e&p for past years, such as where there is e&p in past years, and tested income but no e&p in the current year.

[23] The House-passed version of the Partial Year Ownership Reduction Amount only took into account dividends paid by a CFC to a United States person before a transfer to a U.S. shareholder. H.R. 10650, 87th Cong., 2d Sess., at 105 (April 2, 1962). The Senate bill adopted the current version in the Code. P.L. 87-834. (The sentence referring to Section 1248 deemed dividends was added later by the Taxpayer Relief Act of 1997, P.L. 105-34.) The Senate Report on the Bill did not explain the reason for this change and did not address the potential overlap between the Partial Year CFC Reduction Amount and the Partial Year Ownership Reduction Amount. S. Rep. 87-1881 at 238-39, reprinted in 1962-3 CB at 707, 942-943.

[24] The same issue would arise in these fact patterns if the dividend is to a U.S. shareholder that is eligible for the Section 245A exclusion, including a U.S. seller selling stock with Section 1248 gain. However, as noted above, this Report does not discuss any omission from tested income inclusions arising from Section 245A.

Ownership Reduction Amount of at least $40 (up to a dividend equal to S's $60 share of income).

Example 4. Partial year CFC, U.S. seller, non-U.S. buyer, dividend to buyer. Now assume S is U.S., B is foreign, the CFC stops being a CFC on the sale date, and a dividend of $40 or more is paid to B after the sale. For numerical consistency with the prior example, assume that the U.S. person still owns the stock for 40% of the year, so that the sale occurs 40% (rather than 60%) through the year. Since S is the U.S. shareholder on the Last CFC Date, S has the inclusion. S's inclusion amount is $0, calculated as the Gross Inclusion Amount of $100, reduced by the Partial Year CFC Reduction Amount of $60 and the Partial Year Ownership Reduction Amount of at least $40 (up to a dividend equal to S's $60 share of income).

In both of these cases, the U.S. shareholder's economic share of tested income was $40, and the U.S. shareholder held CFC stock on the last day of the CFC tax year, but there was no tested income inclusion. Again, the reason is the overlapping reductions in the Gross Inclusion Amount on account of the Partial Year CFC Reduction Amount and the Partial Year Ownership Reduction Amount.

To further illustrate the point, in the absence of the dividend to the non-U.S. shareholder in both examples, there would be no Partial Year Ownership Reduction Amount, and the Partial Year CFC Reduction Amount would be $60. The inclusion amount to the U.S. shareholder would be $40, the correct amount.

To avoid the duplicative reduction in the Gross Inclusion Amount, note that the Partial Year CFC Reduction Amount already excludes earnings out of the non-CFC portion of the year, and so the remaining need for the Partial Year Ownership Reduction Amount is to exclude earnings out of the CFC portion of the year during which the stock was not owned by the U.S. shareholder taxed on CFC earnings for the year. Thus, the dividends taken into account by the U.S. shareholder that owned the stock on the Last CFC Date, for purposes of calculating its Partial Year Ownership Reduction Amount, should be limited to the tested income attributable to the portion of the year during which *both* (1) the Partial Year CFC was a CFC and (2) the stock was not owned by the U.S. shareholder.[25] In Examples 3 and 4, there is no such period, so the Partial Year Ownership Reduction Amount should be $0 and there should be a net inclusion amount of $40.

[25] In an analogous situation involving the interaction of two provisions relating to the same fact pattern, in NYSBA Tax Section, Report on the Branch Loss Recapture Rules of Section 91, Report No. 1420, August 29, 2019, at 45-49, we recommended that the overall foreign loss rules in Section 904(f)(3) be coordinated with the branch loss recapture rules of Section 91 in order to avoid a "double recapture" of the same branch loss under both sections.

If Treasury believes this change is desirable but does not believe it has the authority to make the change by regulations, it should request a statutory amendment.

(c) *Avoiding Uneconomic Overinclusions*

It appears from the Final Regulations Preamble that the goal of the Treasury is to better match tested income inclusions of a U.S. shareholder to the U.S. shareholder's economic share of the tested income of a CFC. The previous discussion involved modifications to avoid tested income inclusions that are less than economic income. However, towards the same goal of matching tested income inclusions with economic tested income, consideration should also be given to a modification to the calculation of the Partial Year CFC Reduction Amount. The goal here is to avoid the overinclusion of tested income amounts.

The overinclusion in question is not based on the duplication of the Partial Year CFC Reduction Amount and the Partial Year Ownership Reduction Amount. In fact, it arises even in the absence of dividends paid by the CFC. The overinclusion arises because the Partial Year CFC Reduction Amount reduces the Gross Inclusion Amount for periods that a Partial Year CFC is not a CFC, but not for periods that the Partial Year CFC is a CFC but does not have Section 958(a) U.S. shareholders. It is difficult to see any logic for this distinction, and, as is discussed further below, the occasions when this issue arises have become much more frequent as a result of the Act.

> Example 5. Full year CFC, no Section 958(a) U.S. shareholder except for U.S. buyer, no dividend. S is foreign, B is U.S., the CFC is a CFC before the purchase by B solely by reason of attribution from a U.S. subsidiary of S, and no dividend is paid to S. B's inclusion amount is $100, calculated as the Gross Inclusion Amount of $100 without any reduction since the CFC is a CFC for the entire year and no dividend was paid.

These are the same facts as in Example 2, where the inclusion amount was $40, except that here, the CFC is a CFC for the entire year because a U.S. subsidiary of S is a U.S. shareholder of the CFC under Section 958(b). As a result, B's inclusion amount is $100 even though its economic share of the tested income is $40.

This result arises even though the U.S. subsidiary does not have to report any tested income of the CFC, or pay tax on any dividends from the CFC, because it is not a Section 958(a) shareholder subject to GILTI inclusions and not an actual shareholder that would receive cash dividends. Consequently, the mere existence of this U.S. subsidiary of S that does not pay any U.S. tax on income of the CFC causes B's inclusion amount to increase from $40 to $100. In fact, if B had bought the CFC stock on the last day of the CFC tax year, the existence of the U.S. subsidiary of S would cause B's inclusion amount to increase (as compared with a scenario where S had no U.S. subsidiaries and the CFC is not a CFC until the purchase by B) from a nominal amount to $100 even though B's economic interest in the tested income for the year was nominal.

In order to reach the proper economic result in this situation, the Partial Year CFC Reduction Amount could be expanded to provide for a corresponding reduction in the Gross Inclusion Amount for any period of time during which the CFC was a CFC but did not have U.S. shareholders with Section 958(a) ownership. The rationale of this rule is that the *existing* policy for excluding income earned during the period of non-CFC status is arguably based on the fact that income during the non-CFC period is not fairly allocable to B (the Section 958(a) U.S. shareholder on the Last CFC Date), either directly or as a surrogate for other Section 958(a) U.S. shareholders during a CFC period that are not taxed on the income solely because they cease to be Section 958(a) U.S. shareholders before the Last CFC Date. Under this rationale, the same logic would apply to the period that the CFC was a CFC, to the extent it did not have Section 958(a) U.S. shareholders, since the Section 958(a) U.S. shareholder on the last day of the tax year should likewise not be a surrogate for non-Section 958(a) U.S. shareholders during the CFC period.

This expansion of the Partial Year CFC Reduction Amount would result in more economically correct GILTI inclusions for the Section 958(a) U.S. shareholder on the Last CFC Date. In addition to principles of fairness, it is always desirable for tax results to mirror true economic results, because taxpayers can take advantage of any disparity. It is difficult to predict in advance what the transactions might be to take advantage of the disparity, but, for example, B might be happy with an uneconomically high GILTI inclusion at a 10.5% tax rate in order to increase its tax basis in the CFC stock and later obtain a tax loss at 21%.

We recognize the complexity of this proposed rule. For example, assuming the CFC is a CFC on the last day of the tax year:

(1) For every Section 958(a) U.S. shareholder B owning stock on the last day of the tax year but not for the full tax year, it would be necessary to track the ownership by Section 958(a) U.S. shareholders on a daily basis for the period (the "**pre-ownership period**") during the tax year before B became a Section 958(a) U.S. shareholder but the CFC was a CFC.

(2) During the pre-ownership period, there could be a combination of Section 958(a) U.S. shareholders and non-Section 958(a) U.S. shareholders. A decision would have to be made about whether to look solely to the shareholders that previously owned the particular shares owned by B during the period before B became a Section 958(a) U.S. shareholder, or whether to pro rate any ownership by all Section 958(a) U.S. shareholders on any day during that period.

(3) If a U.S. or foreign partnership was a shareholder of the CFC during the pre-ownership period, logically it would be necessary to look through the partnership to determine whether its partners were Section 958(a) U.S. shareholders under aggregate principles for partnerships. This could be difficult or impossible to find out, although perhaps it could be "presumed" that all partners of all partnerships are Section 958(a) U.S. shareholders unless proven otherwise.

(4) A rule would be needed as to how to treat shareholders during the pre-ownership period that are U.S. persons but not Section 958(a) U.S. shareholders.

(5) If dividends are paid during the pre-ownership period to prior owners of the B stock that were not Section 958(a) U.S. shareholders, then just as in Example 3 where the Partial Year CFC Reduction Amount applies for the period of non-CFC status, the Partial Year Ownership Reduction Amount should disregard dividends paid out of earnings that are already being excluded from B's income under this expanded version of the Partial Year CFC Reduction Amount.

(6) Additional complexity would arise if the CFC was not a CFC for part of the pre-ownership period, and then became a CFC without Section 958(a) U.S. shareholders for another part of that period, or vice versa, since Section 958(a) U.S. shareholder status would be irrelevant during the non-CFC part of the period.

Note that some of these complexities arise in applying the existing Partial Year CFC Reduction Amount and Partial Year Ownership Reduction Amount.

Other approaches would also be possible. For example, on the sale of stock of a CFC to or by a Section 958(a) U.S. shareholder, the taxable year of the CFC could be deemed to end, with respect to the sold stock only, on the sale date.[26] Alternatively, the Partial Year CFC Reduction Amount could be determined by disregarding Section 958(b)(4) in determining CFC status, restoring the rule to the scope it had before the Act. This is a less precise approach than the primary proposal above, and would be more favorable than the primary proposal to the year-end shareholder in some cases and less favorable in other cases.[27] It would also be possible to simplify and narrow the relief provision by limiting relief to the case where there were no Section 958(a) U.S. shareholders during the pre-ownership period. We will be happy to work with the Treasury on these issues if there is any interest in proceeding along any of these lines.

In conclusion, we acknowledge both the fairness to U.S. shareholders of conforming their Subpart F and tested income inclusions to their true economic share of such income, and the necessary complexity of the resulting change in the rules. We do not take a position on the appropriate way to balance these considerations. If Treasury believes the changes should be made, we would be happy to support such changes and assist with any proposal. If Treasury believes these changes are desirable but does not

[26] A similar suggestion was made in our First Prior GILTI Report at 58, and an election to "close the books" under certain circumstances is included in the Section 245A Regulations. Treas. Reg. § 1.245A-5T(e)(3)(i).

[27] This proposal would take into account either all or none of the pre-ownership period when there is actual CFC status during that period, depending on the hypothetical CFC status determined by disregarding Section 958(b)(4). If Section 958(a) U.S. shareholders represented more than 50% (or 50% or less) of the ownership during that period, this proposal would take account of all (or none) of the tested income during the pre-ownership period. By contrast, the primary proposal would disregard tested income during that period based on the actual percentage of Section 958(a) U.S. shareholders (or, as we suggest alternatively above, the status of the actual seller of shares to the year-end owner).

believe it has the authority to make these changes in regulations, it should request a statutory amendment. Alternatively, in light of the complexity of the proposals discussed in this Part III.A.1, consideration should be given to a statutory amendment that would make broader and more sweeping changes, rather than to seek targeted tweaks to the existing framework.[28]

2. Effect of Section 961 Basis Adjustments on Section 951A

(a) *Background*

Under Section 961, the tax basis of a U.S. shareholder in the stock of a CFC (and in any property by reason of which the shareholder is considered to own the CFC stock) (1) increases by the amount of a Subpart F inclusion,[29] and (2) decreases by the amount of a distribution of PTEP.[30] Similar adjustments are made to the basis of one CFC in the stock of a lower-tier CFC, *but "only" for purposes of determining Subpart F inclusions*.[31]

For purposes of applying Section 961, GILTI items included in gross income under Section 951A are treated in the same manner as Subpart F items included in gross income under Section 951.[32] It is clear, therefore, that a GILTI inclusion with respect to a lower-tier CFC (like a Subpart F inclusion with respect to a lower-tier CFC) increases stock basis in both the upper-tier and lower-tier CFC for purposes of determining the U.S. shareholder's Subpart F inclusions, e.g., on a sale by the first tier subsidiary of the stock of the lower-tier subsidiary. However, while GILTI inclusions are treated as Subpart F inclusions for purposes of lower-tier basis adjustments, Section 961(c) by its terms only applies for purposes of determining Subpart F inclusions. Thus, it is not clear whether basis adjustments in lower-tier CFCs are taken into account for purposes of computing tested income or tested loss (and therefore determining GILTI inclusions) of the U.S. shareholder. This question is relevant when an upper-tier CFC disposes of a lower-tier CFC.

---

[28] One approach would be for the U.S. shareholder on the Last CFC Date to include its pro rata share of tested income, as well as the pro rata share of tested income of any other U.S. shareholder that held the same stock during the year, reduced only for dividends paid to any other U.S. shareholder that held the same stock during the year. A distribution to any such other U.S. shareholder that would otherwise be treated as a dividend would be so treated only to the extent of the other U.S. shareholder's allocable share of tested income, and any excess would be treated as a non-dividend distribution. This approach would ensure that all of the CFC's tested income attributable to a U.S. shareholder's ownership period was included once in a U.S. shareholder's income.

[29] Section 961(a); Treas. Reg. § 1.961-1.

[30] Section 961(b), Treas. Reg. § 1.961-2.

[31] Section 961(c). Section 961(c) provides for these basis adjustments "under regulations prescribed by the Secretary." Regulations were proposed in 2006 but never finalized. We assume for purposes of this discussion that Section 961(c) is self-executing, consistent with the approach most practitioners take.

[32] Section 951A(f)(1).

The Final Regulations Preamble notes that Treasury has received comments on this question. The Preamble expresses a concern that making this adjustment for GILTI purposes could inappropriately reduce the amount of stock gain subject to tax and requests comments on this issue.[33]

(b) *Discussion and Recommendation*

As discussed below, to avoid double tax, we recommend taking into account lower-tier basis adjustments for purposes of computing tested income. However, to respond to Treasury's valid concern, we also recommend making other adjustments to ensure that a sale of a lower-tier CFC does not produce e&p that could be used to avoid even a single tax on future tested income inclusions.

Initially, we note that ignoring lower-tier basis adjustments can lead to double tax.

> Example 6. Sale of Lower-Tier CFC by Upper-Tier CFC. Assume a U.S. corporation, US1, forms CFC1 with $100, and CFC1 forms CFC2 with $100. US1 therefore has $100 basis in its CFC1 stock and CFC1 has $100 basis in its CFC2 stock. During year 1, CFC1 generates no tested income and CFC2 generates $100 tested income that is included in US1's GILTI calculation under Section 951A(a). CFC2 does not have any other income (and thus has no non-taxed e&p). US1's basis in its CFC1 stock is increased by $100 to $200 under Section 961(a) for all purposes, and CFC1's basis in its CFC2 stock is increased by $100 to $200 under Section 961(c), but only for certain purposes. CFC1 then sells CFC2 in year 2 for $200.

If CFC1's basis increase in CFC2 is taken into account for purposes of computing tested income, then CFC1's basis for this purpose will be $200, and US1 will not have a tested income inclusion. This result is logical because US1 has invested $100 and included $100 of tested income in its GILTI calculation, so no portion of the $200 sales proceeds represents economic gain to US1.

However, assume that CFC1's increased basis is taken into account only for purposes of determining Subpart F income on CFC1's disposition of CFC2. Then:

(i) US1 would have no Subpart F income inclusion under Section 951;

(ii) US1 would have $100 gain for purposes other than Section 951;

---

[33] Final Regulations Preamble at 29297-29298. We recommended in a prior report that Section 961(c) basis adjustments should be taken into account for purposes of calculating tested income of an upper-tier CFC on the disposition of stock of a lower-tier CFC. NYSBA Tax Section, Report on Previously Taxed Earnings under Section 959, Report No. 1402, October 11, 2018, at 34-37.

(iii) if the statutory exclusions from tested income[34] are interpreted to exclude all items of gross income that are in the nature of Subpart F income, the $100 gain would not be tested income;

(iv) if those statutory provisions are interpreted to exclude only items of gross income that are in fact characterized as Subpart F income, then CFC1 has $100 of tested income that is included in US1's GILTI calculation for year 2;[35]

(v) if US1 has the GILTI inclusion, then its basis in CFC1 of $200 before the sale is increased to $300 under Section 961(a) for all purposes; and

(vi) regardless of the GILTI inclusion, since Section 961(c) clearly does not apply for e&p purposes, CFC1 has an increase of e&p of $100 on the sale.

This leaves two possibilities, either US1 has the GILTI inclusion or not. We now assume that CFC1 increases in value from $200 to $300 and US1 sells CFC1 for $300 in year 3. The results in both cases are as follows:

If US1 has the GILTI inclusion:

(i) before the sale of CFC1, US1 has reported $200 of income on $100 of economic gain, its basis in CFC1 is increased to $300, and CFC1 has e&p of $100;

(ii) US1 would have no gain on the stock sale for $300; and

(iii) while US1 has reported total taxable gain of $200 equal to its economic gain, it reported an "extra" uneconomic $100 gain as its taxable income in year 2 that increased its stock basis and resulted in an offsetting reduced taxable gain in year 3.

If US1 does not have the GILTI inclusion:

(i) before the sale of CFC1, US1 has reported $100 of income on $100 of economic gain, its basis in CFC1 remains at $200, and CFC1 has e&p of $100;

---

[34] Section 951A(c)(2)(A)(i)(II) (excluding "gross income taken into account in determining the subpart F income of such corporation"); Treas. Reg. § 1.951A-2(c)(1)(ii) (same). The concern is that the $100 increase in Subpart F basis prevents the corresponding $100 of sale proceeds from being included in gross income for Subpart F purposes, so there is no Subpart F gross income to exclude for GILTI purposes.

[35] As CFC2 does not have any non-taxed e&p, Section 964(e)(4)(A)(i) does not apply. Section 964(e)(1); Section 1248(a) and (d)(1).

(ii) on the sale, US1 has $100 gain, all of which is treated as a dividend under Section 1248 because the $100 of e&p in CFC1 is available to treat US1's gain as a deemed dividend,[36]

(iii) US1 is entitled to a Section 245A deduction equal to the deemed dividend, so it has no tax liability on the sale; and

(iv) as a result, US1 originally invested $100 and included $100 of CFC2's tested income in its GILTI calculation, but sold the stock for $300 without tax liability.

Thus, the GILTI inclusion results in an uneconomically high tax liability to US1 on CFC1's sale of CFC2 that is only offset when it sells the stock of CFC1, which may be far in the future. The non-GILTI inclusion results in the proper treatment of US1 on the CFC1 sale of CFC2, but a permanent elimination of tax on economic gain to US1 on its sale of CFC1.

We believe the most logical approaches to this puzzle would be the following:

First, CFC1's Section 961(c) basis would be taken into account for purposes of computing tested income on the disposition of CFC2 and, as a result, US1 would not have the GILTI inclusion on the sale of the CFC2 stock. This would provide the correct economic result to US1 on CFC1's sale of CFC2—no GILTI inclusion, the proper basis of $200 in the stock of CFC1, and the proper taxable gain of $100 on the sale of CFC1 for $300.

Second, the "windfall" to US1 under this approach on the sale of CFC1 arises because of the e&p in CFC1 arising on its sale of CFC2. This e&p is anomalous because the Section 961(c) basis increase reduces taxable gain on that sale under this approach but does not apply for e&p purposes. It seems reasonable as a policy matter to "eliminate" this e&p for purposes of applying Section 1248 to US1's sale of CFC1. This could be accomplished by either (1) taking Section 961(c) basis into account for all purposes of computing e&p, or (2) more narrowly, taking Section 961(c) basis into account solely for purposes of computing e&p for purposes of Section 1248(d)(1), i.e., to disregard e&p generated in sales where there would have been an income inclusion but for the application of Section 961(c) basis.[37]

---

[36] Section 1248(d)(1) generally excludes e&p attributable to any amount previously included in the gross income of the applicable U.S. shareholder. It does not apply to the $100 e&p generated by CFC1's sale of CFC2 because we assume here that the sale did not generate an income inclusion for US1.

[37] Note that taking Section 961(c) basis into account for purposes of Section 1248(d)(1) would not only avoid the "windfall" in sales of first tier CFCs (as in Example 6), but would also address the same issue in sales of lower-tier CFCs. In the latter case, Section 964(e) recharacterizes gain as a dividend to the extent it would have been so recharacterized under Section 1248(a) had the selling CFC instead been a U.S. shareholder.

We recommend either of these approaches.[38] If Treasury does not believe it has the authority to take either path, it should request a statutory amendment.

3. Adjustments to Disqualified Basis

(a) *Background*

Under Section 965(a), U.S. shareholders of CFCs are taxed on CFC earnings as of December 31, 2017 (or, if higher, November 2, 2017). The GILTI rules became effective for tax years of foreign corporations beginning after December 31, 2017, and to tax years of their U.S. shareholders in which or with which those tax years of foreign corporations end.[39] For CFCs with a calendar year tax year, the GILTI rules became effective January 1, 2018. For CFCs with a fiscal year tax year, however, there is a gap between December 31, 2017, and the beginning of the first year to which the GILTI rules apply. Earnings generated during that period are not subject to either Section 965 or GILTI. The Final Regulations refer to this gap as the "**disqualified period**."

The Final Regulations define a "**disqualified transfer**" as a transfer of property from a CFC to a related person during the CFC's disqualified period in which the CFC recognized gain.[40] The Final Regulations provide that basis created in a disqualified transfer is "**disqualified basis**."[41] Deductions attributable to disqualified basis generally cannot be used to reduce tested income or increase tested loss[42] and disqualified basis is disregarded for purposes of calculating QBAI.[43] Disqualified basis is, however, taken into account for purposes of determining a CFC's tested income or gain upon a disposition of the property. A taxpayer can eliminate disqualified basis via an election.[44]

If property has disqualified basis ("**disqualified basis property**"), the Final Regulations adjust disqualified basis in the property as follows:

(i) Except on a transfer of disqualified basis property to a related party, described in (ii) below, the disqualified basis in the property is reduced or eliminated to the extent that the disqualified basis reduces taxable income through, for example, depreciation, amortization and taxable sales or exchanges, or to the extent the basis in the property is otherwise reduced or eliminated, for example, through the application of Section 362(e)

---

[38] Yet another possibility might be an elective regime under which taxpayers could elect to obtain the Section 961(c) basis increase in exchange for disregarding the associated e&p.

[39] Act §14201(d).

[40] Treas. Reg. § 1.951A-3(h)(2)(ii)(C)(2).

[41] Treas. Reg. §§ 1.951A-2(c)(5)(iii)(A) and 1.951A-3(h)(2)(ii)(A). Inventory is excluded from this rule. *Id.*

[42] Treas. Reg. § 1.951A-2(c)(5)(i).

[43] Treas. Reg. § 1.951A-3(h)(2)(i)(A). .

[44] Treas. Reg. § 1.951A-3(h)(2)(ii)(B)(3).

or 732(a) or (b).[45] If the disqualified basis property also has basis other than disqualified basis ("**qualified basis**"), the disqualified basis and qualified basis are generally reduced or eliminated proportionately. However, in the case of a loss from a taxable sale or exchange, disqualified basis is reduced to the extent the loss is treated as allocable to the disqualified basis.[46] A loss on a taxable sale is first allocated to disqualified basis.[47] These rules are referred to as the "**general transfer rule**."

(ii) Disqualified basis in property is not reduced or eliminated by reason of a taxable or tax-free transfer of the property to a related person, except to the extent loss is recognized and is treated as attributable to disqualified basis, or the basis is reduced or eliminated in a nonrecognition transaction in which gain or loss is not recognized in whole or in part, such as under Sections 362(e) or 732(a) or (b).[48] Taxable loss is attributable first to disqualified basis.[49] A related person is a person with a Section 267(b) or 707(b) relationship to the transferor immediately before or after the transfer.[50] These rules are referred to as the "**related party transfer rule**."

(iii) If disqualified basis property is exchanged for property the basis of which is determined *in whole or in part* by the basis of the disqualified basis property ("**exchanged basis property**"), then the disqualified basis in the exchanged basis property in the hands of the transferor includes the disqualified basis in the disqualified basis property.[51] This rule is referred to as the "**exchanged basis property rule**."

It should be noted that the general transfer rule and the related party transfer rule apply to transfers of property to any person, even if the transferee is not a CFC. The disqualified basis is not relevant to the transferee if the transferee is not a CFC, since the only penalty for disqualified basis is the inability to use that basis to increase QBAI or reduce tested income or increase tested loss of a CFC. However, if the property is subsequently transferred to another related or unrelated CFC, the disqualified basis would remain with the property under the usual rules and would again become relevant. We assume this is the intent of the Final Regulations.

The policy behind these rules is to ensure that a transfer between related parties during the disqualified period will not produce a costless step up in tax basis for GILTI purposes. However, these rules mean that in substance there is a different tax basis for recognizing tested income than for recognizing tested loss (although in form any loss

---

[45] Treas. Reg. § 1.951A-3(h)(2)(ii)(B)(1)(i).

[46] *Id.*, Treas. Reg. §§ 1.951A-2(c)(5)(ii).

[47] Treas. Reg. § 1.951A-2(c)(5)(ii).

[48] Treas. Reg. § 1.951A-3(h)(2)(ii)(B)(1)(ii).

[49] Treas. Reg. §§ 1.951A-2(c)(5)(ii).

[50] Treas. Reg. § 1.951A-3(h)(2)(ii)(C)(4).

[51] Treas. Reg. § 1.951A-3(h)(2)(ii)(B)(2)(ii).

arising from disqualified basis is still allowed as a nontested deduction). On a sale for more than qualified basis, but less than total basis, there is no tested income after taking disqualified basis into account, and no tested loss after disregarding disqualified basis.

The policy rationale for these results is unclear, although perhaps concerns by the Treasury about its statutory authority led to the distinction between sales at or above basis and sales at a loss. In particular, Treasury states that its authority for the general transfer rule is the authority to allocate deductions to non-GILTI items.[52] This theory justifies the rule that reallocates loss and depreciation and amortization deductions, but would not justify reallocating gain or increasing the dollar amount of gain to disregard disqualified basis.

The Original Proposed GILTI regulations contained an earlier version of these rules, but the Final Regulations contain considerably more detail. In our comments on those proposed regulations,[53] we asked for certain clarifications of the provisions.

The Final Regulations Preamble explains the provisions in some detail. It also requests comments on the application of the rules that reduce or increase disqualified basis including, for example, how the rules should apply in an exchange under Section 1031 where property with disqualified basis is exchanged for property with no disqualified basis.

(b) *Discussion and Recommendation*

(i) *Fully taxable gain transactions*

We first consider a fully taxable transaction.

> Example 7. Sale of property to unrelated party at a gain in taxable transaction. Assume a U.S. corporation, US1, owns CFC1, which owns property P producing tested income or loss. CFC1 has $100 basis in P, $40 of which is disqualified basis and $60 of which is qualified basis. CFC1 sells P to an unrelated party X for $150 in cash or property and recognizes $50 gain. US1's $40 of disqualified basis has thus shielded $40 of gain to CFC1.

Under the general transfer rule, the disqualified basis in the property disappears because it has been used to reduce the taxable gain to CFC1. The same would be true for any sale at $100 or above.

If CFC1 receives property from X, that property is not exchanged basis property because it has a cost basis rather than substituted basis. As a result, the property does not have disqualified basis to CFC1.

---

[52] See the discussion in the Final Regulations Preamble beginning at 29298.

[53] Second Prior GILTI Report at 29-32.

If the property is sold to a related party at a gain, then under the related party transfer rule, the disqualified basis would remain in the property. The property received in exchange for the sold property would still not have disqualified basis because it still would not be exchanged basis property.

(ii) *Fully taxable loss transactions*

Example 8. Sale of property to unrelated party for loss in taxable transaction. Same facts as Example 7, but the sale price is less than $100, say $95.

Any property received by CFC1 would still not have disqualified basis because it is still not exchanged basis property.

As to disqualified basis in P in the hands of X, the $5 loss would not be a GILTI loss to CFC1 because it is attributable to disqualified basis. Nevertheless, in a sense the entire $40 of disqualified basis still "reduced taxable income" of CFC1, reducing it from a gain of $35 to a loss of $5. As a result, it might seem that the general transfer rule would eliminate the entire disqualified basis in P in the hands of X.

However, this does not appear to be the case. As noted in Part III.A.3(a), the general transfer rule has a special rule that on a loss from a taxable sale or exchange of property, disqualified basis is reduced or eliminated to the extent that the loss is attributable to disqualified basis, and loss is first allocated to disqualified basis. This rule appears to override the general rule that reduces disqualified basis to the extent it reduces taxable income.[54]

Under this approach, disqualified basis disappears to the extent of the taxable loss on disposition of the property, but it remains with the property to the extent it exceeds the taxable loss on the sale. In the example, since the taxable loss is $5, $5 of the disqualified basis would disappear, and X would have $60 of qualified basis and $35 of disqualified basis in P.

Conceivably the policy reason for this approach could be explained as follows. The disqualified basis is a tax-free basis step-up in the seller's hands and the Final Regulations prevent the seller from deriving GILTI benefits from that basis in various ways. Even on a sale at a loss, the seller might be able to use the disqualified basis to shelter what would in the absence of such basis be gain on the sale. The Final Regulations ensure that to the extent the seller benefits from the use of disqualified basis to shelter what would otherwise be gain in this manner, the disqualified basis "taint" continues in the buyer's hands. In the example, the disqualified basis sheltered $40 of gain by converting what would have been a $35 gain into a $5 loss. CFC1 did not benefit

[54] The first sentence of Treas. Reg. § 1.951A-3(h)(2)(ii)(B)(1)(i), which contains the rule reducing disqualified basis to the extent it reduces taxable income, states that such rule applies "except to the extent provided in this paragraph (h)(2)(ii)(B)(1)." The special rule for taxable sales at a loss, as well as the rule for transfers to related parties, are contained in the cited paragraph.

from the $5 of disqualified basis that created the $5 loss because the loss was not a GILTI loss, but it did benefit from the other $35 of disqualified basis, so the Final Regulations cause $35 of X's basis in P to be disqualified basis.

Also, perhaps the purpose of the rule in the Final Regulations is to penalize the seller economically on a taxable sale of depreciable property at a loss, in an amount roughly equal to the value of depreciation deductions on disqualified basis that would be disallowed to the seller if it had retained the property. After all, a buyer receiving disqualified basis under the Final Regulations will pay less for the property based on the tax cost to it of its own lost depreciation deductions on disqualified basis, and the value of the lost depreciation should be approximately the same to both parties. In this way, the seller is in roughly the same position as it would have been in had it not engaged in the disqualified transfer at all.

While there may be some logic to these arguments, they are completely inconsistent with the general transfer rule as applied to a sale at or above basis. In that case, disqualified basis is eliminated specifically to the extent it reduces taxable income. In this case, there is seemingly no concern with permitting the buyer to obtain qualified basis even to the extent the seller has benefited from its disqualified basis by reducing its gain on the sale and receiving cash in the same amount.

If this interpretation of the Final Regulations is correct, the difference in the treatment of gain and loss transactions produces extremely illogical results. Assume a property has qualified basis of $0 and disqualified basis of $100. If the property is sold for $99.99 in cash, the loss rule applies and the buyer has disqualified basis of $99.99. If the property is sold for $100.00 in cash, the loss rule does not apply, and under the general rule that reduces disqualified basis to the extent it reduces taxable income, the buyer would have $0 disqualified basis. Surely such totally different results from a $.01 difference in sale price cannot be the intent of the Final Regulations.

Moreover, if this interpretation is correct, disqualified basis would have to be traced through taxable sales of assets at a loss between unrelated parties, even in successive taxable sales. The same would be true following a Section 338(g) election for a CFC. The concept of tracing a tax attribute of an asset through a taxable purchase of property is unprecedented.

Under these rules, if disqualified basis arose in the asset as a result of a transaction in the disqualified period, current disqualified basis in the asset could be determined only by knowing all prior sales prices of the asset since the beginning of the disqualified period. All disqualified basis would permanently disappear any time the asset was sold to an unrelated party for its basis or at a gain, and any remaining disqualified basis would "ratchet down" any time that the asset was sold to an unrelated party for less than the seller's basis. In order for any purchaser of property to know for sure the extent, if any, of disqualified basis in the property, it would need to either:

(i) know the history of all past sales and sale prices of the property since the beginning of the disqualified period (including whether the sales were to related or unrelated parties),

(ii) have assurance of the lack of disqualified basis in the first place, or

(iii) know of a sale of the property to an unrelated party at its basis or at a gain at some time in the past.

If this is the intended result, it should be confirmed specifically in regulations. However, in that event, we urge that serious reconsideration be given to this result in light of the administrative difficulties that would arise. One possibility would be to eliminate disqualified basis on a sale at a loss to an unrelated party, subject to an anti-abuse rule and/or a per se rule that would reverse this result if the transferee disposed of the property at a loss within a specified period of time (e.g., 5 or 7 years). However, we acknowledge that such a rule would not deal with the potential benefit to the transferee of increased depreciation deductions as a result of disqualified basis.

If the property is sold to a related party at a loss, then under the related party transfer rule, the disqualified basis would remain in the property except to the extent that the transferor had a loss that was attributable to such basis. In Example 8, if P was sold for $95 to a related party, the $5 loss would be attributable to disqualified basis, so the property would have $60 of qualified basis and $35 of disqualified basis in the hands of the related transferee. This result is logical and should be confirmed by regulations.

(iii) *Fully nontaxable Section 351 transactions*

We turn now to fully nontaxable transactions. We first discuss this issue in the context of Section 351 transactions.

> Example 9. Fully nontaxable nonrecognition transaction. In Example 7, instead of CFC1 selling P for cash, CFC1 transfers P to corporation X in exchange for X stock in a Section 351 transaction. CFC1's basis in the X stock received is equal to its basis in P ($100)[55] and X's basis in P is equal to CFC1's basis in P ($100).[56]

Under the exchanged basis property rule, regardless of whether X is related to CFC1, the X stock received by CFC1 is exchanged basis property, and so it has a disqualified basis equal to the disqualified basis of the transferred property. Thus, the X stock in the hands of CFC1 has a qualified basis of $60 and a disqualified basis of $40. This result makes sense.

Consider now the disqualified basis of P in the hands of X. If X is related to CFC1 immediately before or after the transfer, then it is clear that under the related party

[55] Section 358(a).

[56] Section 362(a).

transfer rule, X has a disqualified basis of $40 in P. This rule is necessary to carry out the purposes of the disqualified basis rule. Otherwise, instead of CFC1 selling P directly to a third party at a disallowed loss, CFC1 could transfer P to a wholly owned subsidiary CFC2 in a Section 351 transaction, and CFC2 could sell the property at an allowed tested loss.

Now consider the case where the transferee X in the nonrecognition transaction is not related to CFC1. The general transfer rule does not apply to reduce disqualified basis in the property because that basis has not reduced any gain. As a result, it appears that the disqualified basis in P in the hands of CFC1 remains in P in the hands of X, since there is nothing in the Final Regulations to eliminate that disqualified basis. If that is the intent, regulations should make it explicit that the general transfer rule is the exclusive means for disqualified basis in property to be reduced in the hands of a transferee.

This rule can be quite burdensome, since it means that disqualified basis must be traced through property as it is the subject of tax-free exchanges, potentially forever in the case of nondepreciable property such as land. On the other hand, regular tax basis must be tracked in the same manner.

The rationale for this rule might be to prevent monetization of disqualified basis. If disqualified basis in transferred property was eliminated on a tax free transfer to an unrelated party, the transferor could transfer the property to an unrelated party in a Section 351 or other tax free transaction for stock or other consideration. Since the transferee could sell or depreciate the property without a penalty for disqualified basis, the transferee would likely be willing to provide consideration to the transferor that reflects a portion of this benefit to the transferee.

If this is the purpose for the rule, consideration should be given to a rule that eliminates disqualified basis on a tax-free transfer to an unrelated party, subject to an anti-abuse rule and/or a per se rule that would reverse this result if the transferee disposed of the property at a loss within a specified period of time (e.g., 5 or 7 years).

(iv) *Fully nontaxable Section 1031 transactions*

Consider a like kind exchange under Section 1031 without boot, where only one property has disqualified basis.

> Example 10. Section 1031 exchange without boot; disqualified basis in only one asset. Suppose CFC1 has land (P1) with a qualified basis of $60 and disqualified basis of $40, and X has land (P2) with a qualified basis of $60 and no disqualified basis. Both properties have the same value, and they are exchanged in a like kind exchange. CFC1 will acquire a basis of $100 in P2.

Under the exchanged basis property rule, whether or not CFC1 and X are related, CFC1 will continue its disqualified basis of $40 in P2.

Now consider X's disqualified basis in P1. X's total basis in P1 is a substituted basis of $60. If CFC1 and X are unrelated, it appears that under the general transfer rule, the basis in P1 has been "otherwise reduced or eliminated" (other than through a taxable transaction), and so the $40 aggregate basis reduction in P1 is allocated proportionately between disqualified and qualified basis. X would then have disqualified basis of $24 and qualified basis of $36. So far, the results are reasonable, assuming the basic concept is accepted that disqualified basis can carry over to an unrelated party in a nontaxable transaction.

Now, consider X's disqualified basis in P1 if CFC1 and X are related. Under the related party transfer rule, disqualified basis in property is not reduced "except to the extent" a loss is recognized on a sale (with losses first allocated to disqualified basis) or the basis is reduced or eliminated in a nonrecognition transaction. However, *the related party transfer rule does not have a pro rata rule for basis reductions in nonrecognition transactions*. Moreover, the "except to the extent" language makes it clear that in the absence of a specific pro rata rule, there is a full reduction in disqualified basis. As a result, the full basis reduction of $40 in P1 is allocated first to the old disqualified basis of $40, leaving X with basis of $60 in P1 that is entirely qualified basis. Related party X, which ends up with no disqualified basis, is better off than in the preceding case where unrelated X had disqualified basis of $24.[57]

Surely the intent of the related party transfer rule is not to put a related party transferee in a better position (with less disqualified basis) than an unrelated party transferee. The regulations should modify the related party transfer rule to apply the same pro rata rule to reductions in basis in nonrecognition transactions as applies in transfers to unrelated parties.

Finally, consider a like kind exchange without boot where both properties have disqualified basis.

> Example 11. Section 1031 exchange without boot; both properties have disqualified basis. CFC1 owns P1 with qualified basis of $60 and disqualified basis of $40, as in Example 10. In addition, CFC2 owns P2 with qualified basis of $30 and disqualified basis of $70. On a like kind exchange of P1 and P2, CFC1 will acquire a basis of $100 in P2, and CFC2 will acquire a basis of $100 in P1.

Consider CFC1's disqualified basis in P2. This is a puzzle, because in the hands of CFC1, P2 is both transferred property with disqualified basis that is subject to the general transfer rule, and substituted basis property subject to the exchanged basis property rule. The same puzzle arises for CFC2's disqualified basis in P1. Note that on these facts, there is no reduction in the basis of either property, so the special rules for basis reduction do not apply.

---

[57] This same problem arises for basis reductions under the Code sections specifically referred to in the related party transfer rule, namely Sections 362(e), 732(a), and 732(b).

As an initial matter, under the general transfer rule, CFC1 takes P2 with CFC2's disqualified basis of $70 in P2. Then, under the exchanged basis property rule, CFC1's disqualified basis in P2 "includes" its former disqualified basis of $40 in P1. We also know that if CFC1 and CFC2 are related, the disqualified basis in P2 cannot be reduced.

It would not make sense for CFC1's disqualified basis in P2 to be the sum of CFC1's disqualified basis in P1 and CFC2's disqualified basis in P2. In that case, the disqualified basis in both P1 and P2 would be $100. One alternative would be a rule that in a tax-free exchange of properties with disqualified basis to both parties, the disqualified basis in each property is the greater of the disqualified basis that applies under either the general transfer rule (as modified by the related party transfer rule, if applicable) or the exchanged basis property rule. Here, CFC1 would have a disqualified basis of $70 in P2, and CFC2 would have a disqualified basis of $70 in P1. It is true that such a rule increases the total disqualified basis in the system, but that is true for any nonrecognition transaction as in Example 9.[58]

(v) *Section 351 transactions with boot equal to built-in gain*

Consider next the case of a nonrecognition Section 351 transaction where boot is equal to the appreciation in value of the property.

> Example 12. Section 351 transaction with boot equal to built-in gain. CFC1 transfers property P (qualified basis $60, disqualified basis $40, value $150) to X in exchange for $50 in cash and $100 worth of X stock. CFC1 has taxable gain of $50, the full built-in gain on the asset. CFC1's basis in the X stock is $100, calculated as CFC1's basis in P ($100), reduced by the amount of cash received ($50) and increased by the amount of gain recognized ($50). X's basis in P is $150, calculated as CFC1's basis in P ($100), increased by the amount of gain CFC1 recognized ($50).

These gain and basis results are exactly the same as if the transaction had been fully taxable, i.e., where CFC1 had simply sold P to X for $50 of cash and $100 worth of X stock in a "busted" Section 351 transaction. In that case, as discussed in Part III.A.3(b)(i), the disqualified basis would not exist in the X stock issued to CFC1, and if X was unrelated to CFC1, X would not have any disqualified basis in P.

However, it does not appear that the transaction in Example 12 has these results. Assume X is unrelated to CFC1 and consider the disqualified basis of P in the hands of X. Under the general transfer rule, the disqualified basis of $40 only is eliminated to the extent the disqualified basis either (i) reduces taxable income, or (ii) is otherwise reduced

---

[58] The complexities would be greater if, say, the total basis of P1 to CFC1 was less than the basis of P2 to CFC2. In that case, on the exchange, the basis of P2 would decrease and the basis of P1 would increase. This could result in a pro rata reduction in disqualified basis in P2 under Treas. Reg. § 1.951A-3(h)(2)(ii)(B)(1)(i) (because basis in P2 is "otherwise reduced or eliminated"), and an equal increase in the disqualified basis in P1 under Treas. Reg. § 1.951A-3(h)(2)(ii)(B)(2)(i). Then, the exchanged basis property rule could be applied as in the text.

or eliminated, provided that if the aggregate basis reduces taxable income or is otherwise reduced or eliminated, qualified basis and disqualified basis are reduced proportionately.

In the example, there is no reduction in the total basis of P, so clause (ii) of the preceding paragraph does not apply. As to clause (i), as a literal matter, *none* of the basis in P reduced the taxable gain of $50 to CFC1. After all, the taxable gain would have been $50 even if P had a $0 basis to CFC1. Under this interpretation, since none of the disqualified basis reduces the taxable income of CFC1, X has a disqualified basis of $40 in P.

Similarly, CFC1's basis in the X stock is determined in *whole or in part* by reference to CFC1's former basis in P (i.e., P basis, reduced by cash received, increased by gain recognized). Thus, the X stock is exchanged basis property. Under the exchanged basis property rule, CFC1 has a disqualified basis of $40 in that stock.

This interpretation of the Final Regulations obviously makes no sense. All the built-in gain in P has been recognized by CFC1 in both the taxable and Section 351 transactions. In this fact pattern, the end results for taxable gain and tax basis are identical in both cases. It is merely a quirk of the different formulas for gain recognition and basis calculation for taxable and tax-free transactions that these same results are reached in different ways for taxable and tax-free transactions. The differences in methodology should not mean that disqualified basis continues to both the transferor and transferee in a transaction that is in fact fully taxable to the transferor.[59]

We acknowledge that under this proposal, a small amount of boot could result in the elimination of a large amount of disqualified basis. For example, assume CFC1 has $0 qualified basis and $99 disqualified basis in P, and P is worth $100. A Section 351 transfer to X for $100 of X stock would result in X having disqualified basis of $99 in P. On the other hand, a Section 351 transfer to X for $99 in X stock and $1 in cash would, under our proposal, provide X with no disqualified basis in P, since CFC1 would recognize the entire built-in gain of $1 on P.

The underlying anomaly is created by the Final Regulations, not by our proposal. The regulations distinguish between (1) a taxable sale of P for $100 of stock, or $99 of stock and $1 of cash, in which case disqualified basis of $99 disappears, and (2) a tax free Section 351 transaction for $100 of stock, in which case disqualified basis of $99 remains. Our fact pattern, a Section 351 transaction for $99 of stock and $1 of cash, is as an economic matter either $0 or $1 in cash apart from all of these alternative transactions. As a result, we do not see any policy justification for continuing the disqualified basis in this fact pattern where all the taxable gain (as small as it is) is recognized, particularly

[59] Having said that, we acknowledge that there is at least one other area of the Code where taxpayers engaging in a Section 351 transaction in which all the transferor's gain is recognized still cannot take advantage of a benefit available to taxpayers engaging in a fully taxable transaction. Taxpayers engaging in Section 351 transactions are not eligible to make an election under either Section 336(e) or Section 338(g), regardless of how much gain is recognized, whereas taxpayers engaging in Section 1001 transactions can make these elections. Moreover, even in Example 12, X obtains a carryover holding period in P under Section 1223(2), which would not be the case in a taxable purchase.

since the termination of disqualified basis only arises when the transferee X is an unrelated party.

(vi) *Section 351 transactions with boot in excess of built-in gain*

Now consider the case where the boot in a Section 351 transaction exceeds the built-in gain in the asset.

> Example 13. Section 351 transaction with boot greater than built-in gain. Same facts as Example 12, except the boot is $70 and the X stock has a value of $80. CFC1 still has taxable gain of $50, the full built-in gain on the asset. CFC1's basis in the X stock is $80, calculated as CFC1's basis in P ($100), reduced by the amount of cash received ($70) and increased by the amount of gain recognized ($50). X's basis in P is $150, calculated as CFC1's basis in P ($100), increased by the amount of gain CFC1 recognized ($50).

Under the general transfer rule, disqualified basis is reduced to the extent it reduces taxable gain. Here, $20 of the $100 total basis reduced the gain, because if the basis had only been $80, the taxable gain would be $70 rather than $50. Then, under the general transfer rule, the $20 of basis that reduced the gain would be allocated proportionately between disqualified basis and qualified basis to reduce disqualified basis in P.

However, in this case as in the case with $50 of boot, the result is in substance a fully taxable transaction with gain recognized equal to the full built-in gain of $50 in the asset. All of the disqualified basis of P in the hands of X should be eliminated, and none should arise in the stock of X.

(vii)*Section 351 transactions with partial gain recognition*

A similar issue arises in a Section 351 nonrecognition transaction where the boot is sufficient to cause recognition of some but not all the built-in gain in the asset.

> Example 14. Section 351 transaction with partial gain recognition. CFC1 transfers property P (qualified basis $60, disqualified basis $40, value $150) to unrelated X in exchange for $20 in cash and $130 worth of X stock. CFC1 recognizes $20 gain. CFC1's basis in the X stock is $100, calculated as its basis in P ($100), reduced by the amount of cash received ($20) and increased by the amount of gain recognized ($20). X's basis in P is $120, calculated as CFC1's basis in P ($100), increased by the amount of gain CFC1 recognized ($20).

In this case, the total built-in gain in P was $50, and $20 of gain (40% of the total) was recognized. However, none of CFC1's $40 of disqualified basis in P reduced the CFC1 gain on P, because the taxable gain of $20 would have been the same even if that basis did not exist. Likewise, the X stock is exchanged basis property to CFC1.

Therefore, under the general transfer rule and the exchanged basis property rule, the results are exactly the same as in the fully nontaxable transaction. The full amount of disqualified basis to CFC1 would remain in P in the hands of X and would become disqualified basis in the X stock in the hands of CFC1, even though CFC1 and X are unrelated.

In a tax-free exchange in which no gain is recognized, it is clear under the Final Regulations that X would acquire disqualified basis in P equal to the disqualified basis that CFC1 had in P, and CFC1 would have disqualified basis in the X stock equal to its old disqualified basis in P. Likewise, in a tax-free exchange in which 100% of the gain is recognized, we believe that disqualified basis should completely disappear to both X and CFC1. Thus, we believe that in a tax-free exchange in which 40% of the gain is recognized, 40% of the disqualified basis should disappear to both CFC1 and X. Therefore, we believe that the X stock in the hands of CFC1 should have disqualified basis equal to the original disqualified basis of $40 reduced by 40% of $40, or $16, resulting in disqualified basis of $24. Likewise, unrelated X should have disqualified basis of $24 in P.

(viii) *Conclusions for disqualified basis for built-in gain assets*

We believe that the Final Regulation should be revised to make clear that in a nonrecognition transaction with an unrelated party with full or partial gain recognition, for purposes of determining disqualified basis, the transaction should be recharacterized as a part sale/part nonrecognition transaction. If the gain recognized equals a specified percentage of the total built-in gain in the asset, then under the general transfer rule, the same percentage of the total basis should be treated as reducing the gain on the asset, and a proportionate amount of the disqualified basis in the asset in the hands of the transferee should be eliminated.

Likewise, under the exchanged basis property rule, the reference to basis being determined "in whole or in part" by reference to the basis of the transferred property should be clarified. To the extent that the determination of the basis of the property received by the transferor takes into account gain recognized by the transferor, the property should not be treated as exchanged basis property. Thus, a portion of the property received (equal to the transferor's percentage of realized gain that is recognized) should be treated as received in a fully taxable exchange with no disqualified basis. The remaining portion of the property received should be treated as exchanged basis property with disqualified basis determined as if it was received in exchange for the portion of the transferred property deemed to be exchanged in a tax-free transaction.

(ix) *Assets with built-in loss*

Finally, consider the case of a depreciated asset that is transferred to an unrelated party in a Section 351 transaction with boot.

Assume first that the boot is not in excess of qualified basis.

> Example 15. Section 351 transaction of built-in loss property, boot not in excess of qualified basis. CFC1 has a qualified basis of $60 in P and a disqualified basis of $40, and P has a value of $90. CFC1 transfers P to unrelated X for stock worth $40 and cash of $50. CFC1 has no taxable gain or loss. X has a basis of $100 in P (carryover basis) and CFC1 has a basis of $50 in the X stock (basis in P of $100 minus cash received of $50).

As to CFC1, its basis in the X stock is determined by reference to its basis in P. Thus, the exchanged basis property rule applies. It would cause CFC1 to retain its old disqualified basis of $40 in the X stock, and its qualified basis in that stock is $10. In substance, the cash boot has reduced the qualified basis but left the nonqualified basis unchanged.

This result makes sense, since the theory of the Final Regulations is that CFC1 should not be able to take advantage of its disqualified basis in P. To the extent that the cash received is no more than the qualified basis in P, CFC1 has not taken advantage of that disqualified basis. However, in that case, if any of CFC1's old disqualified basis in P did not carry over to CFC1's basis in the X stock, CFC1 would be taking advantage of the old disqualified basis in P in the guise of qualified basis in the X stock.

Now consider the result to X under the general transfer rule. The question under that rule is how much of CFC1's basis of $100 either (i) reduced its taxable gain or (ii) is otherwise reduced or eliminated. The $90 value of P is a given.

Since X has a carryover basis in P, none of CFC1's basis in P is reduced or eliminated, so there is no reduction in disqualified basis in P under the general transfer rule. CFC1's taxable gain under Section 351(b) is the lesser of economic gain (FMV $90 minus basis) or boot ($50). To the extent CFC1's basis is above $90, there is an economic loss and so there is no taxable gain regardless of the amount of cash. Likewise, the full amount of cash of $50 is recognized as long as the basis is $40 or below, since then the lesser of economic gain and cash is always $50. As the amount of basis decreases from $90 to $40, the taxable gain increases from $0 to $50.

It appears, therefore, that the portion of the basis that reduces taxable gain is the basis between (1) the fair market value of the property and (2) such fair market value reduced by the boot received. Note that clause (2) is equal to the value of the stock in X received by CFC1. Under this interpretation, CFC1's basis between $40 and $90 (i.e., $50 of its basis) reduces its taxable gain. This is 50% of the basis of $100. Therefore, under the general transfer rule, 50% of the disqualified basis of $40 would be eliminated. X would have disqualified basis of $20 in P and qualified basis of $80.

Another way to think about this result is that X's $100 basis in P is made up of:

(i) an amount equal to the excess of CFC1's basis over the value of P (i.e., CFC1's loss, or $10) and

(ii) an amount equal to P's value ($90), which is itself made up of an amount equal to the boot X paid in the transaction ($50) and an amount equal to the stock X paid in the transaction ($40).

The basis in (i) is partially disqualified, in proportion to the total amount of disqualified basis P had in CFC1's hands (40% of $10, or $4). As to the basis in (ii), the basis equal to the boot ($50) is not disqualified and the basis equal to the value of the stock X paid in the transaction ($40) is partially disqualified, in proportion to the total amount of disqualified basis P had in CFC1's hands (40% of $40, or $16). In the aggregate, X has $20 of disqualified basis in P.

Finally, suppose the boot is more than the qualified basis but less than total basis.

> Example 16. Section 351 transfer of built-in loss property, boot in excess of qualified basis. Same facts as Example 15, except the boot is $70 and the stock is worth $20. CFC1 has a basis of $30 in the X stock (basis in P of $100 minus boot of $70).

Under the exchanged basis property rule, CFC1's disqualified basis in the X stock includes its old disqualified basis in P of $40. This leaves no basis in the X stock to be qualified basis. This is consistent with the result in Example 15, where the qualified basis in the X stock was reduced by the full amount of cash.

However, this leaves a quandary. CFC1's *total* basis in the X stock is only $30, but the exchanged basis property rule says that the disqualified basis in the X stock includes disqualified basis of $40 from P. Surely disqualified basis cannot exceed total basis, since there is no tax benefit arising from such excess that can be denied. As a result, perhaps CFC1 simply has a basis of $30 in the X stock consisting solely of disqualified basis. This on its face is a "free" reduction of disqualified basis of $10 (the excess of the boot of $70 over the qualified basis of $60) accompanied by the tax-free receipt of $10 of the boot.

This result of a transferor receiving tax-free cash for property in exchange for the elimination of disqualified basis in the property to the transferee is consistent with the result arising in a taxable sale of property at a gain. In that case, the transferor can benefit from its disqualified basis in the property by receiving cash and using the disqualified basis to reduce its taxable gain (and tested income). On the other hand, this result is arguably inconsistent with the fact that on a taxable sale at a loss, disqualified basis to the purchaser is only reduced to the extent of the seller's loss, and not by the amount of disqualified basis that reduced the seller's taxable gain.

Regulations should clarify that the disqualified basis in an asset cannot exceed the total basis of the asset.

4. Entity Treatment of Partnerships for Section 1248 Purposes

(a) *Background*

The Final Regulations state that the aggregate treatment of domestic partnerships is solely for purposes of Section 951A and of any other provision that applies by reference to a GILTI inclusion amount.[60] The Final Regulations Preamble states that aggregate treatment applies for purposes of Sections 959 and 961, but not for purposes of other provisions of the Code and, in particular, Section 1248(a).[61] The preamble to the Proposed Regulations (the "**Proposed Regulations Preamble**") also states that the aggregate treatment proposed in those regulations for purposes of determining Subpart F inclusions does not extend to Section 1248.[62]

The Proposed Regulations Preamble asks for comments on provisions of the Code that refer to Section 958(a) ownership for which aggregate treatment of domestic partnerships would be appropriate.[63] Section 1248 is partly based on Section 958(a) ownership, and aggregate treatment of domestic partnerships would be very relevant for gain attributable to untaxed GILTI and Subpart F income. Thus, this Section of the Report discusses the position in the Final Regulations and the Proposed Regulations that aggregate treatment of domestic partnerships does not apply for purposes of Section 1248, and also discusses related issues involving foreign partnerships.

(b) *Current Law after Finalization of Proposed Regulations*

Direct ownership of CFC. If a U.S. shareholder of a CFC sells stock in the CFC, a portion of any gain equal to the e&p attributable to the stock (and accumulated during the seller's period of ownership) is recharacterized under Section 1248(a) as a dividend (subject to certain limitations in the case of an individual seller under Section 1248(b)).[64] If the U.S. shareholder is a domestic corporation and has held the CFC stock for one year or more, the resulting deemed dividend is a dividend for purposes of Section 245A.[65]

Domestic partnership ownership of CFC. When a domestic partnership sells stock of a CFC, entity principles apply for purposes of Section 1248. In particular, when a domestic partnership that is a U.S. shareholder in a CFC (a "**U.S. shareholder**

---

[60] Treas. Reg. § 1.951A-1(e)(1).

[61] Final Regulations Preamble at 29316.

[62] REG-101828-19, Federal Register Vol. 84, No. 120, June 21, 2019, at 29119. Page references hereinafter to the Proposed Regulations Preamble are to this volume of the Federal Register.

[63] Id.

[64] The e&p taken into account under this provision must have been accumulated in tax years beginning after December 31, 1962, during the U.S. shareholder's ownership period and while the CFC was a CFC. Throughout the remainder of the discussion in this Part III.A.4 we assume that each CFC's e&p meets these requirements.

[65] Section 1248(j).

partnership") sells stock in the CFC at a gain, the partnership has a deemed dividend under Section 1248 to the extent of the CFC's e&p. That dividend is allocated to all the partners of the partnership, both the partners that are themselves U.S. shareholders in the CFC ("**U.S. shareholder partners**") and the partners that are not themselves U.S. shareholders in the CFC ("**non-U.S. shareholder partners**").

By contrast, when any partner sells an interest in a U.S. shareholder partnership, Section 1248 does not apply directly to the partner because the partner has not sold (and is not deemed to have sold) CFC stock. Rather, the partner's gain or loss is capital, except to the extent it is attributable to inventory or "unrealized receivables."[66] Under Section 751, gain is attributable to an unrealized receivable, and is taxed as ordinary income, to the extent the partnership would have gain subject to Section 1248(a) if it sold the stock of the CFC for fair market value.[67] Since the Section 751(a) gain is not specifically treated as a dividend under the language of the statute and the regulation, commentators believe the partner (whether or not a U.S. shareholder partner) is not eligible for Section 245A.[68] This means, for example, that gain on the sale of the partnership interest that is attributable to untaxed income of the CFC (such as income exempt under the QBAI rules) is taxed at ordinary income rates, even though such gain would not be taxed at all to a corporate U.S. shareholder partner (because of Section 245A) if the partnership sold the CFC or if the CFC distributed the untaxed income.[69] Moreover, since the Section 751 gain is not a Subpart F or GILTI inclusion, no foreign tax credits are available on the gain.[70]

Foreign partnership ownership of CFC. On a sale of stock in a CFC by a foreign partnership, Section 1248 applies by treating the foreign partnership as an aggregate.

---

[66] Section 741.

[67] Section 751(c); Treas. Reg. § 1.751-1(c)(4)(iv) (stating that the Section 751 amount includes "the potential gain...that would be treated as gain to which section 1248(a) would apply if....the stock were sold by the partnership at its fair market value").

[68] Section 751(a), Treas. Reg. § 1.751-1(a). See McKee, Nelson & Whitmire, Federal Taxation of Partnerships and Partners, ¶ 17.03[3][f] (Thomson Reuters/Tax & Accounting, 4th ed. 2007 & Supp. 2019-3); Farmer, Huffman, Jackel & Hintmann, "Partnership Dispositions of Stock in Controlled Foreign Corporations," 110 Tax Notes 1319, at 1335-1336 (Mar. 20, 2006).

We assume this interpretation of the statute and the regulation is correct, namely, that Section 751(a) gain is not a dividend, in the remainder of this Part III.A.4. To the extent any other interpretation is possible, it would not, absent confirmation, provide the assurance of the deemed dividend treatment that we request herein.

[69] The Section 245A Regulations do not deny the benefits of Section 245A in this situation. Treas. Reg. § 1.245A-5T(e)(1)(ii).

[70] Section 960. Even before its repeal, Section 902 would not have allowed indirect foreign tax credits to the partner because the partner's Section 751 income is not a dividend.

There is a direct Section 1248 inclusion to partners of the foreign partnership that are U.S. shareholders of the CFC.[71]

However, it appears that entity treatment applies if a partner of a foreign partnership sells its interest in the foreign partnership. Section 1248 does not apply directly because a U.S. person is not directly selling stock in a CFC. Under the Section 751 regulations, a partner selling an interest in a domestic or foreign partnership has ordinary income (not a deemed dividend under Section 1248) to the extent that there would be Section 1248 gain if the partnership sold the stock of the CFC.[72] When this regulation is combined with the rule in the preceding paragraph, the result appears to be that the partner has Section 751(a) gain in an amount equal to the Section 1248 amount that the partner would have had if the foreign partnership had sold the stock of the CFC.

(c) *Discussion*

These rules for sales of CFCs by partnerships were consistent at a time when Subpart F inclusions and GILTI inclusions all occurred at the level of a domestic partnership or the level of a U.S. shareholder of a foreign partnership. It was then generally logical for Section 1248 to also apply at the same level as the inclusion, and for Section 751(a) to apply to built-in Section 1248 ordinary income of a partnership to the same extent it applied to most other built-in ordinary income of the partnership. However, even then, it was not logical for a U.S. shareholder partner not to be entitled to foreign tax credits from the CFC on the partner's sale of partnership interests.

After the Proposed Regulations are finalized, GILTI and Subpart F inclusions will occur only at the partner level and never at the domestic partnership level. U.S. shareholder partners holding through either a domestic or foreign partnership will have those inclusions directly from the CFC, and non-U.S. shareholder partners will not have any such inclusions at all. Continuing to apply entity treatment to partnerships as under current law for purposes of Section 1248 will have the following results:

(i) Non-U.S. shareholder partners holding through domestic or foreign partnerships will have no GILTI or Subpart F inclusions for current income of the CFC. However, if they hold through a domestic partnership, they will continue to have Section 1248 ordinary income on accumulated untaxed income of the CFC when the partnership sells stock of the CFC, and Section 751(a) ordinary income when they sell interests in the partnership.

(ii) U.S. shareholder partners holding through domestic or foreign partnerships will have direct GILTI and Subpart F inclusions for current income of the CFC, Section 1248 ordinary income on accumulated untaxed income of the CFC when the partnership sells stock of the CFC, and Section 751 ordinary income when they sell interests in the partnership. For corporate U.S. shareholder

[71] Treas. Reg. § 1.1248-1(a)(4).

[72] Treas. Reg. § 1.751-1(c)(4)(iv).

partners, the Section 1248 ordinary income will be eligible for Section 245A, and thus will in effect be exempt from tax, except as limited by the Section 245A Regulations in certain cases involving current year GILTI or Subpart F income.

These results, assuming the Proposed Regulations are finalized, can be summarized as follows.

CURRENT LAW INCLUDING PROPOSED REGULATIONS

	Current CFC Income	**Sale of CFC**	**Sale of Partnership Interest**
U.S. shareholder			
holds CFC directly	direct inclusion	§ 1248 applies directly	not applicable
holds CFC through U.S. shareholder partnership	direct inclusion	§ 1248 allocation from partnership	§ 751(a)
holds CFC through foreign partnership	direct inclusion	§ 1248 applies directly	§ 751(a)
Domestic non-U.S. shareholder			
holds CFC directly	no inclusion	capital gain; § 1248 not applicable	not applicable
holds CFC through U.S. shareholder partnership	no inclusion	§ 1248 allocation from partnership	§ 751(a)
holds CFC through foreign partnership	no inclusion	capital gain; § 1248 not applicable	capital gain; § 1248 not applicable

These results are extremely peculiar. As to domestic non-U.S. shareholder partners holding interests in a U.S. shareholder partnership, the same earnings that are not included currently as ordinary income will create an allocation of Section 1248 ordinary income to them on a sale of the CFC by the partnership, and ordinary income to them under Section 751 on their sale of their partnership interest. Section 245A will not apply

in the former case because the shareholder is not a U.S. shareholder,[73] or in the latter case because there is no deemed dividend. Once the decision has been made not to tax non-U.S. shareholder partners on current earnings, it is anomalous to tax them on a sale of the CFC stock at ordinary income rates under Section 1248 or Section 751, *but only if they hold their interests in the CFC through a U.S. shareholder partnership*.

As to U.S. shareholder partners in a domestic or foreign partnership, their current inclusion of Subpart F and tested income is consistent with them having Section 1248 income when the partnership sells stock in the CFC. Section 245A will apply to the deemed dividend on a sale except as limited by the Section 245A Regulations.[74] However, when they sell interests in the domestic or foreign partnership, the application to them of Section 751(a) (and denial of Section 245A) rather than Section 1248 (with Section 245A generally allowed) does not seem consistent with their direct inclusion of Subpart F income and tested income. Again, given the direct inclusions, the application of Section 751 seems especially peculiar because it only applies when the interest in the CFC is held through a partnership, and the main point of direct inclusions is to bypass the partnership.

> Example 17. Sale of a CFC by a U.S. Shareholder Partnership with a Non-U.S. Shareholder Partner. U.S. corporation US1 owns 5% of domestic partnership USP, which, in turn, owns 100% of CFC. There is $50 built-in gain in US1's partnership interest and $1,000 built-in gain in USP's CFC stock. CFC has at least $1,000 e&p. Under the Final and Proposed Regulations, US1 will not include any of CFC's Subpart F income or GILTI items in income.[75]
>
> If USP sells CFC, it will recognize all $1,000 built-in gain. This gain will be recharacterized as a dividend under Section 1248(a). US1 will be allocated $50 of the deemed dividend and will not be entitled to a Section 245A deduction because it is not a U.S. shareholder of CFC.
>
> If US1 sells its interests in USP for fair market value, it will recognize $50 built-in gain, and all $50 will be treated as ordinary income under Section 751(a) (because this is the amount that would be recharacterized as a dividend under Section 1248(a) if USP sold CFC at its fair market value[76]). US1 is not a U.S. shareholder of CFC and, in any event, this

---

[73] Section 245A(a) and (b)(1).

[74] In the case of the CFC owned by a U.S. shareholder partnership, the U.S. shareholder partner is eligible for the Section 245A deduction even though it is not a Section 958(a) U.S. shareholder of the CFC. It is a U.S. shareholder of the CFC by virtue of its Section 958(b) constructive ownership, and this is sufficient for Section 245A to apply. Sections 245A(a) and (b)(1).

[75] Prop. Treas. Reg. § 1.951-1(a)(4) and -1(d)(1), Treas. Reg. § 1.951A-1(e). US1 owns only 5% of the CFC stock through USP, so it is not a U.S. shareholder for this purpose.

[76] Section 751(c); Treas. Reg. § 1.751-1(c)(4)(iv).

> amount is not considered a dividend, so US1 is not entitled to a Section 245A deduction.

Now consider the results where US1 is a U.S. shareholder partner.

> Example 18. Sale of a CFC by a U.S. Shareholder Partnership with a U.S. Shareholder Partner. Assume the same facts as in Example 17, except that US1 owns 10% of USP and has $100 built-in gain in its USP interests. If USP sells CFC for its fair market value, US1's $100 allocable share of the gain is recharacterized as a dividend under Section 1248(a) and US1 is entitled to a Section 245A deduction (subject to the Section 245A Regulations) because it is a U.S. shareholder of CFC.

In this case, since US1 is a U.S. shareholder partner, it must include its share of CFC's tested income and Subpart F income currently, so it is logical that those earnings would cause a portion of its allocable share of the gain on a sale of CFC by USP to be recharacterized as a dividend under Section 1248(a). Indeed, if US1 held its 10% interest in CFC directly, its gain on a sale would be recharacterized as a dividend under Section 1248(a) and US1 would be entitled to a $100 Section 245A deduction subject to the Section 245A Regulations.

Alternatively, if US1 sells its USP interests, US1 recognizes $100 built-in gain and all $100 is recharacterized as ordinary income under Section 751(a) (because this is the amount that would be recharacterized as a dividend under Section 1248(a) if USP sold CFC at its fair market value[77]). However, US1 is not entitled to a Section 245A deduction because it has not received a dividend or a deemed dividend.

We do not believe this latter result is appropriate. Broadly speaking, Section 751(a) is designed to prevent a partner selling its partnership interest from obtaining a better tax result (capital gain rather than ordinary income) than if the partnership had sold its assets and allocated the gain to the partners. Creating ordinary income at the partner level equal to the partnership-level gain on a hypothetical sale of partnership assets makes sense in the typical situation to which Section 751(a) applies.

However, there is no indication that Section 751(a) was intended to put a partner selling its partnership interest in a materially *worse* position than if the partnership had sold the underlying asset. Yet this consequence arises in the treatment of Section 1248 gain as an unrealized receivable under Section 751(c). An actual sale of CFC stock by a domestic or foreign partnership would not only result in ordinary income to U.S. shareholder partners of a domestic or foreign partnership, but would have collateral consequences that are favorable to taxpayers – a foreign tax credit in the past, a potential Section 245A deduction today, and a reduction in the earnings and profits of the CFC.

The Section 245A deduction, when available, means that the Section 1248 gain is exempt from tax, and, as noted above, the deduction is available whenever the increase in

---

[77] Id.

value in the stock of the CFC is attributable to untaxed income of the CFC, such as income exempt by QBAI. In contrast, the ordinary income that arises under Section 751 is not subject to any offsetting deduction. Thus, Section 751 converts exempt income that would arise on a sale of the CFC stock by the partnership, into taxable ordinary income on a sale of a partnership interest. We are not aware of any other situation where Section 751 has such an adverse effect as compared to a partnership sale of assets.

By adopting Section 1248(j) in the Act, Congress indicated a clear intent that the gain on a sale of the stock of a CFC should be eligible for a Section 245A deduction if the other conditions of that section are satisfied. If entity treatment applies for purposes of applying Section 751(a) to a domestic or foreign partnership, Section 751(a) puts the partner in a worse position than if the partnership had sold the CFC stock directly. We believe this is inconsistent with the purposes of both Section 751(a) and 1248(j).

Current law is also anomalous in that Section 751(b), relating to partnership distributions that involve an exchange of unrealized receivables for other partnership assets, or vice versa, by its terms creates a deemed sale of the underlying partnership assets. If a partnership holds a CFC, an actual dividend under Section 1248 is considered to arise in the Section 751(b) context.[78] As a technical matter, this result can be justified by differences in the statutory language between Sections 751(a) and (b).[79] However, we are not aware of any policy reason why there should be a Section 1248 deemed dividend under Section 751(b) when a partner's indirect interest in a CFC is reduced by a distribution of the CFC to other partners, but not when the interest is reduced by a sale of a partnership interest.

(d) *Recommendation*

In order to avoid these results, we recommend extending the aggregate treatment of domestic partnerships to apply for purposes of Section 1248(a). Aggregate treatment should apply at a minimum to domestic partnerships for purposes of determining whether Section 1248(a) would apply directly to partners (and not to the partnership) on a sale of a CFC by the partnership. This would have little effect on U.S. shareholder partners, since it would only mean that on the partnership's sale of a CFC, their Section 1248 inclusion would be direct rather than by allocation from the partnership. This would also conform the result to the existing result for a sale of CFC stock by a foreign partnership.

This proposal would mean that on a sale of a CFC by a domestic or foreign partnership, no portion of any gain allocated to a non-U.S. shareholder partner would be

---

[78] Proposed Treas. Reg. § 1.751-1(g) Ex. 8.

[79] When Section 751(b) applies to a distribution of a CFC from a partnership to a partner, the distribution is "considered as a sale or exchange of [the CFC] between the distributee and the partnership (as constituted after the distribution)." Section 751(b) therefore creates a deemed sale of the CFC between the partner and the partnership to which Section 1248 can apply. By contrast, Section 751(a) does not create any deemed sale and, instead, simply provides that an amount of consideration attributable to unrealized receivables and inventory "shall be considered as an amount realized from the sale or exchange of property other than a capital asset."

recharacterized as a dividend under Section 1248(a). It would also mean that no portion of any gain recognized by a non-U.S. shareholder partner on its sale of its partnership interest would be treated as ordinary income under Section 751(a) as a result of the partnership's ownership of a CFC.

Preferably, regulations would go further to apply aggregate treatment when a U.S. shareholder partner sold its interest in a domestic or foreign partnership, so that the Section 1248 inclusion would apply directly to the partner and Section 751(a) would not apply. This would entitle the partner to a Section 245A deduction as a result of the deemed dividend. This result is logical because it would apply if the U.S. shareholder partner held the interest in the CFC directly.

The result of these proposals would be as follows, for both domestic and foreign partnerships. We believe that these results are far more logical than the results in the previous chart.

RESULTS OF PROPOSAL

	Current CFC Income	**Sale of CFC**	**Sale of Partnership Interest**
U.S. shareholder			
holds CFC directly	direct inclusion	§ 1248 applies directly	not applicable
holds CFC through U.S. shareholder partnership	direct inclusion	§ 1248 applies directly	§ 1248 applies directly
holds CFC through foreign partnership	direct inclusion	§ 1248 applies directly	§ 1248 applies directly
Domestic non-U.S. shareholder			
holds CFC directly	no inclusion	capital gain; § 1248 not applicable	not applicable
holds CFC through U.S. shareholder partnership	no inclusion	capital gain; § 1248 not applicable	capital gain; § 1248 not applicable
holds CFC through foreign partnership	no inclusion	capital gain; § 1248 not applicable	capital gain; § 1248 not applicable

We acknowledge that collateral issues would arise if a U.S. shareholder partner selling an interest in a domestic or foreign partnership is deemed to have direct Section 1248 gain on a deemed sale of CFC stock held by the partnership. In particular, the selling partner's Section 1248 gain would create a PTEP account in the CFC under Section 959(e), and the CFC's distribution of PTEP to the partnership would reduce the partnership's tax basis in the CFC under Section 961(b). If the partnership does not have a Section 754 election in effect, there is a potential decrease in inside basis in the stock in the CFC (and potential gain recognition for distributions in excess of basis) to reflect the distribution of PTEP, without a corresponding inside basis increase under Section 754 that reflects the selling partner's Section 1248 gain.

The resulting net basis decrease would be completely uneconomic to the purchasing partner. This result does not arise under current law because the application of Section 751 at the level of the selling partner results in a purely notional Section 1248 gain on the sale of the CFC, not an actual Section 1248 inclusion to the selling partner, and so does not create a PTEP account. Under our proposed approach, an adjustment to the basis reduction for PTEP would have to be made to protect the purchasing partner from the net reduction in tax basis resulting from the distribution of PTEP.

The proposed aggregate treatment of partnerships under Section 1248 on a sale of partnership interests might be considered inconsistent with Section 751(c)(2), which refers specifically to Section 1248 gain as a hot asset. Arguably this implies that Section 1248 gain arises at the partnership level. Otherwise, it is not clear what the reference to Section 1248 in Section 751(c)(2) accomplishes. Moreover, Section 1248(g)(2)(B) states that Section 1248 does not apply to any amount that is otherwise treated as ordinary income under the Code.[80]

However, if the partnership is treated as an aggregate for purposes of Section 1248 under entity/aggregate principles, this rule comes before the potential application of Section 751. Under aggregate principles, the partnership would not have partnership-level Section 1248 gain if it hypothetically sold the CFC, so on a sale of a partnership interest, there is no hypothetical ordinary Section 1248 income in the partnership to which Section 751(a) would apply. In any event, if Treasury does not believe it has the authority to adopt our proposals by regulation, we urge a statutory amendment.

Finally, we note that the definition of "U.S. shareholder" under Section 951(b) was broadened under the Act to include domestic shareholders that own or are considered to own 10% of a CFC by value, even if not by vote. The ownership threshold under Section 1248(a)(2) was not similarly broadened and still includes only those domestic shareholders that own 10% of a CFC by vote. Section 1248 therefore will not apply to shareholders of a CFC that satisfy the 10% value but not vote test, even though the shareholders will have current Subpart F and GILTI inclusions. This means that even if our proposal is adopted, there will still not be perfect symmetry between the treatment of current inclusions of GILTI and Subpart F income and the treatment of these income items on a sale. This continuing discrepancy is beyond the scope of this Report.

---

[80] This provision appears to be the basis for the Treasury's past rejection of applying Section 1248 in lieu of Section 751 on a sale of a partnership interest. See the Preamble to T.D. 9345, adopting Treas. Reg. § 1.1248-1(a)(4), Fed. Reg. Vol. 72, No. 145, July 30, 2007, at 41,442, 41,443:

"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."

(e) *Effects of Aggregate Treatment on Section 951(a)(2)(B)*

As noted in Part III.A.1, Subpart F and GILTI inclusions to U.S. shareholders on the Last CFC Date are reduced by the Partial Year Ownership Reduction Amount, which represents dividends paid to other owners of the CFC stock during the year. Dividends taken into account in the Partial Year Ownership Reduction Amount include deemed dividends under Section 1248 that result from a sale by the prior owner of the CFC stock to the U.S. shareholder.

Under current law, if that prior owner is a U.S. shareholder partnership, Section 1248 applies at the partnership level and all of the partnership's gain will be eligible to be recharacterized as a dividend under Section 1248 and included in the Partial Year Ownership Reduction Amount. This is true even if the U.S. shareholder partnership has no U.S. shareholder partners, or, indeed, any partners that are U.S. persons. It may seem surprising that the partnership's Section 1248 deemed dividend can be included in the Partial Year Ownership Reduction Amount even though no partner may be taxed on the Section 1248 amount. However, the same result would arise if all the partners of the partnership held their interests in the CFC directly and received an actual cash dividend from the CFC, since all actual dividends are taken into account regardless of the recipient. On the other hand, if the stock in the CFC was held through a foreign partnership, the partnership's sale of the stock in the CFC would result in a Section 1248 deemed dividend (and inclusion in the Partial Year Ownership Reduction Amount) only to the extent of the interest in the partnership by U.S. shareholder partners.

Under our proposal, Section 1248 would be applied at the partner level and therefore only the portion of the gain allocated to U.S. shareholder partners would be a deemed dividend under Section 1248 that is included in the Partial Year Ownership Reduction Amount. Thus, our proposal would result in a smaller Partial Year Ownership Reduction Amount (and increase the inclusion amount to the U.S. shareholder on the Last CFC Date) to the extent that the partners of the U.S. shareholder partnership are not U.S. shareholder partners. This increased inclusion would be the same as the result mentioned in the preceding paragraph that would arise if the partners held the CFC stock directly or through a foreign partnership, but the increased inclusion would not arise if the CFC paid an actual dividend before the sale.

As a result, our proposal brings the Partial Year Ownership Reduction Amount on a sale by a U.S. shareholder partnership more in line with the result for a sale by a foreign partnership owning the CFC or a sale by direct shareholders of the CFC. On the one hand, none of those results is consistent with the result for an actual dividend paid by the CFC. In fact, our proposal brings the current results for a sale by a U.S. partnership, which are similar to the results for an actual cash dividend, away from the dividend result and towards the existing results for sales by direct owners and by a foreign partnership owner. Our proposal makes sense even in this context, since Section 951(a)(2)(B) already creates a very different result for actual dividends than for sales of stock of CFCs (because Section 1248 only applies to U.S. shareholders). Given that existing disparity, the current law rule for U.S. partnership shareholders is the outlier, and we believe it

makes sense to treat partnerships as aggregates for purposes of the Partial Year Ownership Reduction Amount also.

5. Inside Basis Increases for Tested Income and Subpart F Inclusions Through Partnerships

Under Section 961, the tax basis of a U.S. shareholder in the stock of a CFC (and in any property by reason of which the shareholder is considered to own the CFC stock) increases by the amount of a Subpart F inclusion.[81] GILTI inclusions are treated like Subpart F inclusions for purposes of Section 961.[82] It is clear, therefore, that when a U.S. shareholder partner of a domestic or foreign partnership has a GILTI inclusion from a CFC owned by the partnership, the U.S. shareholder partner's basis in its partnership interest increases by the amount of the inclusion.

As to the partnership's inside basis in the CFC, in the past (i) a U.S. shareholder partnership would have increased its basis in the CFC by the amount of a Subpart F inclusion from the CFC, under a direct application of Section 961, but (ii) regulations did not address whether a foreign partnership could increase its basis in the CFC by the direct Subpart F inclusions of the U.S. shareholder partners. Now, under the Final Regulations and the Proposed Regulations, neither domestic nor foreign partnerships will have GILTI or Subpart F inclusions, and so there is uncertainty about basis increases in the CFC in both cases. We believe that regulations should provide that any increase in a partner's outside basis from Subpart F and GILTI inclusions from a CFC is replicated in the inside basis of a domestic or foreign partnership in the CFC, and such increase in partnership basis is allocable to the partner with the inclusions.[83]

This rule will have no effect on non-U.S. shareholder partners. They will have no GILTI or Subpart F inclusions from the CFCs owned by the partnership and therefore will have no inside basis increases allocated to them.

U.S. shareholder partners will have GILTI and Subpart F inclusions and therefore will have inside basis increases allocated to them under our proposal. Their Subpart F inclusions should be proportionate to their interests in the partnership and the resulting basis increases should be relatively straightforward. However, the outside basis increases resulting from GILTI inclusions, and therefore the inside basis increases allocated to them from GILTI inclusions, will be an individual calculation for each U.S. shareholder partner.

This is because each U.S. shareholder partner includes its share of tested income not only from any CFCs owned by the U.S. shareholder partnership, but also from other CFCs of which they are U.S. shareholders. The aggregate GILTI inclusion of a particular

---

[81] Section 961(a); Treas. Reg. § 1.961-1.

[82] Section 951A(f)(1).

[83] This discussion assumes that the partnership hybrid rule for Subpart F inclusions contained in the Proposed Regulations is finalized.

U.S. shareholder partner is then allocated among the U.S. shareholder's CFCs (including any CFCs owned through the U.S. shareholder partnership) in proportion to the tested income of each CFC.[84] Tested losses or QBAI in a CFC held by a U.S. shareholder partner outside the partnership would reduce the shareholder's overall GILTI inclusion and therefore the GILTI inclusion allocated to the shareholder's interest in the CFCs held within the partnership.

As a result, each U.S. shareholder partner will have a unique outside basis increase that will depend on its GILTI items from CFCs held outside the U.S. shareholder partnership. This means that the inside basis increases will need to be tracked separately for each partner in much the same way as basis adjustments under Sections 734 and 743.[85] This will introduce complexity and may be somewhat burdensome, but it is necessary to ensure that each U.S. shareholder partner receives the full basis benefit from any GILTI inclusion.

The following example illustrates this principle.

> Example 19. Allocation of GILTI Items to Different Partners. Two domestic corporations, US1 and US2, and one foreign corporation, FC, are equal partners in domestic partnership, USP, which owns CFC. CFC generates $150 of tested income, has $1,500 of QBAI and no interest expense. FC is not a U.S. shareholder and therefore has no GILTI inclusion. Each of US1 and US2 is a U.S. shareholder of CFC and each includes $50 of tested income and $500 of QBAI in its GILTI calculation.
>
> US1 has no other CFCs, so its GILTI inclusion is $0 ($50 of tested income, less 10% of $500 of QBAI).[86] It has no outside basis increase and therefore there should be no inside basis increase in respect of US1's interest.
>
> US2 has another CFC that generated $50 of tested income, has no QBAI and no interest expense. US2's GILTI inclusion is $50 ($100 of tested income, less 10% of $500 of QBAI). For purposes of Section 961, this GILTI inclusion is allocated evenly between the two CFCs,[87] such that US2's basis in its partnership interest and its directly-held CFC will

[84] Treas. Reg. § 1.951A-5(b)(1) and (2).

[85] Unlike basis adjustments under Sections 734 and 743, however, a partner's inside basis adjustments will depend on facts relating to the partner's GILTI items that are completely unrelated to the partnership. As a result, the U.S. shareholder partnership will have no way of knowing its partners' inside basis adjustments resulting from the allocation of partnership GILTI items unless the partners report this information to the partnership.

[86] Section 951A.

[87] Treas. Reg. § 1.951A-5(b)(1) and (2).

increase by $25 each.[88] There should be an inside basis increase in CFC equal to $25, and this basis should apply solely with respect to US2.

6. Measurement of 10% of Vote and Value Through a Domestic Partnership

The Final Regulations provide that, for purposes of determining whether a U.S. partner in a U.S. shareholder partnership is a U.S. shareholder partner, the U.S. shareholder partnership is treated as a foreign partnership – i.e., the U.S. person looks through the domestic partnership and, if it is considered as owning 10% or more of the vote or value of the CFC, then it is a Section 958(a) U.S. shareholder and must include the CFC's GILTI items in its GILTI calculation.[89] The Proposed Regulations include the same principle for Subpart F purposes.[90]

The method of determining how to allocate the partnership's ownership in a CFC to its partners for purposes of determining whether the U.S. shareholder and CFC tests under Sections 951(b) and 957, respectively, are satisfied is a long-standing and difficult issue. However, the significance of the issue is greatly increased under the Final Regulations and the Proposed Regulations. Previously, only U.S. partners in foreign partnerships owning stock in a foreign corporation needed to grapple with this issue to determine whether they were U.S. shareholders of a CFC and therefore were required to include their share of the CFC's Subpart F income in their income. By contrast, all partners of a U.S. shareholder partnership had Subpart F inclusions by allocations from the partnership, and the status of the partners as U.S. shareholders of the CFC did not matter. Now, for the first time, these tests are also relevant to all partners of a U.S. shareholder partnership, because only a partner that meets one of the 10% tests will be a U.S. shareholder partner that will have GILTI and Subpart F inclusions. In light of this increased significance of the 10% tests, we urge that guidance be provided on this issue.

(a) *10% Value Test*

In cases where the partners share in partnership capital, profits and losses on a pro rata basis, determining each domestic partner's percentage interest in any CFC held by the partnership will be straightforward. In cases where partnership items are shared in more complicated ways, however, this determination will be more difficult and regulations should provide guidance.

The sharing of capital and profits in a partnership can be quite complex. Examples include the following. Assume the partnership owns 100% of the CFC.

1. The U.S. person is entitled to less than 10% of partnership capital and 10% or more of partnership profit (or vice versa).

---

[88] Section 961(a); Treas. Reg. § 1.961-1.

[89] Treas. Reg. § 1.951A-1(e).

[90] Prop. Treas. Reg. § 1.958-1(d)(1).

2. The U.S. person is entitled to less than 10% of certain profit streams and 10% or more of other profit streams, such that it may be entitled to 10% or more of profit overall but less than 10% of the profit generated by any particular CFC or, alternatively, less than 10% of profit overall but 10% or more of the profit generated by any particular CFC.

3. The U.S. person is entitled to a "hurdle" return of 10% or more of partnership profits up to a certain threshold, and then shares in less than 10% of partnership profits thereafter.

4. As partnership profits increase, the U.S. person's proportionate share of those profits decreases, such that at lower levels of partnership profits the U.S. person's share will equal or exceed 10%, and at higher levels of partnership profits the U.S. person's share will be less than 10%.

5. Another partner is entitled to a hurdle return, such that the U.S. person is entitled to 0% of the partnership profits up to a certain threshold, and then shares in 10% or more of partnership profits thereafter. As profits increase, the U.S. person's proportionate share of those profits increases, such that at lower levels of partnership profits the U.S. person's share will be less than 10%, and at higher levels of partnership profits the U.S. person's share will equal or exceed 10%.

In many of these fact patterns, the U.S. person's share of partnership profits in some years may equal or exceed 10% and in other years may not reach 10%, and it would not be known until after the end of the year whether the 10% threshold had been met. Moreover, these profit sharing percentages might often differ from relative capital interests.

To complicate matters further, in any situation where capital and profits are not allocated on a pro rata basis and a partnership has multiple investments, it will not be clear whether any particular allocation of income by the partnership is attributable to income of the partnership arising from any particular investment. For example, assume partners A and B form partnership AB, which invests in a CFC and a non-CFC. The partnership agreement provides that A will be allocated the first $10 of profits, and all profits in excess of $10 will be allocated equally between A and B. Each investment generates $25 of income in year 1. A is allocated $30 and B is allocated $20. A's allocation represents 60% of the total partnership profits, so A could be viewed as having been allocated 60% of the profits from each investment, or $15 from the CFC. Alternatively, on a marginal "but for" basis, the $25 of income from the CFC only increased A's total allocation from $17.50 (A's entitlement if the total income of the

partnership was $25 from the non-CFC) to $30. Under this approach, A would be allocated $12.50 from the CFC rather than $15.[91]

Regulations should provide guidance as to how the 10% value test is applied when a CFC is held through a partnership and should address the fact patterns described above.

The approach that is most consistent with the statutory rule would be to base the determination on the fair market value of the partner's partnership interest relative to other partners' interests, assuming the stock in the CFC and income from the CFC are not treated differently than other partnership assets and income in the capital and income allocation rules of the partnership.

However, an annual valuation of the partnership and the partnership interests would be quite burdensome. Moreover, this could potentially result in particular partners flipping in and out of U.S. shareholder status from year to year. This would be particularly onerous in cases where the CFC in question was a PFIC/CFC because the U.S. person would have Subpart F income and GILTI inclusions in some years and would be subject to the PFIC rules (including QEF election rules) in other years.

One possibility would be valuations by the partnership of the partnership and different classes of partnership interests at minimum regular intervals, such as every 2 to 5 years. Partners could be presumptively entitled to rely on those valuations until the earliest of (i) the end of such period, (ii) a significant event outside the ordinary course of business, or (iii) a valuation prepared by the partnership for some other purpose such as for booking up capital accounts.

Of course, determinations of fair market value are inherently subjective and therefore present some opportunity for abuse. It may therefore be prudent for regulations to provide some specific guidance as to how the determination should be made. For example, a presumption could be created based on prior partnership performance, but the presumption could be rebutted based on current projections about future performance.

We have considered whether the liquidation value of a partner's interest relative to the other partners' interests would be a reasonable alternative to using fair market value. Relative liquidation values tend to be more objective because they take into account only how the existing assets of the partnership would be divided among the partners in a liquidation and do not require projecting or valuing future income streams. However, such an approach ignores the value of allocations of future profits as well as the value attributable to future shifts of allocations of capital or profits. In circumstances where partnership capital and profits are shared differently or will shift in the future, relative liquidation value will be a poor proxy for relative fair market value.

---

[91] Under yet another approach, the profits from the CFC might be allocated *first* to A, so that A's share of the CFC income would be the $10 priority return plus 50% of the remainder of the $25 of income from the CFC, for a total of $17.50.

Indeed, if a U.S. person had a greater than 10% profits interest and no capital interest in a partnership that owned a CFC, under a liquidation value approach it would not be a U.S. shareholder of the CFC. Yet it could well be a U.S. shareholder if it held the same economic interest in the form of direct equity in the CFC just as long as the CFC was expected to have sufficient profits to cause the partner's economic interest in the CFC to reach 10%. Moreover, that partner would not become a U.S. shareholder of the CFC unless and until it had accumulated sufficient capital in the partnership to meet the 10% threshold. No matter how high the profit allocations to the partner were, so long as the partnership distributed sufficient earnings currently, the 10% test would not be met. The partnership could even make periodic disproportionate distributions to the partner in amounts sufficient to ensure that its capital interest in the partnership stayed below 10%. Using this technique, the partner could avoid U.S. shareholder status indefinitely.

An alternative approach would be to look solely to the profit share of a partner for a particular year in testing for the 10% value test. However, a percentage of profits for a particular year has little or no relation to a percentage interest in the value of the partnership. Moreover, such a test could result in a partner inadvertently shifting in and out of U.S. shareholder status on a regular basis, and, on the other hand, would facilitate manipulation of the test by having high sharing of profits in some years and low sharing in other years.

(b) *10% Vote Test*

Regulations should also provide guidance as to how the 10% vote test is satisfied for CFCs held through a partnership. In particular, regulations should address whether a general partner in a partnership (a "**GP**") that has the sole say in how shares in the CFC are voted is considered to have 100% of the voting power in the partnership's stock in the CFC. On the one hand, a GP that makes all decisions for the partnership concerning the voting of CFC stock could be viewed as having 100% of the voting power in the CFC stock.[92]

On the other hand, GPs typically have fiduciary duties to the limited partners (the "**LPs**") that require them to act in the LPs' interests rather than their own. By virtue of these duties, a GP could be viewed as akin to a board of directors or a trustee, and not as a controlling shareholder in its own right. Likewise, the GP could be viewed as having a role similar to an investment manager that manages stock for an investor in a discretionary account or in a blind trust account, where the manager has discretion to vote the stock in the account as it determines is in the best interest of the investor. Based on these analogies, it could be argued that a GP does not have voting power in the CFC stock within the meaning of Sections 951(b) and 957(a) and its voting power should

[92] When Section 958(a) is applied to determine the amount of voting power a person owns in a CFC, that person's proportionate interest in the CFC will generally be determined by reference to the amount of voting power in the CFC that that person owns. Treas. Reg. § 1.958-1(c)(2).

instead be attributed to the LPs on whose behalf it acts, presumably based on the relative fair market value of all the equity in the partnership.

Even if attributing the GP's voting power to the LPs is considered reasonable in the simple case, the consequences become peculiar where at least one LP to whom the voting power of a partnership is attributed is itself a partnership. Under Section 318(a)(2)(A), a partner in a partnership is deemed to own what the partnership owns in proportion to its interest in the partnership, based on value. Suppose that the lower-tier partnership P1 has a GP and LPs, and the GP's voting power is attributed to the LPs. If a particular LP is itself a partnership, P2, then a portion of the GP's voting power in P1 would be attributed to P2 and then to the partners of P2. That would mean that the partners of P2 would be considered to have voting power in P1 and the CFC, even though they have no actual direct or indirect voting power in P1 or the CFC and the GP of P1 that has actual direct voting power over P1 and the CFC has no fiduciary obligations to them. This result is arguably inconsistent with the theory for attributing the GP's voting power in P1 and the CFC to the LPs of P1.

These issues are beyond the scope of this Report. If the Treasury is contemplating regulations on these issues, we would be happy to assist.

7. Collateral Consequences of Aggregate Treatment of Domestic Partnerships

The aggregate treatment of domestic partnerships for Section 951A purposes under the Final Regulations, and for Subpart F purposes under the Proposed Regulations, appears to have certain collateral consequences. These consequences are not referred to in the Final Regulations Preamble or the Proposed Regulations Preamble. Final regulations should confirm that these results are intended.

(a) *Taxable Year of Inclusion*

In the case of a U.S. shareholder that holds stock in a CFC through a domestic partnership with a fiscal year tax year, the Final Regulations appear to require the U.S. shareholder to include the CFC's GILTI items in its GILTI calculation one year earlier than might otherwise be expected. This point is best explained using an example.

> Example 20. Year of GILTI Inclusion for Partner in Domestic Partnership. Assume a U.S. corporation, US1, is a 10% partner in a domestic partnership, USP. USP owns CFC, which generates $100 of tested income in 2019, has no QBAI and has no interest expense. US1 and CFC report on a calendar year and USP reports on a fiscal year ended June 30.

Under the Final Regulations, USP is not treated as owning the stock of CFC for purposes of determining the GILTI inclusion. Instead, US1 is treated as owning its

proportionate share of the stock of CFC.[93] US1 therefore includes CFC's GILTI items in its GILTI calculation directly.

US1 therefore includes $100 of tested income in its 2019 GILTI calculation. This is a logical result, but it is different from the result if CFC's GILTI items instead flowed through USP up to US1. In that case, the $100 of tested income would have been included in USP's fiscal year ended June 30, 2020,[94] and US1's distributive share of that tested income would have been included in its 2020 tax year.[95]

Regulations should confirm that this acceleration of the GILTI inclusion is the intended result. This same issue is discussed in Part III.B.1(c)(ii) below in the Subpart F context, where the previous reporting of Subpart F income under partnership entity principles can result in the doubling up of income in the year of transition to the new rules.

(b) *Amount of Inclusion to U.S. Shareholder Partners*

Suppose a U.S. shareholder partnership owns 100% of a CFC. Under an entity theory of partnerships, the tested income from the CFC is included in the income of the partnership and is allocated to the partners under the terms of the partnership agreement. Presumably this allocation to partners increases their capital accounts and reflects their economic interests in the tested income when it is received by the partnership.

Under the Final Regulations, the tested income of the CFC is allocated directly to the U.S. shareholder partners. Normally tested income of a CFC is allocated among shareholders of the CFC in proportion to the distributions that would be made to the shareholders if the tested income was distributed on a current basis.[96] Here, the partnership is the sole shareholder, so the general rule does not answer the question of how the tested income should be allocated directly to the partners of the partnership.

However, the treatment of the partnership as an aggregate does not change the economic arrangement among the partners. They have the same relative economic interests in the income of the CFC that they would have if entity treatment applied. As a result, we believe that the allocation of tested income among the partners under aggregate treatment should be the same as under entity treatment, i.e., in the manner that the partnership would allocate the income if entity treatment applied. Regulations should confirm this result.

---

[93] Treas. Reg. § 1.951A-1(e).

[94] Section 951A(e)(1).

[95] Section 706(a), Treas. Reg. § 1.706-1(a).

[96] Treas. Reg. §§ 1.951A-1(d)(1), 1.951-1(b) and (e).

(c) *Relation to Section 163(j)*

Section 163(j) generally limits interest deductions of a taxpayer to 30% of the "adjusted taxable income" ("**ATI**") of the taxpayer. Under Section 163(j)(4), the Section 163(j) limitation is determined at the level of a partnership, based on the ATI of the partnership. If the partnership has ATI that is not needed under Section 163(j) at the partnership level, there is a corresponding increase in the ATI of the partners.

If a partnership owns stock in a CFC, under an entity theory the partnership has the tested income inclusions, and those inclusions increase the ATI of the partnership. That ATI can increase the interest deductions allowed to the partnership. However, under the aggregate approach of the Final Regulations, there is no tested income inclusion at the partnership level, and the inclusion goes directly to the U.S. shareholder partners. As a result, the ATI of the partnership is decreased as compared to the entity approach, and the ATI of the U.S. shareholder partners is increased as compared to the entity approach. This could increase the interest deductions allowed at the U.S. shareholder partner level and decrease the deductions allowed at the partnership level. Of course, the ATI allocated to non-U.S. shareholder partners disappears under the aggregate approach, consistent with the fact that those partners do not have an income inclusion as a result of tested income of the CFC (as they do under the entity approach).

These results appear to follow directly from the aggregate approach adopted in the Final Regulations, and that are proposed for Subpart F in the Proposed Regulations. However, since the change in consequences under Section 163(j) is somewhat unexpected, it would be helpful if this result was confirmed in the regulations.

B. The Proposed Regulations

The Proposed Regulations consist of two parts. First, they would extend to Subpart F the hybrid approach to partnerships that was adopted in the Final Regulations. Second, they would allow an election to exclude high-taxed income from the GILTI regime. These two proposals are discussed separately in Parts III.B.1 and III.B.2 below.

1. The Hybrid Approach to Partnerships

(a) *The Proposed Regulations*

The Proposed Regulations[97] provide that the partnership rules described in Part III.A.4 will apply not only for purposes of Section 951A inclusions under GILTI, but also for determining Section 951 inclusions under Subpart F. In particular, Subpart F inclusions, like GILTI inclusions under the Final Regulations, would not give rise to income inclusions to a U.S. shareholder partnership and then be allocated to all the partners of the partnership. Rather, the income inclusions would arise directly to the U.S. shareholder partners of the U.S. shareholder partnership. Non-U.S. shareholder partners of a U.S. shareholder partnership would have no GILTI or Subpart F inclusion.

The Proposed Regulations would be effective for Subpart F inclusions for taxable years of a CFC beginning on or after adoption of final regulations, and taxable years of U.S. persons within which such taxable years of CFCs end.[98] For prior taxable years, there is an option (the "**retroactivity option**") to apply these rules to taxable years of a CFC beginning after December 31, 2017, and to taxable years of a domestic partnership within which such taxable years of the CFC end. The retroactivity option is applicable only if the partnership, related domestic partnerships, and their U.S. shareholder partners "consistently apply" the Proposed Regulations to all CFCs any of whose stock is owned by the partnerships under Section 958(a) (without regard to -1(d)).[99] Pursuant to the Proposed Regulations Preamble, a domestic partnership can rely on this aspect of the Proposed Regulations before they are finalized.[100]

We note that the retroactivity option is not relevant for purposes of GILTI, since the Final Regulations adopt the same rule for taxable years of a CFC beginning after December 31, 2017. The only change for GILTI is the location of the rule in the regulations. As a result, the retroactivity option only affects Subpart F inclusions for taxable years of CFCs beginning after December 31, 2017 and before the date of adoption of the Proposed Regulations as final (the "**retroactivity period**"). For calendar year taxpayers, if the Proposed Regulations are finalized before the end of 2019, the

---

[97] Proposed Treas. Reg. § 1.958-1(d)(1), (2).

[98] Proposed Treas. Reg. § 1.958-1(d)(4).

[99] *Id.*

[100] Proposed Regulations Preamble at 29119.

retroactivity period is calendar years 2018 and 2019; if they are finalized during calendar year 2020, the retroactivity period is calendar years 2018-2020.

The Proposed Regulations do not require a formal election to adopt the retroactivity option. Rather, the requirement is that the partnership, related partnerships, and all U.S. shareholder partners must consistently apply the Proposed Regulations for the retroactivity period.

(b) *Background on PFIC rules*

As will be seen below, the Proposed Regulations will cause many non-U.S. shareholder partners of a U.S. shareholder partnership to become subject to the PFIC rules for the first time. For convenience, a brief summary of the relevant PFIC provisions is discussed here.

Under Section 1297, a PFIC is a foreign corporation that satisfies certain tests relating to passive income, and/or assets that generate passive income. Shareholders of a PFIC that are U.S. persons are subject to a penalty regime of taxation under Section 1291, to reflect the fact that income is not taxed currently to the shareholder. In particular, taxes on "excess distributions" are subject to an interest charge, and gains from the disposition of PFIC stock are taxed as ordinary income and also subject to the interest charge.

However, under Sections 1291(d) and 1296(j), the penalty regime of Section 1291 does not apply to a shareholder of a PFIC if, for the entire holding period of the shareholder in the PFIC, the shareholder has in effect an election under Section 1295 or Section 1296, each described below.

Section 1295 provides for a "qualified electing fund" ("**QEF"**) election under which the shareholder pays tax currently on the income and gain of the PFIC, essentially as if the PFIC was a partnership. If a QEF election is in effect for the shareholder's entire holding period in the PFIC, then Section 1291 will not apply to the shareholder. If the shareholder makes the election after its holding period has begun, then under Section 1291(d), Section 1291 will continue to apply to the shareholder unless the shareholder makes one of two alternative elections (so-called "**purging elections**") for the first year the QEF election is in effect. Under the general purging rule, the shareholder recognizes built-in gain on the PFIC stock on the first day the QEF election is in effect, and the regular rules under Section 1291 apply to that gain. Alternatively, under the special purging rule available for PFICs that are also CFCs, the shareholder includes as a dividend its share of accumulated e&p of the CFC, and the entire amount of the dividend is treated as an "excess distribution" subject to the interest charge under Section 1291.

Under Section 1296, if the PFIC stock is a marketable security, the shareholder may make a "mark to market" ("**MTM"**) election to mark the stock to market annually, at ordinary income rates. Under Section 1296(j), if the MTM election is made for a taxable year after the beginning of the shareholder's holding period in the PFIC, unless

the QEF election applied to such prior period, then Section 1291 applies to the initial amount that is marked to market.

Under Section 1297(d), a foreign corporation is not a PFIC with respect to a shareholder during the period that the corporation is a CFC and the shareholder is a U.S. shareholder of the CFC. This period is known as the "**qualified portion**" of the shareholder's holding period. This rule is necessary to prevent a shareholder from being subject to both Subpart F inclusions and the PFIC rules on the same income. If a corporation is both a CFC and a PFIC (referred to herein as a "**PFIC/CFC**"), the result is that if the shareholder remains a shareholder but ceases to be a U.S. shareholder of the CFC, or if the CFC ceases to be a CFC but remains a PFIC, the shareholder can make the QEF or (if available) MTM election when it first becomes subject to the PFIC rules without being subject to the purging elections.

(c) *Comments*

(i) *The general rule*

We strongly support the rule in the Proposed Regulations conforming the treatment of partnerships for Subpart F purposes to the treatment of partnerships for GILTI purposes in the Final Regulations. The Proposed Regulations Preamble explains the complexity that would arise if different rules applied to GILTI and Subpart F.[101] We agree that considerable complexity would arise if a U.S. shareholder partner of a U.S. shareholder partnership had a direct GILTI inclusion under the Final Regulations, but an indirect Subpart F inclusion allocated from the partnership. As discussed in Part III.B.1(c)(ii), the two inclusions could even be in different taxable years of the partner, even though the underlying income came from the same taxable year of the CFC. It would also be illogical for a non-U.S. shareholder partner of the U.S. shareholder partnership to have no GILTI inclusion under the Final Regulations, but an indirect Subpart F inclusion allocated from the U.S. shareholder partnership under existing law.

(ii) *Taxable year of inclusion*

The Proposed Regulations raise a question about the timing of income inclusions to a U.S. shareholder partner of a U.S. shareholder partnership. The GILTI and Subpart F inclusions to the partner will now arise directly from the CFC, rather than as a distributive share of GILTI and Subpart F income of the partnership. Therefore, the taxable year for an inclusion is the partner's taxable year in which ends the CFC taxable year, rather than the partner's taxable year that includes the last day of the partnership taxable year that includes the last day of the CFC taxable year.

> Example 21. Taxable year of inclusion after transition period. Assume that the CFC has a calendar year tax year, the U.S. shareholder partnership has a June 30 year, and the U.S. shareholder partner has a calendar year

[101] Proposed Regulations Preamble at 29118.

> tax year. Assume the Proposed Regulations are finalized in 2020 and the CFC has Subpart F income in its 2021 tax year.

Absent a look-through approach, the income would be included in income of the partnership for its tax year ending on June 30, 2022, and in the 2022 tax year of the U.S. shareholder partner. Under the look-through approach of the Proposed Regulations, it appears that the income is included in the 2021 tax year of the U.S. shareholder partner. Moreover, the latter rule would apply in the example, since the tax year of both the CFC and the U.S. shareholder partner begin after the publication of final regulations.

> Example 22. Taxable year of inclusion during transition period. Now assume the CFC in Example 21 has Subpart F income for its 2020 tax year, and the Proposed Regulations are still finalized in 2020. The 2020 tax year of the CFC is a pre-effective date year of the CFC, so the income is included in the income of the partnership for its 2020-2021 fiscal year, a pre-effective date year of the partnership. The income would then be allocated to the partners for inclusion in their taxable income for calendar year 2021. However, the 2021 calendar tax year of the CFC begins after promulgation of the final regulations, so the final regulations apply to that tax year, and that tax year ends within the 2021 tax year of the partners. Thus, the 2021 tax year of the partners is governed by the new rules in respect of income earned by the CFC in its 2021 tax year.

We assume that the intent is that the 2020 Subpart F income of the CFC is fully under the old rules and included in the income of the U.S. shareholder partners (as well as non-U.S. shareholder partners) in 2021. The alternative would be a complete omission of the 2020 Subpart F income from the income of all partners, clearly an unintended result and a result that would not apply if the CFC was held directly or through a foreign partnership. Regulations should clarify the result.

However, this result means that *two years of Subpart F income of the CFC (2020 and 2021) will be included in a single taxable year (2021) of the U.S. shareholder partners.* One inclusion is a direct inclusion from the first tax year of the CFC to which the final regulations apply, and the other inclusion is a partnership distributive share out of CFC earnings from the immediately prior tax year of the CFC. We recognize that this "catch up" effect is a necessary corollary to the switch from an entity to an aggregate view of partnerships. Nevertheless, consideration should be given to treating this as a change in method of accounting under Section 481 and allowing for a spread in the reporting of the second inclusion over a number of years.

(iii) *Mechanics of the retroactivity option*

The mechanics of the retroactivity option raise a number of issues discussed in paragraphs (1) to (4) below. Paragraph (5) presents our overall proposals to deal with these issues.

(1) *Effective date of retroactivity*

The effective date of the retroactivity option is taxable years of the CFC beginning after December 31, 2017, and taxable years of domestic partnerships in which such taxable years of the foreign corporation end. It is not clear why the reference here is to "domestic partnerships" rather than to "U.S. persons," as in the basic effective date rule.

This difference in language can create confusion. For example, consider a calendar year CFC, a June 30 fiscal year U.S. shareholder partnership, and a calendar year partner of the partnership. If the option applies, presumably the Subpart F income of the CFC for 2018 is intended to be included in the income of the U.S. shareholder partners for calendar year 2018, as would be true under an aggregate approach. However, this result is not clear from the stated effective date, which, in contrast to the proposed effective date of the final regulations, does not refer to the tax years of any U.S. persons except domestic partnerships. The Proposed Regulations should be clarified in this regard, perhaps by conforming the language of the effective date of the retroactivity option to the language of the regular effective date of this provision.

Assuming this is the intended result, we note that the doubling up of the timing of Subpart F inclusions discussed in Part III.B.1(c)(ii) would also arise in this situation. In the example, Subpart F income of the CFC for both 2017 and 2018 would be included in the 2018 taxable income of the U.S. shareholder partners, 2017 under the prior rules and 2018 under the new rules. In substance, the application of the retroactivity option accelerates the taxable year in which the doubling up of the Subpart F inclusion arises. Any relief granted for such doubling up in the absence of the retroactivity option should also be available when the retroactivity option is applicable.

(2) *Who must agree to retroactivity*

For the retroactivity option to apply, the U.S. shareholder partnership and every U.S. shareholder partner must file an original or amended tax return consistent with the Proposed Regulations for the retroactivity period, e.g., for calendar year partnerships and CFCs, an original or amended return for 2018. An amendment to an already-filed return will often have little or no significance to a U.S. shareholder partner, since it will not usually matter whether Subpart F income is reported directly from the CFC or as an allocable share of partnership Subpart F income.[102]

However, the option can make a significant difference to U.S. shareholder partners with Subpart F income in the fiscal year situations discussed in Part III.B.1(c)(ii)

[102] The retroactivity option will also have no significance to a U.S. shareholder partner that disposes of its partnership interest before the Last CFC Date. Whether or not the option applies, the partner will have no Subpart F inclusion, and, on the sale of its stock, Section 751 rather than Section 1248 will continue to apply (absent adoption of our proposal concerning Section 1248 in Part III.A.4 above) even if the option applies. Since the Proposed Regulations literally require all U.S. shareholder partners to consistently apply the retroactivity option, final regulations should confirm that these partners are automatically considered to consistently apply the option even if their returns are unaffected by the option.

above.[103] Moreover, the option will have considerable significance to a non-U.S. shareholder partner. If the CFC is not a PFIC/CFC, the partner would likely prefer the option to apply so that it may file original or amended returns to exclude any Subpart F inclusions during the retroactivity period. If the CFC is a PFIC/CFC, some partners might prefer the no-option result so as to remain subject to the Subpart F rules for the retroactivity period, yet others might prefer the option to apply so they will become subject to the PFIC rules for past periods.

As a result, the substantive tax liability of the non-U.S. shareholder partners, and in some cases the U.S. shareholder partners, depends upon whether the U.S. shareholder partnership and all the U.S. shareholder partners file an original or amended return consistent with the retroactivity option.

Even if the U.S. shareholder partnership files its own original or amended return for the retroactivity period consistent with the retroactivity option, it is not clear how the partnership, let alone all the U.S. shareholder partners and non-U.S. shareholder partners, will obtain assurance that every U.S. shareholder partner has filed an original or amended return for the retroactivity period consistent with the retroactivity option. The partnership and the partners might not even be able to determine if any particular partner of a U.S. shareholder partnership is a U.S. shareholder partner, since the partner might hold less than a 10% interest in a CFC through the U.S. shareholder partnership and an additional interest in the CFC either directly or through an unrelated partnership.

Moreover, a U.S. shareholder partner might simply not be willing to file an amended return for 2018. A number of reasons are possible:

- It might not want to go to the expense of filing an amended return that has no substantive tax significance to itself.

- It might be concerned about an IRS review of other aspects of an amended return.

- It might obtain a more favorable tax result by not filing an amended return, such as avoiding the doubling up of Subpart F income in 2018 in the situations discussed in Part III.B.1(c)(ii) above.

- It might simply refuse unless it receives unrelated concessions from non-U.S. shareholder partners who would benefit from retroactivity.

Finally, the persons most affected by the retroactivity option are the non-U.S. shareholder partners, for the reasons described above, and different non-U.S. shareholder partners may have different preferences concerning the option. Yet these partners have no say in the decision over whether the option applies. We are not aware of a good

[103] It would also make a difference to U.S. shareholder partners selling partnership interests in the retroactivity period, if our proposal for aggregate treatment of partnerships for Section 1248 purposes was applied during the retroactivity period.

policy reason why these partners should not be permitted to make individual elections as to whether to apply the retroactivity option.

We acknowledge that if individual elections are allowed for partners of a U.S. shareholder partnership, if the partnership has a fiscal tax year, U.S. shareholder partners not electing the option might be reporting the Subpart F income of the CFC in a later taxable year than the corresponding Subpart F income is reported by the U.S. shareholder partners electing the option. We do not believe that this would create undue administrative difficulty for the relatively short retroactivity period.

(3) *Effect of amended tax returns*

The Proposed Regulations do not make clear whether the requirement to consistently apply the Proposed Regulations for the initial or subsequent years can be satisfied by amended returns filed at any time before the expiration of the relevant statutes of limitations. The intent might be, for example, that any returns filed after the Proposed Regulations are finalized must be initially filed consistent with the final regulations. A similar issue arises if all relevant returns are originally filed in accordance with the retroactivity option, but one or more U.S. shareholder partners files an amended return for the first relevant year that is inconsistent with the retroactivity option. The consequences in these situations should be clarified in final regulations.

(4) *Consistency of option over multiple years*

The Proposed Regulations do not state the result where the retroactivity option properly applies for, say, calendar year 2018, but either the partnership or one of the U.S. shareholder partners does not file consistently with the retroactivity option for calendar year 2019. This could arise because a particular U.S. shareholder partner changes its mind between 2018 or 2019, or there could be a new U.S. shareholder partner in 2019 that simply refuses to file in accordance with the retroactivity option. In this situation, the retroactivity option might apply (1) in 2018 but not in 2019 or thereafter, (2) initially in 2018, but retroactively not in 2018 or in 2019, or (3) mandatorily in 2018 and thereafter.

Alternative (1) would cause enormous complexity, because the rule in the Proposed Regulations would apply in 2018, not apply in 2019, and apply again after the Proposed Regulations are finalized. Alternative (2) would cause non-U.S. shareholder partners to retroactively lose the tax benefits of the retroactivity option in 2018 through no fault of their own in 2019. Similarly, alternative (2) would allow an intentional retroactive change in application of the option in 2018 through the filing of tax returns for later years.

(5) *Proposal*

In light of the foregoing, we believe that:

(i) Final regulations should allow each U.S. shareholder partner and each non-U.S. shareholder partner to take its own tax position on retroactivity, with a consistency

requirement that related partners must take the same position. The decision would have little effect on U.S. shareholder partners except to change the year in which duplicated income inclusion arises for fiscal year partnerships. However, in the case of a PFIC/CFC, this would allow each non-U.S. shareholder partner to decide whether to be subject to the PFIC or CFC regime during the retroactivity period. This approach would also protect non-U.S. shareholder partners from Subpart F inclusions for the retroactivity period (which would be particularly important where the CFC is not a PFIC/CFC) but where the U.S. shareholder partnership or U.S. shareholder partners for whatever reason decline to adopt the retroactivity position. We do not see any policy objection to this electivity.[104]

(ii) If this proposal is not adopted, final regulations should provide for a formal election to be made by the partnership with respect to its application of the retroactivity option. Under this approach, consistent with the Proposed Regulations, the election would be made effective only if also made by all related partnerships, and it would be binding on all partners of those partnerships, whether or not the partners are U.S. shareholder partners.

This rule would avoid the problem in the Proposed Regulations of the partnership, non-U.S. shareholder partners and U.S. shareholder partners not being sure that the retroactivity option applies to them because they would not be sure that all U.S. shareholder partners took the consistent position. This rule would also avoid the problem of U.S. shareholder partners who for no good reason simply refuse to file in accordance with the retroactivity option applied by the partnership. We do not believe that this rule would be unfair to U.S. shareholder partners, since the election is being made by their own partnership and they are affected by numerous tax elections made by the partnership. However, this approach puts non-U.S. shareholder partners in the same position as they are in under the Proposed Regulations, in that they are bound by the position taken by the partnership.

(iii) Under the approach of the existing Proposed Regulations or either of the foregoing alternatives, if the retroactivity option properly applies to a taxable year of a partnership or partner, all parties to which the option applies (including future U.S. shareholder partners of the U.S. shareholder partnership) should be bound by the option for all future taxable years, and the result should not be allowed to change by the filing of amended returns. In other words, for any partnership or partner, the application of the retroactivity option should be irrevocable without the Commissioner's consent to change. (It is difficult to imagine a reason for the giving of such consent.)

---

[104] A selling U.S. shareholder partner would not have a Subpart F inclusion with or without the retroactivity option (and it would be indifferent to the option assuming our proposal concerning Section 1248 in Part III.A.4 above is not adopted). However, in the case of a non-U.S. shareholder partner in a PFIC/CFC, considerable complexity would arise if the partner in the first part of the year was subject to the PFIC rules and the partner in the second part of the year was subject to the CFC rules, or vice versa. In the PFIC/CFC situation, perhaps the position taken by the partner on the last day of the tax year should be controlling.

(iv) If the proposal in paragraph (iii) is not adopted and so the retroactivity option is not made binding for future years, taxpayers might intentionally or inadvertently not comply with the requirements for the option to be applicable in those future years. In that case, relief should be available to allow the option to be applicable in future years in the event of an inadvertent failure to comply with the reporting requirements of the retroactivity option in those future years.

(v) Under the approach of the existing Proposed Regulations or under the alternatives in paragraphs (i) or (ii), final regulations should clarify whether the retroactivity option can be adopted for the entire retroactivity period by the timely filing (before expiration of all applicable statutes of limitations) of amended returns by all parties required to file in accordance with the retroactivity option. We support such a rule because we do not see any significant abuse potential from allowing retroactivity in this case. Moreover, there may well be cases where U.S. shareholder partnerships, U.S. shareholder partners, or (if applicable under paragraph (i)) non-U.S. shareholder partners fail to file original returns in accordance with the retroactivity option, even after the Proposed Regulations are finalized, without being aware of the Proposed Regulations or final regulations or understanding the significance of the retroactivity option. If this rule is not adopted, the final regulations should provide a date by which all amended tax returns applying the retroactivity option must be filed.

(vi) An immediate issue arises for partnership or individual tax returns that have recently been filed for calendar year 2018, or that will be filed by October 15, 2019. Original partnership returns for a U.S. shareholder partnership may have been filed with the IRS, and Schedule K-1s issued to partners, reporting Subpart F income at the partnership level in accordance with prior law. Non-U.S. shareholder partners might have already filed their personal tax returns on that basis, reporting their share of such income. The partnership might then file a revised return for 2018, before the original due date of its return, in accordance with the Proposed Regulations. Even then, under the Proposed Regulations, the retroactivity option will not be effective unless all the U.S. shareholder partners likewise file original or amended returns reporting their share of Subpart F income directly, rather than as a distributive share of partnership income.

Consistent with our proposals above, we urge that at a minimum, the effectiveness of the retroactivity option should not depend upon the filing of these returns by all the U.S. shareholder partners. Moreover, some non-U.S. shareholder partners that have already filed their 2018 tax returns may wish to file amended returns reporting under the retroactivity option, and some may not. We urge that these partners not be required to file amended returns even if the partnership does so. Moreover, if they choose to do so and the CFC is a PFIC/CFC, rules should be made as simple as possible for the partners to make QEF or MTM elections, and the rules should clearly state that the partners do not need to make purging elections simply because of the status of the PFIC/CFC during the retroactivity period.

These proposals are similar to the relief provided in Notice 2019-46 to partners and partnerships that may have filed 2018 tax returns in accordance with the Original Proposed GILTI Regulations that were changed by the Final Regulations. There,

taxpayers were given flexibility to rely or not rely on a proposed regulation that was not adopted into law and was retroactively superseded by the Final Regulations. Here, taxpayers should be given similar flexibility to follow or not follow the then-current binding law that was subsequently permitted to be superseded retroactively.

(iv) *Coordination with PFIC regime*

(1) *Background*

Under current law, a non-U.S. shareholder partner of a U.S. shareholder partnership is not itself a U.S. shareholder of the CFC and does not itself report Subpart F inclusions. Rather, it reports its allocable share of Subpart F inclusions of the U.S. shareholder partnership. Therefore, if the CFC is a PFIC/CFC, the partner's holding period as a non-U.S. shareholder partner is not literally eligible for exclusion under Section 1297(d), which as discussed in Part III.B.1(b) above disregards holding periods during which a shareholder of a PFIC/CFC was a U.S. shareholder of the PFIC/CFC.

If this relief is not available, then at the time the non-U.S. shareholder partner ceases to report Subpart F inclusions from the partnership for any reason, not only would the PFIC rules apply, but the partner would have been an indirect shareholder of a PFIC during the prior years of inclusion of Subpart F income. As a result, the non-U.S. shareholder partner would not be able to make a QEF election or MTM election for the current period without being subject to the continuing application of Section 1291 or the requirement to make a purging election.

However, under the consistent private letter ruling ("**PLR"**) position of the IRS under Section 1297(d), all the partners of a U.S. shareholder partnership are eligible for relief under Section 1297(d), since they all reported their share of Subpart F income as partnership distributive share.[105] This rule is necessary to prevent both the CFC rules and PFIC rules from applying to the same Subpart F income allocable to the partner, which would be contrary to the purpose and legislative history of Section 1297(d).

Consequently, before the effectiveness of the Proposed Regulations, a U.S. shareholder partner reported its share of the Subpart F income of a PFIC/CFC allocated to the partnership. The existence of the partnership as an entity did not prevent a partner with sufficient economic interest in the CFC from being a U.S. shareholder of the CFC, because under the constructive ownership rules of Sections 958(b) and 318(a)(2)(A) the partnership's interest in the CFC would be attributed to the partner. Thus, under Section 1297(d), the partner was not subject to the PFIC rules in respect of the CFC. After the effectiveness of the Proposed Regulations, the partner's share of Subpart F income will be reported directly by the partner, and the PFIC rules will still not apply (either for the same reason as previously, or because the partnership will then be treated as an aggregate for this purpose).

[105] See, e.g., PLR 201108020.

Likewise, before the effectiveness of the Proposed Regulations, a non-U.S. shareholder partner reported its share of Subpart F income of a PFIC/CFC allocated by the partnership, and the PFIC/CFC was not treated as a PFIC as to those partners under Section 1297(d) and the PLR position. After the effectiveness of the Proposed Regulations, the non-U.S. shareholder partner will still not be a U.S. shareholder of the CFC and will no longer be reporting any Subpart F income, and therefore the PFIC/CFC will become a PFIC as to this partner.

These rules for a PFIC/CFC can be summarized as follows:

	U.S. shareholder partner	**non-U.S. shareholder partner**
before prospective or retroactive effectiveness of Proposed Regulations	report share of partnership Subpart F income; PFIC rules not applicable	report share of partnership Subpart F income; under PLRs, PFIC rules not applicable
after prospective or retroactive effectiveness of Proposed Regulations	direct inclusion of Subpart F income; PFIC rules not applicable	no Subpart F income; PFIC rules apply

We note that, whether or not the retroactivity option applies, a non-U.S. shareholder partner of a PFIC/CFC will likely want to make a QEF election, or if available an MTM election, to apply beginning with the date that the Proposed Regulations first cause the shareholder to become subject to the PFIC rules.[106] Likewise, the partner will not wish to have to make a purging election.

The QEF and MTM elections raise a number of issues.

(2) *Ability to avoid need for purging elections*

As noted in Part III.B.1(c)(iv)(1) above, there is only PLR authority for the proposition that Section 1297(d) would disregard a non-U.S. shareholder partner's holding period in a PFIC/CFC for Section 1291 purposes during the period the partner included its share of the partnership's Subpart F inclusion under current law. As a result, the partner would not have assurance that it could avoid Section 1291 by making a QEF or MTM election without the need for a purging election.[107]

[106] An MTM election is much less common than a QEF election because it requires that stock in the PFIC be a marketable security. In particular, the opportunity for an MTM election will not often arise for stock in a PFIC/CFC, since most CFCs do not have marketable stock. However, the election could arise, e.g., for a PFIC/CFC with a 51% U.S. corporate shareholder and 49% publicly traded stock. Moreover, it could arise if a U.S. partnership owned 51% of a PFIC/CFC (and the other 49% was publicly traded), with the partnership having any combination of U.S. shareholder partners not subject to the PFIC rules, and non-U.S. shareholder partners subject to the PFIC rules.

[107] In theory, if a non-U.S. shareholder partner cannot rely on Section 1297(d), not only will it need to make a purging election once the Proposed Regulations are in effect if it wishes to make a QEF election, but presumably it should have had PFIC inclusions throughout its holding period. As a practical matter,

This is not a new issue, hence the need for PLRs in the past. However, the issue will arise under the Proposed Regulations in every case where a U.S. shareholder partnership holds stock in a PFIC/CFC, where, under prior law, one or more non-U.S. shareholder partners have been reporting Subpart F inclusions as partnership allocations. We urge that final regulations confirm that for a non-U.S. shareholder partner of a U.S. shareholder partnership of a PFIC/CFC, Section 1297(d) disregards the partner's holding period in PFIC stock for Section 1291 purposes during the period the partner included its share (if any) of the partnership's Subpart F income. This would avoid the need for individual PLRs confirming this result.[108]

(3) *QEF and MTM elections and inclusions at partnership or partner level*

The Proposed Regulations Preamble asks for comments on whether elections (including QEF and MTM elections) and income inclusions under the PFIC rules should be made at the level of the domestic partnership or at the level of the partners.[109]

Currently, for PFIC stock held by a domestic partnership, the partnership (rather than the partners of the partnership) makes the QEF or MTM election. The partnership reports its income inclusions under the elections, and the partners report their share of partnership income under the usual rules.[110] On the other hand, if the PFIC stock is held through a foreign partnership, the QEF and MTM income arises directly to the U.S. partners of the partnership, and each partner makes its own election.[111]

In the past, these elections were relevant to a domestic partnership that owned less than 10% of the stock in a PFIC/CFC (so the partnership was not a U.S. shareholder of a CFC), or to a partnership that owned any amount of stock in a PFIC that was not a CFC. Now, the elections will also be relevant to every U.S. shareholder partnership of a PFIC/CFC unless every partner is a U.S. shareholder partner. This can be expected to considerably expand the number of QEF and MTM elections applicable to partners of partnerships.

---

however, Subpart F and PFIC inclusions both represent the CFC's current income, so most non-U.S. shareholders would be more comfortable relying on the fact that they were including Subpart F income currently to avoid a double inclusion of the same income under the PFIC rules than they would be relying on the same analysis to avoid the need for a purging election.

[108] This clarification would not be necessary for a U.S. shareholder partner of a CFC for periods before the Proposed Regulations apply. Section 1297(d)(2) disregards the period that a shareholder is a U.S. shareholder of the CFC, without regard to the fact that the shareholder was reporting Subpart F income as a distributive share of partnership income rather than directly as under the Proposed Regulations.

[109] Proposed Regulations Preamble at 29120.

[110] Treas. Reg. §§ 1.1293-1(c)(1), 1295-1(d)(2)(i)(A); 1.1296-1.

[111] Treas. Reg. §§ 1.1295-1(d)(2)(i)(B), 1.1296-1(e)(1).

We have considered whether the existing rule for foreign partnerships holding PFIC stock should be extended to domestic partnerships, so that QEF and MTM inclusions would arise directly to the partners of a domestic partnership owning stock in a PFIC. We acknowledge that Section 1293(a)(1) requires that QEF income be reported to a U.S. person that owns stock in a PFIC, and Section 1296 is the same for MTM income. Nevertheless, requiring that such income be reported directly to the partners of a partnership that is a shareholder of a PFIC would be consistent with the aggregate approach that the Final Regulations and the Proposed Regulations apply to tested income and Subpart F income of a CFC, respectively.

We have several reasons for supporting aggregate treatment of domestic partnerships for these purposes. First, when a QEF or MTM election is made, the PFIC regime is broadly similar to the GILTI and Subpart F regimes for a CFC. Thus, it would be logical for the treatment of domestic partnerships to be the same in all three cases, just as the treatment of foreign partnerships is currently the same in all three cases (and will remain the same after the Proposed Regulations are finalized). It would also be logical for the treatment of domestic partnerships under the PFIC rules to be the same as the treatment of foreign partnerships under those rules, as is now the case for GILTI and will be the case for Subpart F after the Proposed Regulations are finalized.

Second, if the QEF and MTM inclusions were directly on the tax return of the partner of a domestic partnership, the respective elections would logically be made by the individual partners themselves. This would allow individual QEF and MTM elections to be made not only by direct shareholders of a PFIC and partners in foreign partnerships owning stock in a PFIC, but also by partners in domestic partnerships owning stock in a PFIC.

We do not see a policy reason why partners in domestic partnerships should not have this option. This is particularly so since in many cases a purging election is necessary to obtain the full benefits of a QEF or MTM election, and the effects of a purging election can vary dramatically among particular partner/shareholders based on individual circumstances. Some might prefer the QEF election standing alone, some might prefer the MTM election standing alone, some might prefer the QEF or MTM election and one of several purging election options, and some might prefer neither.

Likewise, a QEF election can only be terminated with the consent of the Commissioner, unless it is replaced with an MTM election.[112] An MTM election is irrevocable without the consent of the Commissioner.[113] An election by a partnership therefore binds future partners, even though a purchaser of direct stock in a PFIC (or an interest in a foreign partnership holding stock in a PFIC) can make its own election. There is no good policy reason for this difference.

---

[112] Section 1295(b)(1), Treas. Reg. § 1.1295-1(i)(2), (3).

[113] Treas. Reg. § 1.1296-1(h)(3).

Third, aggregate treatment of partnerships would be consistent with other rules under the PFIC regime. The partner of a domestic partnership makes the election under Section 1294 to defer tax, with an interest charge, on undistributed QEF income inclusions of a PFIC.[114] Likewise, if a partner in a U.S. partnership sells its partnership interest, the indirect disposition of PFIC stock results in a direct Section 1291 inclusion at the partner level. If a U.S. partnership receives an excess distribution from a PFIC or sells the stock in a PFIC, the partnership is not considered a shareholder for Section 1291 purposes and the partner receives the direct Section 1291 inclusion.

To be sure, the Section 1291 calculations are based on notional inclusions of income on the partners' own tax returns and interest on the resulting marginal tax liability to the partners. These calculations could not be made at the partnership level unless the partners reported significant information about their own individual tax positions to the partnership. There is no comparable compelling reason to so move QEF and MTM inclusions to the partner level. Nevertheless, moving QEF and MTM inclusions to the partner level would eliminate the bifurcated nature of the existing regime and increase consistency within the PFIC regime.

Fourth, for a PFIC/CFC, absent the look-through rule for PFIC inclusions, U.S. shareholder partners of a U.S. shareholder partnership would have Subpart F and GILTI inclusions at the partner level, and the non-U.S. shareholder partners would have PFIC inclusions at the partnership level allocated to them. This would lead to complexity, including potential inclusions in different tax years of the partners for the same income arising in the same taxable year of the CFC.

For example, if the PFIC/CFC and all the partners of the partnership had a calendar year tax year and the partnership had a fiscal year, the Subpart F income of the PFIC/CFC in a particular calendar year would be included in the income of the U.S. shareholder partners for the same calendar year, but assuming a QEF election, the income of the PFIC/CFC in that calendar year would be included in the taxable income of the non-U.S. shareholder partners as inclusions from the partnership in the following calendar year. This complexity would be avoided if all inclusions were at the partner level.

On the other hand, the benefits of individual decisions on purging elections and inclusions at the partner level should not be overstated. First, a purging election is not necessary for a partnership that newly purchases stock of a PFIC, although even in that case some partners might prefer a QEF or MTM election and some might prefer to be subject to Section 1291.

Second, it is true that the proposed change is simplifying, in the sense that absent this proposed change, for a PFIC/CFC, PFIC inclusions would be at the partnership level and GILTI/Subpart F inclusions would be at the partner level. Yet this result would not add much complexity to the existing regime that applies in the absence of a partnership,

[114] This rule is not stated in the regulations, but it is in the Instructions to IRS Form 8621 (rev. Dec. 2018), page 6, right hand column.

where a direct shareholder that is not a U.S. shareholder may have QEF or MTM inclusions at the same time that U.S. shareholders have GILTI/Subpart F inclusions.

Third, the proposed change could result in increased complexity in tax reporting. The proposal could not logically be limited to PFIC/CFCs, since it would not be feasible to have partnership level elections and inclusions for a PFIC that is not a CFC, and partner level elections and inclusions for a PFIC/CFC. As a result, the proposal would necessarily apply to all PFICs, a much broader category. Today, if a domestic partnership holds stock in a PFIC and there is no Section 1291 inclusion to partners, the partnership and not the partners files Form 8621 each year, reporting any QEF inclusion.[115] The proposal as described would shift the burden of making and reporting elections and inclusions to all partners of domestic partnerships holding stock in a PFIC, except for U.S. shareholder partners in U.S. shareholder partnerships that own PFIC/CFCs that would be subject to the CFC rules.

The burden of individual partners making QEF elections could be reduced if a domestic partnership was permitted to continue to make a QEF election, and collateral purging elections, on behalf of its partners, if the partnership agreement authorized it to do so. Such an election would have to be binding on all the partners as if they had made the election themselves, and the partnership would be committed to providing the necessary tax information to the partners. If the partnership did not make the election for all partners, individual partners should still be permitted to make the election for themselves. Arguably a partnership should also be permitted to make an MTM election on behalf of all partners that is binding on all partners, but this is less clear because of the less predictable tax results to partners. In any event, individual partners could still be permitted to make an MTM election, and such an election could be permitted to override a partnership QEF election made on behalf of partners.

Taking these factors into account, on balance we believe that the PFIC rules should be changed to cause QEF and MTM elections and inclusions to arise at the level of the partners of a domestic partnership rather than at the level of the partnership itself. An additional option should be added so that, in appropriate cases, a partnership could instead make QEF (and possibly MTM) elections on behalf of all its partners, with inclusions still at the partner level.

If the inclusions are made at the partner level, we do not believe the basis and capital account adjustments involving the partnership would be difficult. The end result should be the same as arises today. The partner's basis and capital account in the partnership, and the partnership's basis in the PFIC with respect to the particular partner, should be increased by the amount of the income inclusion. Likewise, if some partners are subject to the PFIC rules and others are subject to the Subpart F/GILTI rules, the basis and capital account adjustments described above should apply to each partner separately.

---

[115] Treas. Reg. § 1.1295-1(f)(2)(i)(B), instructions to IRS Form 8621, page 1, right hand column.

(4) *QEF and MTM elections under the retroactivity option*

The retroactivity option raises an additional issue concerning the QEF and MTM elections for a non-U.S. shareholder partner. A QEF election for a taxable year must be made by the due date (including extensions) for filing a tax return for the year.[116] A later election is allowed, to the extent provided in regulations, if the taxpayer reasonably believed the corporation was not a PFIC for the year. The regulations[117] provide the exclusive method for a late election, and include restrictive requirements including the filing of a protective statement by the due date (including extensions) and an agreement to extend the statute of limitations. Similarly, an MTM election must be made by the due date (including extensions) for filing a tax return for the year in which the election is effective, with late elections permitted only in accordance with regulations under Section 9100.[118]

The retroactivity option would provide unjustified and punitive results to non-U.S. shareholder partners if they (or their partnership) could not make a QEF or MTM election for the first year to which the PFIC rules would apply to them. This is because of the requirement of a purging election, discussed in Part III.B.1(b) above, to prevent the continued application of Section 1291 in this case. Moreover, as to a retroactive QEF election, there is no doubt that the partners reasonably believed that the CFC was not a PFIC as to them during the retroactivity period. In fact, the belief was correct, since in fact the CFC was not a PFIC as to them under the law in effect at the time, and it only becomes a PFIC as to them retroactively as result of the retroactivity option. As to a retroactive MTM election, there is certainly good cause for the retroactive nature of the election, since the election would not have been relevant on a timely filed return.

As a result, we believe that final regulations should provide blanket permission for a QEF or MTM election to be made retroactively, effective as of the beginning of the period for which a PFIC/CFC is a PFIC with respect to a non-U.S. shareholder partner under the retroactivity option. It would be reasonable for the election to be required to be made on an amended tax return that is filed within some period of time (such as 90 or 180 days) after adoption of final regulations. We would not object to an extension of the statute of limitations as provided in the existing regulations for late QEF elections, although given that the retroactivity option only goes back at most to the 2018 tax year, consideration should be given to not requiring such an extension of the statute for elections made in the near future.

We expect that many QEF or MTM elections will be made by (or for) non-U.S. shareholder partners of U.S. shareholder partnerships of PFIC/CFCs that for the first time will become subject to the PFIC rules rather than the Subpart F rules as a result of the

---

[116] Section 1295(b)(2).

[117] Treas. Reg. § 1.1295-3.

[118] Treas. Reg. § 1.1296-1(h).

Proposed Regulations. As a result, we urge prompt guidance on these issues concerning the election.

(v) *Extension of aggregate treatment under Section 958(a)*

The Proposed Regulations Preamble asks for comments on whether the aggregate treatment for partnerships should be extended to other Code provisions that are based on Section 958(a) ownership.[119] We believe that this determination must be based on a case by case analysis.[120]

(1) *Section 953(c)(2)*

Related person insurance income ("**RPII"**) of a CFC is defined as income from a policy where the insured is a U.S. shareholder in the CFC or a person related to such shareholder.[121] A U. S. shareholder is defined for this purpose as any U.S. person under Section 7701(a)(30) that owns any stock in the CFC under Section 958(a).[122] A partner would be related to the partnership only if it was a greater than 50% partner.[123]

If the insured is an operating U.S. partnership that is a shareholder in the CFC, the partnership as an entity would today be a U.S. shareholder, so that the income of the CFC from a policy with the partnership as the insured would be RPII. If the partnership was treated as an aggregate, there would not be any RPII to the extent that the partners were not U.S. persons. This is arguably the correct result, since, absent the partnership, there would not be RPII for an insured that is not a U.S. person, even if that person is operating through a U.S. branch. Likewise, a policy with a shareholder that is a foreign partnership would presumably not give rise to RPII except to the extent of U.S. partners. We are not aware of any policy behind the RPII rules that would justify the creation of RPII solely as a result of non-U.S. persons operating their businesses through U.S. partnerships.

(2) *Section 163(j)*

Under proposed regulations under Section 163(j),[124] a "CFC group election" can be made to allow income of a CFC group to increase the Section 163(j) limitation of U.S. shareholders of the CFC group. The election is made separately for each CFC group,

---

[119] Proposed Regulations Preamble at 29119.

[120] Section 545(a), which defines "undistributed foreign personal holding company income," contains a modification to the term if U.S. persons own, under Section 958(a), 10% or less of a foreign corporation that meets the tests for a personal holding company under Section 542. However, this reference to Section 958(a) is obsolete, since Section 542(c)(5) was amended in 2004 to exclude all foreign corporations from the definition of personal holding company.

[121] Section 953(c)(2).

[122] Sections 953(c)(1)(A), 957(c).

[123] Sections 953(c)(6), 954(d)(3).

[124] Proposed Treas. Reg. § 1.163(j)-7(b)(5).

which is defined as the CFCs 80% owned, within the meaning of Section 958(a), by a single U.S. shareholder or by multiple related U.S. shareholders.[125]

Suppose that a U.S. partnership owns 80% of multiple CFCs but no single partner or group of related partners has an indirect 80% interest in the CFCs. The question is whether entity principles apply, so that the U.S. partnership is the parent of a single CFC group, and the same election must be made for all the CFCs. Alternatively, under aggregate principles, the partners and not the partnership would be taken into account in determining whether there was one or more CFC groups and whether an election could be made for each.

In this situation, it seems logical to adopt the entity treatment for partnerships. The purpose for the election and for the grouping of CFCs is to permit the excess taxable income of the CFCs in a group to be included in the Section 163(j) calculations for a related group of shareholders. The Section 163(j) limitation is applied at the partnership level rather than at the partner level.[126] As a result, it would not be logical to disregard the partnership for purposes of making the CFC group election or in determining the CFCs to be included in a group.

(vi) *Other entity/aggregate issues*

(1) *Controlling domestic shareholders of a CFC*

The Proposed Regulations do not apply the aggregate treatment of partnerships for purposes of determining the controlling domestic shareholders of a CFC as defined in Treasury Regulation § 1.964-1(c)(5). However, the Proposed Regulations Preamble asks for comments on whether the final regulations should extend aggregate treatment for domestic partnerships for this purpose.[127] Controlling domestic shareholders are defined as U.S. shareholders who in the aggregate own more than 50% of the voting stock of the CFC under Section 958(a), or if there is no such group, all of the U.S. shareholders that own stock under Section 958(a).

Outside the context of the Final Regulations, controlling domestic shareholders make certain accounting elections with respect to a CFC.[128] In addition, under proposed regulations,[129] an audit of controlling domestic shareholders permits the IRS to change the method of calculating e&p of the CFC in order to clearly reflect income. Finally, controlling domestic shareholders make the election to exclude high-tax GILTI income

---

[125] *Id.*; Treas. Reg. § 1.163(j)-7(f)(6).

[126] Section 163(j)(4)(A).

[127] Proposed Regulations Preamble at 29119.

[128] Treas. Reg. § 1.964-1(c)(3).

[129] Proposed Treas. Reg. § 1.964-1(c)(9).

under the Proposed Regulations[130] and are the basis for the groupings of CFCs that are mandatorily subject to a single such election.

The existing rules under Section 964 arguably made sense when Subpart F income was included in the income of a U.S. shareholder partnership. Now that both GILTI and Subpart F will be included directly in the income of U.S. shareholder partners of a U.S. shareholder partnership, it seems more logical to look through the U.S. shareholder partnership for purposes of determining the controlling domestic shareholders. Moreover, the use of entity treatment would give undue influence to a U.S. partnership that might not even have any U.S. shareholder partners that would be including any GILTI or Subpart F income. Finally, even under an aggregate approach, only U.S. shareholder partners of a U.S. shareholder partnership would be taken into account in determining the control group. As a result, even under an aggregate approach, there is not an administrative problem of requiring numerous "small" indirect shareholders to make a decision and file tax elections.

On the other hand, the Final Regulations do not apply aggregate treatment of partnerships for purposes of determining the controlling domestic shareholders eligible to make elections under those regulations. As noted in the Final Regulations Preamble, these elections include the election to use non-alternative depreciation system (known as "non-ADS") depreciation methods for pre-enactment property, and the election to eliminate disqualified basis by reducing the regular tax basis of property. The Final Regulations Preamble states that entity treatment was applied to partnerships in order to reduce the number of parties required to comply with the rules for making the elections.[131]

On balance, while we believe that aggregate treatment of partnerships makes sense in the context of the various elections under Section 964, we do not see any logical rationale for treating partnerships differently, in determining the controlling domestic shareholders of a CFC, for purposes of Section 964 as compared with these GILTI elections. Therefore, unless the Treasury is reconsidering the rules in the Final Regulations for GILTI elections, we do not believe that aggregate principles should apply to partnerships for purposes of determining controlling domestic shareholders for purposes of the Section 964 elections.

We separately discuss the high tax exception in Part III.B.2(b)(v) below.

(2) *Non-grantor trusts and estates*

The Proposed Regulations Preamble asks for comments on whether the aggregate treatment of domestic partnerships for purposes of GILTI and Subpart F inclusions should be extended to other pass-through entities such as certain trusts or estates.[132] We

[130] Proposed Treas. Reg. § 1.951A-2(c)(6)(v).

[131] Final Regulations Preamble at 29316.

[132] Proposed Regulations Preamble at 29120.

have considered whether aggregate treatment similar to that for domestic partnerships should apply to domestic non-grantor trusts (or domestic estates) that are U.S. shareholders of a CFC. We do not believe this should be the case.

First, we are not aware of any circumstance where a domestic non-grantor trust or a domestic estate has been disregarded as a "U.S. person" under the Code. The authority for applying aggregate principles in this situation would be unclear. Section 7701(a)(4) gives the Secretary authority to treat a domestic partnership as foreign, but there is no comparable rule for domestic trusts or estates. Likewise, while there is historic legislative history to the Code stating that entity or aggregate principles apply to partnerships as appropriate, we are not aware of any similar legislative history relating to trusts or estates.

Second, to the extent a trust or an estate has a Subpart F or GILTI inclusion and does not make a corresponding distribution to beneficiaries, the trust or estate must be treated as an entity since it (unlike a partnership) is the taxpayer that owes tax on its undistributed income.

Third, Sections 651-663 provide for income inclusions for trusts and estates under the normal rules for taxable income, and for deductions for distributions. These rules are fundamentally different than the partnership look-through model under which the trust or estate would be disregarded altogether for Subpart F and GILTI inclusions and corresponding distributions to beneficiaries.

Fourth, trusts and estates often retain some income (including capital gain allocated to corpus) and distribute other income such as current income. An aggregate approach limited to distributed income would potentially require two separate tax regimes for the same trust or estate.

Fifth, trusts often have discretionary beneficiaries, or change beneficiaries over time, which would make it difficult to determine whether any particular beneficiary was a U.S. shareholder of the CFC.

We acknowledge, of course, that look-through rules would apply to a foreign trust or estate, and some of the foregoing issues also arise in that case. However, even foreign trusts and estates have never been treated as aggregates except for purposes of applying attribution rules in the same manner as, say, a foreign corporation is treated. Moreover, foreign trusts and estates are subject to tax rules that are more punitive than the rules for domestic trusts.[133] We therefore do not believe that their treatment for CFC inclusion purposes should determine the treatment of domestic trusts.

[133] See, e.g., §§ 668 (interest charge on accumulation distributions), 679 (grantor trust rules applicable to transfer by U.S. person to foreign trust with U.S. beneficiaries), and 684 (transfer of property by U.S. person to foreign non-grantor trust or estate is taxable event).

(vii) *Tax basis and related issues*

The Proposed Regulations Preamble asks for comments on appropriate transition rules relating to tax basis, capital accounts, and PTEP accounts.[134] We do not see any need for transition rules for tax basis, capital accounts, and PTEP accounts as a result of adoption of the Proposed Regulations. Before the effective date of the Proposed Regulations for a particular partnership, all partners of the partnership would report their pro rata share of the partnership's Section 951 inclusion. This should have increased the partnership's tax basis in the CFC, all the partners' tax bases and capital accounts in the partnership, the partnership's PTEP accounts in the CFC, and the PTEP account allocated to each partner.

After the effective date of the Proposed Regulations for the partnership, the partnership should increase its tax basis in the CFC stock by an amount equal to the Subpart F inclusions to the U.S. shareholder partners, and allocate such basis increase solely to such partners.[135] Likewise, the U.S. shareholder partners should increase their tax basis and capital accounts in their partnership interests by the same amount. The partnership would have a PTEP account equal to such inclusions and notionally allocate it to the U.S. shareholder partners. The PTEP accounts in the CFC for the U.S. shareholder partners from the period before the Proposed Regulations are effective would carry over to those partners in the same manner as if those partners had always had direct Subpart F inclusions.

As to the non-U.S. shareholder partners, for future periods, the partnership would not increase its tax basis in the CFC stock and would not increase its PTEP account for those partners. Likewise, the partners would not increase their basis or capital account in the partnership interest (comparable to the rules for a non-U.S. shareholder directly holding stock in a CFC) or their PTEP account in the CFC. Any existing PTEP account that the partnership had in the CFC that was allocated to these partners under the prior rules should remain at both the partnership and partner level.

If the CFC made a distribution out of PTEP, the portion allocable to U.S. shareholder partners would be tax free and would reduce the partnership's PTEP account for such partners and the partners' PTEP account. The portion allocable to non-U.S. shareholder partners should first be treated as reducing any PTEP account arising from past periods, and reduce tax basis accordingly.[136] Any additional distributions would be taxable. If the retroactivity option applies, the non-U.S. shareholder partner would be entitled to a tax refund for any tax paid on Subpart F income during the retroactivity period and would reduce its tax basis and capital account in the partnership accordingly, and the partnership should reduce its tax basis and PTEP account in the CFC accordingly.

---

[134] Proposed Regulations Preamble at 29119-29120.

[135] Our recommendations on this point are discussed in Part III.A.5.

[136] Section 959 applies to a distribution of amounts previously included in the income of a U.S. shareholder even if the U.S. distributee is not a U.S. shareholder at the time of the distribution.

Similar rules would apply for GILTI, except there would not be an issue of retroactivity. Moreover, we do not see any complexity for Subpart F that would arise if the retroactivity option did not apply. During the interim period before the Proposed Regulations become effective, non-U.S. shareholder partners would be subject to the existing rules for Subpart F (pass-through inclusion and basis increase at both levels) and the Final Regulations for GILTI (no inclusion and no basis increase at either level).

2. The Elective Exclusion of High-Taxed Income from GILTI

(a) *The Proposed Regulations*

The Proposed Regulations provide for an election to exclude from tested income of a CFC for GILTI purposes any items of gross income and allocable deductions if the resulting net income is subject to foreign tax at a rate at least equal to 90% of the 21% U.S. rate (i.e., 18.9%).[137] The foreign tax rate is determined separately for each qualified business unit ("**QBU"**) of the CFC, as defined in Section 989, based on the income properly shown on the books and records of the QBU. As a result, either all the income of a particular QBU is included in tested income because the election does not apply to the QBU, or all the income of the QBU is excluded under the election.

The gross income of a QBU is determined under U.S. tax principles and is reduced by allocating deductions to that income. Adjustments are made to account for disregarded payments as under the Section 904 regulations.[138] The foreign tax rate is determined separately for each QBU by allocating a portion of the foreign taxes paid by the CFC for the tax year to the income of the QBUs.

The election for a CFC is made by the controlling domestic shareholders of the CFC for a CFC inclusion year,[139] applies to all the QBUs of the CFC that meet the test for high-taxed income, and is binding on all U.S. shareholders of the CFC.[140] The election is made on an original or amended tax return for the year for which the election will be effective[141] and is binding for all future CFC inclusion years of the CFC unless validly revoked for any future year by the controlling domestic shareholders.[142]

---

[137] Proposed Treas. Reg. § 1.951A-2(c)(6).

[138] However, in contrast to the foreign tax credit regulations, disregarded interest payments are taken into account for this purpose. Proposed Treas. Reg. § 1.951A-2(c)(6)(ii)(A)(2).

[139] Proposed Treas. Reg. § 1.951A-2(c)(6)(v)(A)(1). As noted above, controlling domestic shareholders are U.S. shareholders who in the aggregate own more than 50% of the voting stock of the CFC under Section 958(a), or if there is no such group, all of the Section 958(a) U.S. shareholders of the CFC. Except where otherwise indicated, we assume that the first prong of this test is satisfied.

[140] Proposed Treas. Reg. § 1.951A-2(c)(6)(v)(B).

[141] Proposed Treas. Reg. § 1.951A-2(c)(6)(v)(A)(1).

[142] Proposed Treas. Reg. § 1.951A-2(c)(6)(v)(C).

An election can be revoked in the same manner in which an election is made.[143] However, following a revocation, a new election cannot be made for a CFC inclusion year of the CFC that begins within 60 months following the close of the last prior inclusion year for which the election was in effect.[144] Moreover, that subsequent election cannot be revoked for an inclusion year that begins within 60 months following the close of the first inclusion year for which the new election was in effect.[145] The Commissioner may allow a CFC to make a new election or revocation for an inclusion year if more than 50% of the voting stock of the CFC at the beginning of such inclusion year is owned under Section 958(a) by persons that did not own any stock at the end of the prior inclusion year for which the prior election or revocation became effective. Ownership by related persons under Sections 267(b) and 707(b)(1) is aggregated for this purpose.[146]

Foreign income taxes allocable to tested income that is treated as non-tested income under the election are not allowed as a deemed paid credit under Section 960. Moreover, property used to generate such income is not eligible to be treated as QBAI that reduces the Section 951A inclusion.

If a CFC is a member of a "controlling domestic shareholder group" (a "**CFC Group**"), a single election or revocation applies to all the CFCs in the CFC Group, and therefore to all the high-taxed QBUs of all such CFCs.[147] The single election or revocation also applies to any CFC that joins the CFC Group after the election or revocation.[148]

A CFC Group is defined as two or more CFCs if

> (a) more than 50% of the voting stock of each CFC is owned under Section 958(a) by the same controlling domestic shareholder, or
>
> (b) if no single controlling domestic shareholder owns more than 50% of the voting stock of each corporation, more than 50% of the voting stock of each CFC is owned under Section 958(a) in the aggregate by the same controlling domestic shareholders and each such shareholder owns under Section 958(a) the same percentage of stock in each CFC.[149]

---

[143] Proposed Treas. Reg. § 1.951A-2(c)(6)(v)(D)(1).

[144] Proposed Treas. Reg. § 1.951A-2(c)(6)(v)(D)(2)(i).

[145] Id.

[146] Proposed Treas. Reg. § 1.951A-2(c)(6)(v)(D)(2)(ii).

[147] Proposed Treas. Reg. § 1.951A-2(c)(6)(v)(E)(1).

[148] Id.

[149] Proposed Treas. Reg. § 1.951A-2(c)(6)(v)(E)(2).

Importantly, for purpose of this definition, a controlling domestic shareholder includes any person related to the controlling domestic shareholder under Section 267(b) or 707(b)(1).[150]

The Proposed Regulations, if adopted in final form, will be effective for taxable years of CFCs beginning on or after the date of such adoption in final form, and to taxable years of U.S. shareholders within which such taxable years of CFCs end.[151]

(b) *Comments*

(i) *Scope of comments*

We do not comment on the validity of this aspect of the Proposed Regulations under the Code, or on the general scope or effective date of this aspect of the Proposed Regulations. Rather, our comments are limited to technical issues under these provisions.

(ii) *Notice of election and revocation*

The validity of an election or revocation depends upon statements by sufficient Section 958(a) U.S. shareholders on their own individual tax returns. If there are multiple Section 958(a) U.S. shareholders of the CFC, it may not be possible for any particular U.S. shareholder, whether or not it made the election or revocation on its own return, to know whether the requirement for an election or revocation has been satisfied in the aggregate. For example, a 51% U.S. shareholder may not be willing to disclose information to minority U.S. shareholders, or there might be multiple 10% U.S. shareholders that need to make the election. Moreover, even if all U.S. shareholders are aware of elections and revocations for current years made by all other U.S. shareholders, as discussed below, elections and revocations can be made by amended returns filed for prior tax years by U.S. shareholders, and other U.S. shareholders might not be aware of those.

We suggest that final regulations state that any Section 958(a) U.S. shareholder making or revoking an election on its own original or amended return is required to notify the CFC of such action, and include in such notice a statement of its total Section 958(a) ownership in the CFC. Likewise, the CFC should be required to notify all U.S. shareholders when it has received an election or revocation notice by a U.S. shareholder for a tax year, stating both the action taken by the U.S. shareholder and the percentage ownership of such U.S. shareholder.

(iii) *The 60-month rules*

The 60-month rules in the Proposed Regulations should be clarified. Suppose an election is validly made for calendar year 2020 of a CFC, and is validly revoked for

---

[150] Id.

[151] Proposed Treas. Reg. § 1.951A-7(b).

calendar year 2021. A new election cannot be made for a taxable year of the CFC "that begins within 60 months following the close" of the 2021 tax year of the CFC.

We assume the intent of the regulation is to require a total of 6 years of no election, i.e., the revocation year of 2021 and 60 months (5 years) thereafter, so that a new election could be made for 2027. However, it can be argued under the language of the Proposed Regulations that since the 2027 tax year begins *exactly* 60 months after the end of the tax year of the revocation (2021), it begins *within* 60 months of the close of the 2021 tax year and so a new election cannot be made for 2027. The same issue arises for the 60-month period that a new post-revocation election must remain in effect before being revoked. This should be clarified, perhaps by replacing "begins within 60 months following the close" with "begins less than 60 months following" (or "begins 60 months or less following" if the alternative interpretation is intended).

(iv) *Elections and revocations on amended returns*

The Proposed Regulations state that an election can be made on an amended return, and that a revocation of an election is made in the same manner as an election. It appears, therefore, that a revocation can also be made on an amended return. Retroactive elections and revocations raise a number of issues.

(1) *Retroactive application of 60-month rule*

The Proposed Regulations raise a number of issues as to how the 60-month waiting periods apply in the context of amended returns.

> Example 23. Retroactive election; beginning of 60-month waiting period. US1 owns 100% of a CFC. US1 makes no election on currently filed returns. In year 6, while the statute of limitations in year 1 is still open, US1 makes the election on an amended return for year 1 and revokes the election on an amended return for year 2.

In the example, we believe that the Proposed Regulations allow a new election to be made for year 8 (assuming hereinafter that our interpretation of the 60-month rule above is correct), i.e., without regard to the date that the election and revocation for years 1 and 2 were actually filed on the amended returns. If this interpretation is not correct, the result should be clarified in final regulations.

Next, the final regulations should clarify the scope of a "revocation" of an election that brings into play the 5-year no-election rule. The issue can be illustrated as follows.

> Example 24. Undoing a retroactive election. US1 owns 100% of a CFC, and US1 makes an election for the CFC on a timely filed return for year 1. US1 later files an amended return for year 1 that does not include the election.

The question is whether the amended return in year 1 is:

(i) a "revocation" of the original election for year 1 that prevents a new election from being made for years 2-6, or

(ii) a new filing that merely puts US1 in the same position as if it had never made the election in year 1, so that a new election could be made in year 2 or a later year.[152]

An analogous issue exists concerning the undoing of a revocation statement. The final regulations should clarify and provide procedural rules around the effect of an amended return, e.g., filing an amended return that does not contain a revocation statement that was included in the original return. For example:

> Example 25. Undoing a revocation. US1 makes an election on an original return for year 1, and revokes the election on an original return for year 2. In year 5, while the statute of limitation is still open on year 2, US1 files an amended return for year 2 that does not contain the revocation.

Possibly, the action in year 5 makes the revocation in year 2 (retroactively) ineffective, so that the year 1 election continues in year 2 and thereafter unless and until a revocation is filed for a future year on an original or amended return. For example, a new revocation could be filed on an amended return for year 3, and a new election could be made in year 9. Alternatively, once the election was revoked in year 2, the revocation is final and cannot be undone with an amended return, and so a new election is subject to the 60-month waiting period after year 2.

(2) *Non-electing U.S. shareholders*

The Proposed Regulations raise issues concerning the tax treatment of U.S. shareholders that do not make the election, even though the election is binding on them.

> Example 26. Nonelecting U.S. shareholders. US1 is a U.S. shareholder owning 70% of a CFC, and US2 is a U.S. shareholder owning the remaining 30%. In year 1, US1 unilaterally makes the election, which is binding on US2. US2 properly files a return accordingly. In year 4, US1 files an amended return for year 1 revoking the election in year 1, and US2 obtains notice of the revocation. US2 would owe more tax in year 1 in light of the retroactive revocation of the election.

Since US2 filed a proper tax return in year 1, and did nothing to retroactively increase its tax liability in year 1, under general tax principles it is not clear that US2 is required to file an amended return for year 1 and pay the additional tax. (Of course, if it was entitled to a refund, it could clearly choose to file an amended return.)

---

[152] Cf. Treas. Reg. § 1.911-7(b)(1) (amended return for year of election, revoking election made on original return, is subject to rules for revocation). See also Rev. Rul. 90-77, 1990-2 C.B. 183, Situations 2 and 3 (noting that taking a position inconsistent with a past election on Section 911(a) should result in the revocation of such election, while computational errors in good faith should not result in a revocation).

If the intent of the regulations is to require that such a tax return be filed, this should be so clarified. We also note that even if the statute of limitations for US2 for year 1 is still open, US2 might have limited time to file a refund claim, and the IRS might have limited time to audit US2 for any claimed deficiency as a result of the revocation of the election. The same issues would arise if US1 had not initially made an election in year 1, US1 makes an election for year 1 on an amended return, and the result of the election is an increase or decrease in tax on US2 for year 1.

> Example 27. Statute of limitations. US1 makes the election in year 1 on an original return, and following an audit of year 1, files an amended return revoking the election for year 1 in year 8. At that time, US1 has its tax years 1-8 all open, but US2 has its tax years closed for years 1-3.

It appears that US2 is not liable for any deficiencies or entitled to any refunds for years 1-3. If this is correct, US2 will have an incentive to file a protective refund claim each year to reflect the refund, if any, that would be available if the election or nonelection in effect that year were to retroactively change.

(v) *U.S. partnerships as shareholders*

The Proposed Regulations treat a Section 958(a) U.S. shareholder partnership of a CFC (rather than any Section 958(a) U.S. shareholder partners of the partnership) as the shareholder that is taken into account in determining whether the election for the CFC has been made by the controlling domestic shareholders of the CFC. As noted above, the Proposed Regulations Preamble asks whether aggregate principles of partnerships should instead be used for this purpose.

A number of arguments would support aggregate treatment in this situation. Under the Final Regulations, the GILTI inclusion arises directly in the income of the Section 958(a) U.S. shareholder partners. Moreover, since the election can affect different Section 958(a) U.S. shareholders in very different ways, it would be logical for the decision about the election to be made by direct or indirect Section 958(a) U.S. shareholders who actually report a majority of the GILTI income on their tax returns.

This would not be the case under the approach of the Proposed Regulations, however. For example, suppose a CFC is owned (i) 51% by a U.S. partnership with no U.S. shareholder partners, i.e., all the partners are foreign or are domestic non-U.S. shareholders, and (ii) 49% by a direct U.S. shareholder. Under the Proposed Regulations, the partnership will unilaterally decide whether to make the election, and the decision is binding on the 49% shareholder, even though none of the partners of the partnership will have any economic interest in the issue. If aggregate principles applied, the direct U.S. shareholder, the only one affected by the election, could itself decide whether to make the election. This would also be the result if the partnership was a foreign partnership.

To be sure, as noted above, the Final Regulations treat a domestic partnership as an entity for purposes of other shareholder elections under GILTI. In particular, the elections involving depreciation methods to be used by the CFC and the tax basis of CFC

property. However, those elections involve CFC-level calculations of GILTI income. By contrast, the high-tax election involves purely a shareholder level determination of its own GILTI inclusions (based, of course, on CFC level items of income and deduction). It therefore seems justifiable to use aggregate treatment of U.S. shareholder partnerships for purposes of determining eligibility for the high-tax election even if entity principles are used for purposes of other elections.

(vi) *Definition of CFC Group*

There are two ways that a CFC Group can exist, and we discuss them separately.

(1) *Single controlling domestic shareholder*

Under the first test for a CFC Group, a single controlling domestic shareholder must own more than 50% of the voting power of the stock of each of two or more CFCs under Section 958(a). For this purpose, a controlling domestic shareholder includes any person bearing a relationship described in Section 267(b) or 707(b)(1) to the controlling domestic shareholder (the "**related party rule**").

The purpose of this test is to require CFCs with a sufficient degree of related ownership to be subject to a single election or revocation. The related party rule is necessary to achieve this goal. For example, the rule is necessary to place two CFCs, CFC1 and CFC2, in the same CFC Group if:

(1) U.S. corporation US1 owns all of CFC1 and all of US2, and US2 owns all of CFC2,

(2) US1 owns all of US2 and US3, US2 owns all of CFC1, and US3 owns all of CFC2, or

(3) foreign corporation F owns all of US1 and US2, US1 owns CFC1, and US2 owns CFC2.

The meaning of the related party rule is not entirely clear, however. The phrase is somewhat circular, since it requires the already-determined existence of a controlling domestic shareholder to apply the rule that a controlling domestic shareholder "includes" persons bearing the specified relationship to the controlling domestic shareholder.

Most likely, the intent of the related party rule is that the analysis begins with any U.S. corporation US1 that is a Section 958(a) U.S. shareholder of at least one CFC, taking into account Section 958(a) ownership by parties related to US1 in the required manner. Then, a CFC Group exists if US1, together with such related parties, in the aggregate have Section 958(a) ownership of more than 50% of the voting power of each of the other CFCs in question.

However, "any person" referred to in the related party rule can literally be foreign, since Section 958(a) is not limited to stock owned by U.S. persons, at least for direct ownership.[153]

> Example 28. Scope of Section 958(a) ownership. Foreign corporation F owns 100% of US1 and 60% of CFC1. US1 owns 40% of CFC1 and 100% of CFC2. CFC1 is a CFC by attribution from F to US1.

If the intent is that a foreign person can have Section 958(a) ownership of a CFC for purposes of the 50% test, the rule would create a CFC Group among CFC1 and CFC2. The CFC Group would exist because US1 and a person related to US1 under 267(b) (namely F) together own more than 50% of both CFC1 and CFC2 under Section 958(a). If this result is not intended, the related party rule should be clarified so that the relevant related parties with Section 958(a) ownership are limited to U.S. persons, or Section 958(a) ownership is limited to ownership by U.S. persons.

Next, under this interpretation of the related party rule, at least as applied to U.S. persons, any time a group of U.S. shareholders satisfies the ownership tests to create a CFC Group, every one of the U.S. shareholders will be a controlling domestic shareholder of the CFC Group. The reason is that any one U.S. shareholder, together with the other U.S. shareholders related to it under Section 267(b), will in the aggregate necessarily have more than 50% Section 958(a) ownership of each CFC in the group.

As a result, even though a CFC Group under this prong of the test appears to be required to have a single controlling domestic shareholder, in fact there will be numerous controlling domestic shareholders that meet the ownership test directly and by ownership through related parties. Therefore, it is impossible to "tag" a CFC Group by identifying its single controlling domestic shareholder. The significance of this fact will be seen below.

Finally, under the Proposed Regulations, a CFC Group can only exist if a single U.S. shareholder US1 has more than 50% of the voting power of each CFC in the group. Suppose US1 is the controlling domestic shareholder of CFC1 (with the sole ability to make the high tax election) by virtue of being the sole Section 958(a) U.S. shareholder of CFC1 with 10%-50% of the vote in CFC1. Since US1 does not have more than 50% of the voting power in CFC1, CFC1 would not be in any CFC Group, including a group with any CFC2 of which US1 was the sole controlling domestic shareholder by virtue of having any level of ownership in CFC2 between 10% and 100%.

We note that an alternative test might aggregate all CFCs owned by a single controlling domestic shareholder into a CFC Group in all cases. However, under that test, CFC1 and CFC2 would form a CFC group if US1 was the only Section 958(a) U.S. shareholder of each and only owned 10% of each. Regulations should confirm the interpretation in the preceding paragraph, assuming that is the intent.

---

[153] Section 958(a)(1)(A).

(2) *Multiple controlling domestic shareholders*

Under the alternative test for a CFC group, more than 50% of the stock in each of two or more CFCs must be owned in the aggregate under Section 958(a) by controlling domestic shareholders each of which has identical stock ownership in each CFC. As in the prior test, a controlling domestic shareholder includes any person bearing a relationship under Section 267(b) or 707(b)(1) to the controlling domestic shareholder.

The test would be satisfied if U.S. shareholder US1 owns 25% of CFC1 and CFC2, unrelated U.S. shareholder US2 owns 30% of CFC1 and CFC2, and unrelated parties own the rest of each CFC. Yet the test is not satisfied if US1 or US2 acquires any additional stock in either CFC1 or CFC2, unless each acquires stock in both CFCs in identical proportions.

If the rationale for the test is common ownership, then logically, once the common ownership threshold is satisfied by A and B, it should not matter if the remaining stock is held by A, B, or unrelated parties. Under this approach, each U.S. shareholder would take into account its lowest common percentage ownership in each CFC, and there would be a CFC Group if the sum of such percentages for each U.S. shareholder exceeded 50%.

For example, suppose US1 owns 25% of CFC1 and 35% of CFC2, and US2 owns 40% of CFC1 and 30% of CFC2. Under the proposal, US1 would get "credit" for its 25% common ownership of both CFCs, and US2 would get "credit" for its 30% common ownership of each CFC. Since the "credits" exceed 50%, both CFCs would be in the same CFC Group. Note that this would be the result under the Proposed Regulations if US1 sold its "excess" 10% interest in CFC2, and US2 sold its excess "10%" interest in CFC1, so that US1 had identical 25% interests in both CFCs and US2 had identical 30% interests in both CFCs. Since these smaller identical interests in both CFCs allow for the creation of a CFC Group under the Proposed Regulations, it is logical for the larger aggregate interests to reach the same result.

On the other hand, it is possible that the sole purpose of the test in the Proposed Regulations is to place into a single CFC Group a CFC and its wholly owned CFC subsidiaries, as long as U.S. shareholders of the parent CFC have in the aggregate more than 51% ownership of the parent CFC. The test reaches that result since each U.S. shareholder of the parent CFC would have the same percentage interest in the subsidiary CFCs as in the parent CFC.

Yet under the test, there would not be a single CFC Group of the parent and subsidiary CFCs, absent a single greater-than-50% U.S. shareholder of the parent CFC, if the subsidiary CFCs issued a single share of common or preferred stock directly to one of the U.S. shareholders or to a third party. The approach described above would avoid this anomaly also. We suggest that the Treasury better explain the rationale for this test and consider these issues further.

Moreover, the requirement of identical ownership percentages is both a trap for the unwary and a tax planning opportunity. For unrelated U.S. shareholders that do not wish to have two CFCs be part of the same CFC Group, it is simple enough to create a slight change in percentage ownership in one of the CFCs. For shareholders who are not aware of the test, which is very counterintuitive, it is easy to fall into the "trap" of creating a CFC Group inadvertently.

(3) *Entity treatment for U.S. partnership shareholders*

The Proposed Regulations apply entity treatment to a U.S. partnership in determining the existence of a CFC Group, just as they do in determining the controlling domestic shareholders of a CFC for purposes of making the high-tax election. Thus, if a U.S. partnership owns more than 50% of multiple CFCs, they are automatically part of a single CFC Group.

This rule goes well beyond the rule of common ownership discussed in Part III.B.2(b)(vi)(2) above. For example, a U.S. partnership that owns 51% of multiple CFCs would always cause all the CFCs to be in a single CFC Group, under the rule for a single controlling domestic shareholder. However, this might not be the case under aggregate principles, even taking into account the rule discussed in section (2) above. For example, suppose the U.S. partnership with a 51% interest in the CFCs has at least one U.S. shareholder partner and a 5% partner that is not a U.S. shareholder. Then, on an aggregate basis, there is less than 50% ownership by U.S. shareholder partners. Neither prong of the test for a CFC Group could be satisfied.

Moreover, using entity principles to determine a CFC Group can reach peculiar results. For example, suppose three U.S. partnerships own 40%, 30% and 30% respectively of each of three CFCs. The CFCs might be "sister" CFCs, or two might be subsidiaries of the third. There is no single controlling domestic shareholder of any of the CFCs, so any two of the partnerships could make the election. The election will then apply to all three CFCs, since they form a single CFC Group under the alternative test. But the partners of the three partnerships may be entirely different, and if they directly held the stock in the three CFCs (or in the parent CFC), there would be no CFC Group and so a separate election could be made for each CFC.

It is not clear to us why mandatory aggregation of the CFCs should apply in this situation because of the use of a U.S. partnership, when aggregation would not apply in the case of direct ownership by the partners, or indirect ownership through a foreign partnership.

(vii) *Changes in ownership of CFCs*

(1) *Acquired CFC joining a CFC Group*

As noted in Part III.B.2(a) above, if a CFC "joins" a CFC Group, the preexisting elections or revocations for the CFC Group apply to the new CFC as well (the "**CFC Group Joinder Rule"**). The CFC Group Joinder Rule raises a number of issues.

Case 1: Acquired single CFC creating a CFC Group. A U.S. shareholder, US1, owns a single CFC, CFC1, and acquires a second CFC, CFC2. Technically speaking, there was no CFC Group in existence before US1 acquired CFC2, since a CFC Group requires two members. As a result, the CFC Group Joinder Rule technically does not apply, and a different election or revocation could be made for CFC2 than for CFC1.

This was presumably not the intent of the CFC Group Joinder Rule. The rule should be clarified to state that the elections or revocations applicable to a CFC that is not a member of a CFC Group also apply to another CFC that becomes part of the same CFC Group as the former CFC, in the same manner as the CFC Group Joinder Rule would apply if the former CFC had already been a member of a CFC Group.

Case 2: Acquired CFC leaving a CFC Group and not joining a CFC Group. A CFC is a member of a CFC Group that is subject to an election in year 1 and a revocation in year 2. In year 3, there is a change in ownership of the CFC to some extent, resulting in the CFC leaving its CFC Group and not becoming a member of another CFC Group. In this case, the CFC Group Joinder Rule has no application. As a result, we believe that the 60-month rule that was applicable to the CFC in its old CFC Group continues to apply to the CFC individually, preventing a new election for the CFC in year 3 unless the 50% change in ownership test is satisfied and the IRS consents to a new election. This should be confirmed.

Case 3: Acquired CFC joining a preexisting CFC Group that has an election in place. Assume the same facts as in Case 2, except the CFC joins a preexisting CFC Group with an election in place. Now, there is a conflict between the 60-month prohibition on a new election for the CFC based on its former status, and the rule that a new member of the CFC Group takes the same position as the CFC Group as a whole. Regulations should clarify the result in this case. Note that this issue cannot always be resolved by a consent by the IRS to a new election, since it can arise without a 50% change in ownership of the CFC (e.g., a CFC is owned 60/40 by two U.S. shareholders and the ownership becomes 40/60, or else there is only a single 40% U.S. shareholder and the entire 40% is transferred to another U.S. shareholder). This same issue would arise even if the CFC in Case 2 had not been a member of a previous CFC Group, since it would still be subject to the same prohibitions on new elections at the time it joined the new group.

Case 4: Acquired CFC joining a preexisting CFC Group that does not have election in place. A CFC is subject to an election in year 1, a revocation in year 2, and a new election in year 8. In year 9, the CFC becomes a member of an existing CFC Group for which an election has never been made. Under the general rule, the year 8 election cannot be revoked for 60 months. Suppose the result in Case 3 is that the CFC Group Joinder Rule overrides the 60-month rules that would otherwise apply to a CFC joining a CFC Group. In that case, the lack of an election for the acquiring CFC Group might override the 60-month rule prohibiting a revocation of the year 8 election, therefore turning off the election for the CFC.

This would be the logical result if the purpose of the CFC Group Joinder Rule is to cause all members of a CFC Group to be subject to the same election or non-election. However, it is not clear that the CFC Group Joinder Rule even applies on this fact pattern, since there has never been an election for the acquiring CFC Group. The Rule by its terms only binds new members of a CFC Group to elections or revocations made by the CFC Group. Regulations should clarify whether the CFC Group Joinder Rule applies to a CFC joining a CFC Group that has never made an election or revocation.

Case 5: Simultaneous acquisitions of CFCs. Suppose a U.S. corporation has no CFCs. It simultaneously acquires 100% of two different CFCs from different unrelated parties with different election histories. The CFCs might or might not have been part of prior CFC Groups. There is clearly a new CFC Group consisting of the two CFCs. Presumably the intent is that both CFCs will be "deemed" to have the same election history. Regulations should consider how to determine which history is controlling, and clarify whether the acquiring corporation can choose the election history it prefers, either as a matter of right or by acquiring one of the CFCs a moment before the other.

Case 6: Acquisition of controlling domestic shareholder. Suppose that in any of Cases 1-5, the acquisition is not of the "target" CFC itself, but of the controlling domestic shareholder of that CFC. Logically, the results would be the same in each case, since the CFC that is owned by the acquired controlling domestic shareholder joins any CFC Group of the acquiring group. However, this fact pattern raises additional issues that are discussed in Part III.B.2(b)(vii)(2) below. In any event, regulations discussing the above cases should include this fact pattern also.

(2) *Acquisitions of U.S. shareholders*

Acquisitions of U.S. shareholders raise additional issues.

Case 7: Acquisition of U.S. shareholder. Suppose US1 owns 100% of the CFCs in a CFC Group, CFC Group 1. US2 owns 100% of the CFCs in another CFC Group, CFC Group 2. Then, either (1) US1 acquires all the stock of US2, (2) US2 acquires all the stock of US1, or (3) a domestic or foreign corporation C that is not the controlling shareholder of any CFC Group simultaneously acquires all the stock of both US1 and US2.[154]

In each of these fact patterns, a single CFC Group exists following the acquisition because of the related party rule. For example, US1 is a controlling domestic shareholder of all the CFCs. This is because US1 is related under Section 267(b) to US2, and in all the cases, US1 and US2 in the aggregate have 100% Section 958(a) ownership of all the CFCs. As a result, CFC Group 1 might be thought to continue, with the CFCs in the old CFC Group 2 being bound by the history of CFC Group 1.

[154] Such simultaneous acquisitions include acquisitive Section 351 transactions commonly known as "horizontal double dummy" transactions, pursuant to which a new holding company acquires two historic corporations by having a subsidiary merge into each historic corporation.

Of course, US2 is also a controlling shareholder of all the CFCs, for exactly the same reason. This would mean that all the CFCs in the old CFC Group 1 would be bound by the history of CFC Group 2. The problem is that under the definition of controlling domestic shareholder, the old unrelated controlling domestic shareholders of two separate CFC Groups are now *both* controlling domestic shareholders of the combined CFC Group.

Obviously, either CFC Group 1 can continue with its history, or CFC Group 2 can continue with its history, but both cannot continue. Regulations need to resolve this puzzle. Among the possible rules of decision would be:

> (1) the taxpayer elects which CFC Group should continue,
>
> (2) Section 958(a) ownership by an acquiring U.S. shareholder and its related parties trumps Section 958(a) ownership by an acquired U.S. shareholder and its related parties, so that CFC Group 1 would continue, for example, if US1 acquired US2, or
>
> (3) the CFC Group with a greater value survives, as in the consolidated return "reverse acquisition" rules.[155]

Note, however, that alternative (2) would not resolve the issue in the case where a U.S. or foreign corporation with no CFC Group of its own acquires both US1 and US2 at the same time. That is because neither US1 nor US2 is the acquiring corporation, and both US1 and US2 are Section 958(a) controlling shareholders of the CFCs they don't own directly solely by virtue of Section 958(a) ownership of those CFCs by a related party, i.e., the other such corporation. Alternative (3) would likely be impracticable because it requires valuations of all the relevant CFCs.[156]

These are very significant issues that will arise any time one U.S. corporation with CFCs acquires another U.S. corporation with CFCs. In some cases, the change of control exception may permit the parties to obtain a ruling from the IRS to resolve any conflict between the election rules for the two CFC Groups. However, in many situations the conditions for the change of control exception will not apply, and even when they do apply, the IRS is not likely to wish to be burdened by the large number of ruling requests it might receive on this issue. As a result, we urge as detailed as possible guidance on these issues.

(3) *Successor CFCs*

The Proposed Regulations do not have an explicit concept of a successor CFC for purposes of limiting changes in elections or revocations under the 60-month rules.

---

[155] Treas. Reg. § 1.1502-75(d)(3).

[156] The consolidated return reverse acquisition rules do not require valuation because they only apply in the case of issuance of stock, and their application depends upon whether shareholders of the target group acquire more than 50% of the stock of the acquiring group.

Frequently the concept will not matter, since elections and revocations apply to the entire CFC Group, and a successor CFC will often be within the same CFC Group. However, a successor CFC might not be in the original CFC Group.

In particular, in Cases 1-5 above, instead of an acquisition of stock of the CFC, the CFC could merge into a "shell" CFC in an "A" reorganization with (say) a former 60% U.S. shareholder obtaining a 40% interest in the new CFC plus boot. The new CFC might or might not be part of a CFC Group. The same issues would arise in Case 7 if one of the U.S. shareholders merged into the other. It would be surprising if the results in these Cases are different if the same ownership shifts were accomplished through asset transfers rather than stock transfers. Regulations should clarify the extent, if any, to which a successor rule applies for purposes of the 60-month limitations on elections and revocations.

(4) *The change in control exception*

As noted in Part III.B.2(a) above, the IRS can waive the 60-month waiting periods for elections and revocations for an inclusion year following a change in ownership of a CFC. The change in ownership requirement is satisfied if more than 50% of the voting stock of the CFC at the beginning of such inclusion year is owned under Section 958(a) by persons that did not own any stock at the end of the prior inclusion year for which the prior election or revocation became effective. Ownership of stock by related parties is taken into account under the test.

This test is not satisfied if, for example, a shareholder that owned 1% of the stock of a CFC at the beginning of the 60-month period acquires the remaining 99% of the stock during the 60-month period. It is not clear why the preexisting ownership of 1% should prevent the IRS from having the ability to waive the 60-month waiting periods.

Moreover, the test is based on total changes in ownership of the CFC stock, not changes in ownership by Section 958(a) U.S. shareholders. Assume there is a 40% Section 958(a) U.S. shareholder and no other Section 958(a) U.S. shareholders. The 40% shareholder constitutes the controlling domestic shareholder and has the sole right to make the high-tax election. Yet the change in ownership rule (i) allows relief by the IRS if the ownership of the other 60% of the stock in the CFC changes hands, even though the ownership in the CFC by the only Section 958(a) U.S. shareholder does not change, and (ii) does not allow relief if the 40% ownership in the CFC by the only Section 958(a) U.S. shareholder changes hands, even though the tax treatment of that 40% U.S. shareholder is the only point of the election. The rationale for these distinctions is not clear. Regulations should clarify whether these results are intended.

Next, the rule applies to a CFC if more than 50% of the CFC is owned under Section 958(a) by persons that did not own any interest in the CFC at the beginning of the 60-month period, *taking into account ownership by persons related to such persons under Section 267(b)*. Suppose US1 does not have any CFCs, and unrelated US2 owns 100% of the CFCs in a CFC Group. US1 acquires all the stock of US2 for cash, and perhaps they file a consolidated return. The change of control rule does not apply, even

though in substance there has been a 100% change of control of the CFCs, because US2 was and remains the sole Section 958(a) shareholder of the CFCs. US1 is not a Section 958(a) U.S. shareholder of the CFCs because it owns the CFCs through a domestic corporation US1. Under this interpretation, a change in ownership of a Section 958(a) U.S. shareholder of a CFC would rarely if ever satisfy the change in ownership test for the CFC unless a Section 338(h)(10) election was made with respect to the U.S. shareholder.

Regulations should clarify the application of the change of control rule when there is a change in ownership of the controlling domestic shareholders of the CFC.

Moreover, the Proposed Regulations state that the IRS can waive the 60-month waiting periods. Presumably it will be possible to obtain PLRs on this question, although the language of the Proposed Regulations appears to also allow such a waiver on audit. In this regard, it would be helpful to both taxpayers and the IRS if the final regulations provided guidelines for the issuance of advance PLRs, both for situations where rulings are likely to be granted and for situations where rulings are unlikely to be granted. This will allow both taxpayers and the IRS to avoid the effort in requesting and receiving futile requests, and will give taxpayers some assurance as to the types of transactions that might make a request for a ruling worthwhile.

In addition, if there are situations where the IRS believes it would be almost certain to grant an advance PLR, consideration should be given to providing safe harbors directly in the final regulations. This would avoid the necessity for the IRS to issue, and taxpayers to obtain, numerous boilerplate rulings. For example, if the IRS believes there are circumstances in which it would almost always issue a PLR where there is a "true" transfer to unrelated parties of some specified level of direct and indirect Section 958(a) ownership of a CFC, a safe harbor could be provided.

Finally, if the change in control test is satisfied, the Proposed Regulations state that the "Commissioner may permit a controlled foreign corporation to make" an election or revocation under the various sections without regard to the 60-month periods.[157] However, elections and revocations are all otherwise made by controlling domestic shareholders of a CFC, and not by the CFC itself. As a result, we assume the reference to elections and revocations by a CFC is a drafting error. We do not see any logic to allowing or requiring a CFC to be the party to make or revoke an election solely in the event of a change of control of the CFC.

[157] Prop. Treas. Reg. § 1.951A-2(c)(6)(v)(D)(2)(ii).

(viii) *Loss sharing situations*

The Proposed Regulations Preamble asks for comments on how to address circumstances in which QBUs are permitted to share losses or determine tax liability based on combined income for foreign tax purposes.[158]

> Example 29. Loss sharing among QBUs of same CFC. Country X has a 20% tax rate on all income. CFC has QBU 1 in country X with tested income of $100, and QBU 2 in country X with a tested loss of $50. Since net income is $50, the foreign tax is $10. Even if all this tax is allocated to QBU 1, the tax of $10 is only 10% of the QBU 1 income of $100.

We note that the $100 of QBU 1 income would have an economic tax "cost" of $20 (an effective 20% tax rate) if the absorption of the $50 of loss prevented the loss from being carried forward or back and therefore prevented a refund or reduced tax liability of $10. That economic cost would be more apparent if there was a tax sharing agreement on the books of QBU 1 and QBU 2 under which QBU 1 paid $10 to QBU 2 for the use of the latter's $50 loss.

On the other hand, in fact QBU 1 has $100 of income, and CFC has only paid $10 of tax to country X in the year in question. Absent the election, the total available foreign tax credits for CFC for GILTI purposes would be $10. This limitation of $10 on foreign tax credits is arguably inconsistent with "pretending" that $20 of foreign taxes was paid on the income of QBU 1. Regulations should clarify the intended result in this case.

The same issue could arise if a single QBU had both a business that gave rise to items of tested income and a business that gave rise to items of nontested income.[159]

> Example 30. Loss sharing within a QBU. CFC has a single QBU that engages in both activities giving rise to tested income and activities not giving rise to tested income, such as foreign oil and gas extraction income.[160] There is tested income of $100 and a nontested loss of $50. There is a 20% foreign tax rate and total tax payment of 20% of $50, or $10.

This fact pattern raises the same issue of allocating foreign taxes as in Example 29. Allocating between two QBUs is no different than allocating between exempt and nonexempt businesses of a single QBU. (In fact, in Example 29, each of the QBUs might themselves have had exempt as well as nonexempt income, requiring an allocation to four

---

[158] Proposed Regulations Preamble at 29121.

[159] A single QBU would exist under the Proposed Regulations if the CFC keeps a single set of books for both businesses, but the CFC would nevertheless be required to separately account for the tested income and nontested income in order to properly report the shareholder's GILTI inclusion.

[160] Section 951A(c)(2)(A)(i)(V).

groupings of income in that case.) Regulations should use the same allocation methodology for Examples 29 and 30.

> Example 31. Combined returns among CFCs. CFC1 files a combined return in country X with CFC2, and the only business of each is from its own QBU in country X. CFC1 and CFC2 might or might not be in the same CFC Group, and the same election (or non-election) might or might not be made for both. CFC1 has a profit of $100 and CFC2 has a loss of $50, so at the 20% tax rate, the tax on the combined return is $10.

In this situation, the final regulations should clarify whether CFC1 is considered to have high-taxed income, based on the 20% tax rate in country X and CFC1's own income of $100, even though the total tax paid to country X is only $10. Logically, the same principles would apply here as in Examples 29 and 30. In fact, it would be an invitation for tax planning if the result in Example 31 was different than in Example 29 or 30. Example 31 could involve parent/subsidiary CFCs, and that fact pattern could easily be converted into the multiple QBU case by checking CFC2 so that it became a disregarded subsidiary of CFC1.

(ix) *Disregarded entities and partnerships*

The Proposed Regulations Preamble asks for comments on how to apply these rules to disregarded entities and U.S. tax partnerships.[161] If a CFC owns a disregarded entity, and the entity is a separate taxable entity in a particular tax jurisdiction and does not file a combined return with the CFC itself in the same jurisdiction, then the entity should be treated as a separate entity from the CFC. The entity should be treated as having its own QBUs, taxable income and foreign tax paid. In that case, the foreign jurisdiction itself has provided the economically correct allocation of tax liability between the "parent" CFC and the disregarded entity, and there is no reason to combine the income and foreign taxes of the two legal entities and then to reallocate the aggregate foreign taxes to the separate income of each under a mechanical formula.

On the other hand, if the disregarded entity is also disregarded in its local jurisdiction, then the disregarded entity should be disregarded for purposes of the QBU rules. Then, a QBU of the disregarded entity should be treated just like a QBU of the CFC itself, and the total tax liability of the CFC in the jurisdiction should be allocated among all the QBUs in the usual manner.

If a CFC is a partner in a U.S. tax partnership, the same principles should apply. If the partnership is a taxable entity in its local jurisdiction, then it should be treated as a separate entity for purposes of the QBU rules. Its own tax liability should be allocated among its own QBUs in the usual manner, and the CFC's share of partnership income and taxes for each partnership QBU should be separately tested under the high-tax exception, without regard to the CFC's nonpartnership income or taxes.

---

[161] Proposed Regulations Preamble at 29121.

If the partnership is a pass-through in its local jurisdiction, the CFC's share of partnership income for each partnership QBU should be treated the same as any other QBU of the CFC in the same jurisdiction. Thus, the total tax imposed by the jurisdiction on the CFC should be allocated to the various QBUs of the CFC (including the CFC's share of partnership QBUs) under the usual principles for a CFC with multiple QBUs.