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IRS Provides Very Modest Relief from Downward Attribution Resulting from the Repeal of Section 958(b)(4)

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On October 2, 2019, the Internal Revenue Service ("IRS") and the U.S. Department of the Treasury (the "Treasury") issued Revenue Produce 2019-40 (the "Revenue Procedure") and proposed regulations (the "Proposed Regulations") that provide guidance on issues that have arisen as a result of the repeal of section 958(b)(4) by the tax reform act of 2017.[1] The repeal of section 958(b)(4) was intended to prevent certain taxpayers from "de-controlling" their controlled foreign corporations ("CFCs") and avoid paying current tax on earnings of those CFCs. However, the repeal has inadvertently caused a number of foreign corporations to be treated as CFCs for U.S. federal income tax purposes. As a result, U.S. persons who directly or indirectly own between 10% and 50% of the voting stock or value of foreign corporations that are now treated as CFCs are subject to tax on income ("subpart F income") and 951A (globally intangible low-taxed income, or "GILTI"). The repeal has had other unintended consequences. For example, if a foreign corporation receives U.S.-source interest from a related person, the repeal of section 958(b)(4) may cause the interest to be subject to U.S. withholding tax (i.e., the interest would fail to qualify for the "portfolio interest exemption").[2]

The Proposed Regulations "turn off" certain special rules that arise solely as a result of the repeal of section 958(b)(4). However, the Proposed Regulations do not prevent foreign corporations from being treated as CFCs as a result of the repeal of section 958(b)(4), do not limit the subpart F or GILTI income required to be reported as a result of the repeal of section 958(b)(4), and do not reinstate the portfolio interest exemption for foreign corporations affected by the repeal of section 958(b)(4).

The Revenue Procedure provides safe harbors for certain U.S. persons to determine whether they own stock in a CFC and to use alternative information to determine their taxable income with respect to foreign corporations that are CFCs solely as a result of the repeal of section 958(b)(4) if they are unable to obtain information to report these amounts with more accuracy.

The Proposed Regulations are generally proposed to apply on or after October 1, 2019. However, a taxpayer may rely on the Proposed Regulations for taxable years prior to the date they are finalized. The Revenue Procedure is effective for the last taxable year of a foreign corporation beginning before January 1, 2019.

Background

A foreign corporation is a CFC if more than 50% of the total combined voting power of all classes of stock entitled to vote or the total value of the stock of the corporation is owned directly, indirectly, or constructively by "United States shareholders" on any day during the taxable year of the foreign corporation.[3] A "United States shareholder" is a U.S. person that owns 10% or more of the total combined voting power or value of the foreign corporation.[4] Section 958 provides indirect and constructive stock ownership rules that deem a taxpayer to own stock that it does not own for purposes of determining whether it is a "United States shareholder" of a foreign corporation and whether a foreign corporation is a CFC. For these purposes, section 958(b) requires taxpayers to apply the attribution rules of section 318(a), which generally treat a shareholder as constructively owning stock owned by taxpayers with whom the shareholder has certain specified relationships. Under the "downward attribution" rules of section 318(a)(3)(A), (B), and (C), stock owned by a person is attributed to certain partnerships, estates, trust and corporations in which the person has an interest. Section 958(b)(4) prevented the "downward attribution" of stock held by a foreign person to a U.S. person.

As the result of the repeal, a U.S. corporation owned by a foreign corporation may bizarrely be treated as constructively owning the stock of the foreign corporation that owns the U.S. corporation. This, in turn, may cause the foreign corporation to be a CFC for U.S tax purposes even though the foreign corporation does not have any United States shareholders that directly or indirectly own its stock.[5] If the foreign corporation is treated as a CFC because of the downward attribution of the stock from the foreign person to the U.S. corporation, section United States shareholders who own between 10% and 50% of the foreign corporation would be required to include any subpart F income or GILTI from the foreign corporation, even if the foreign corporation is owned 50% or less by United States shareholders, and any interest paid by the U.S. corporation to the foreign corporation may be subject to U.S. withholding tax.

The legislative history behind the repeal of section 958(b)(4) does not suggest that Congress intended this result. The repeal was instead intended to prevent certain taxpayers from "decontrolling" a CFC to avoid the inclusion of subpart F income without relinquishing control.[6] Although the legislative history also provides that the repeal was not intended to cause a foreign corporation to be treated as a CFC with respect to a United States shareholder "as a result of attribution of ownership under section 318(a)(3) to a U.S person that is not a related person," the current version of section 958 does not reflect this intent.

In early 2019, Kevin Brady, former Chairman of the Committee on Ways and Means, released the Tax Technical and Clerical Corrections Act (the "TTCCA"), which proposed to reinstate section 958(b)(4), except where a person would directly or indirectly own more than 50% of the stock of a foreign corporation if downward attribution were applied. However, the TTCCA has not been enacted, and there is no certainty as to whether this change will ever become law.

The Proposed Regulations

The Proposed Regulations turn off the repeal of section 958(b)(4) (and do not apply downward attribution) for certain sections of the Internal Revenue Code, generally by applying the pre-tax reform version of section 958(b)(4) in such situations.

Section 267: Deduction for certain payments to foreign related persons

Section 267(a) generally provides that certain interest and expenses paid to a related taxpayer (including a foreign person) are not deductible until the related payee includes the payments in gross income.[7] However, there is an exception from this cash method of accounting for amounts, other than interest, that the related payee is not required to include in income by reason of a U.S. income tax treaty.[8] Thus, if the exception applies, the U.S. taxpayer may deduct amounts payable to a related taxpayer as they accrue (i.e., before they are paid). However, the treaty exception does not apply to amounts owed to a CFC. In that case, the amount is deductible before the year of payment only to the extent the item is included in the income of a United States shareholder that owns stock in the CFC.[9]

The repeal of section 958(b)(4), by turning foreign corporations into CFCs by reason of downward attribution, denied them the benefit of the treaty exception. The Proposed Regulations turn off the repeal of 958(b)(4) for these purposes and provide that if an amount is owed to a CFC that has no direct or indirect United States shareholders that would include income attributable to the item owed to the CFC, and the payment to the CFC is exempt from tax under an income tax treaty, then a taxpayer can take the deduction when the amount accrues.[10] This generally should be a taxpayer-favorable rule.

Section 332: Liquidation of applicable holding company

Section 332(a) provides that a corporation does not recognize gain or loss upon the receipt of property distributed in complete liquidation of another corporation. However, foreign corporations are required to recognize gain on distributions received in complete liquidation of certain domestic holding companies and to treat any liquidating distribution as a taxable dividend under section 301, which would generally be subject to a 30% U.S. withholding tax.[11] Notwithstanding this rule, section 332(d)(3) provides that a liquidating distribution will not be treated as a taxable dividend and will be treated as a sale of the stock of the liquidating company (which would generally not be taxable) if the distributee is a CFC. The reason for this exception is that, before the repeal of 958(b)(4), CFCs generally had United States shareholders that would be subject to tax on their pro rata share of the gain upon the liquidation. If this rule were to apply after the repeal of section 958(b)(4), CFCs that have no United States shareholders could avoid taxable dividend treatment. Accordingly, the Proposed Regulations provide that, notwithstanding section 332(d)(3), gain on liquidating distributions of holding companies to CFCs that have no direct or indirect United States shareholders that would be subject to tax on the gain under section 951 are treated as a taxable dividend.[12] This generally should be a government-favorable rule.

Section 367(a): Triggering events exception for other dispositions or events under Treas. Reg. § 1.367(a)-8(k)(14)

Section 367(a)(1) generally provides that for transactions where a U.S. person transfers assets or stock to a foreign corporation in a tax-free transaction under sections 332, 351, 354, 356 or 361, the foreign corporation will not be treated as a corporation for purposes of determining the extent to which gain is recognized on the transfer. This rule generally treats the transaction as taxable. However, the rule does not apply to certain transfer of stock or securities of a foreign corporation if the U.S. transferor enters into a gain recognition agreement (“GRA”), which provides that the U.S. transferor will recognize gain if a certain “triggering events” occurs during the term of the GRA.

Accordingly, if the GRA is entered into with respect to a transfer of stocks or securities by a U.S. person, the transfer is treated as tax-free, but if a triggering event occurs, tax is payable. Under the GRA, a disposition of the securities by a foreign corporate transferee generally is a triggering event that triggers tax. However, a disposition of transferred stocks or securities is not a triggering event if (i) the disposition or other event qualifies as a nonrecognition transaction, (ii) immediately after the disposition, the U.S. transferor retains a direct or indirect interest in the transferred stock or securities or, as applicable, in substantially all of the assets of the foreign corporation[13] and, (iii) if a foreign corporation acquires the transferred property, the U.S. transferor owns at least 5% of the total voting power and total value of the outstanding stock of the foreign corporation. The attribution rules of section 318 as modified by 958(b) apply when determining whether a U.S. transferor meets this ownership requirement. The Proposed Regulations provide that for purposes of this ownership test, 958(b) is applied without regard to the repeal of section 958(b)(4).[14] This generally should be a government-favorable rule. In the absence of this rule, U.S. taxpayers could satisfy the 5% ownership requirement without directly or indirectly owning the foreign transferee's stock.

Section 672: CFC's ownership of a trust

Section 672(f)(1) generally provides that the grantor trust rules in the Code apply only to the extent that they result in income being currently taken into account (either directly or through one or more entities) by a U.S. person.[15] For purposes of this rule, CFCs are generally treated as a U.S. person. The Proposed Regulations provide that only foreign corporations that are CFCs without regard to the downward attribution rules are treated as U.S. persons for purposes of section 672(f).[16] This generally should be a government-favorable rule. In the absence of it, a trust owned by a CFC could qualify as a grantor trust even if U.S. taxpayers did not report the income of the trust.

Section 706: Taxable year of a partnership

Section 706 provides that a partnership's taxable year is determined by reference to the taxable years of its partners. Although a foreign partner is generally disregarded for making this determination, a CFC is not treated as a foreign partner for these purposes and therefore is counted.[17] The Proposed Regulations provide that a CFC that has no direct or indirect United States shareholders will not be taken into account for purposes of determining a partnership's taxable year.[18] This generally should be a government-favorable rule.

Section 863: Space and ocean income and international communications income of a CFC

In general, space and ocean income is U.S.-source income if derived by a U.S. person and foreign source income if derived by a foreign person. However, space and ocean income derived by a CFC is treated as U.S. source income except to the extent the income is attributable to functions performed, resources employed, or risks assumed in a foreign country.[19] International communications income is treated as 50% U.S. source income and 50% foreign source income if derived by U.S. person, but 100% foreign source income if derived by a non-U.S. person.[20] CFCs are treated as U.S. persons for purposes of sourcing international communications income. The Proposed Regulations provide that a foreign corporation will not be treated as a CFC for purposes of these rules if it would be a CFC solely as a result of the repeal of section 958(b)(4).[21] This generally should be a taxpayer-favorable rule.

Section 904: Look-through rules and active rents and royalties exception to categorization as passive category income

Section 904(a) generally limits the amount of foreign income taxes that a taxpayer may claim as a credit against its U.S. income tax based on the taxpayer's foreign source income. Section 904(d) further limits foreign tax credits by category of foreign source income, including general category and passive category income. Passive category income includes income that would be "foreign personal holding company income" if the recipient were a CFC, such as dividends, interest, rents and royalties.[22] However, if these amounts are received or accrued by a United States shareholder of a CFC from the CFC, the amounts are treated as passive category income only to the extent they are allocable to passive category income of the CFC.[23] This CFC look-through rule requires determining the category of income of the CFC to which the dividends, interest, rents, or royalties paid to the United States shareholder are allocable.

Rents and royalties received by a CFC are generally passive category income unless the income is derived in the active conduct of a trade or business, taking into account affiliated group members (the “active rents and royalties exception”).[24] The active rents and royalties exception applies both (i) when determining the category of income to which a United Shareholder’s subpart F income inclusion attributable to the rents and royalties of a CFC belongs and (ii) for purposes applying the CFC look-through rule described above.

Financial services income received by certain CFCs or domestic corporations is treated as general category income (the “financial services income rule”), and in determining whether income is financial services income for purposes of the foreign tax credit, activities of affiliated group members, including CFCs, are taken into account in determining whether these entities are financial services entities.

The application of CFC look-through rule and the affiliated group rules in the context of the active rents and royalties exception and the financial services income rule was based on the assumption that CFC income (including income from affiliated group members) would be subject to U.S. tax under section 951(a) or on a distribution of earnings and profits generated by such income, and that the foreign corporations subject to these rules would be controlled by U.S. persons who have access to information concerning their activities, income, and expenses.

Treating foreign corporations as CFCs or U.S. persons as United States shareholders by reason of downward attribution from foreign persons for purposes of the CFC look-through rule and the affiliated group rules would be inconsistent with the intent of the rules. Prior the repeal of section 958(b)(4), a United States shareholder that owned between 10-50% of the voting stock or value of a foreign corporation would be eligible to treat dividends, but not interest, rents, and royalties, as other than passive category income. Similarly, under the affiliated group rules, neither the active conduct requirement of the active rents and royalties exception nor the financial services entity requirement of the financial services income rule could be satisfied by a foreign corporation that would be a CFC only by reason of downward attribution from a foreign person.

Accordingly, the Proposed Regulations limit the application of the affiliated group rules in the active rents and royalties exception and the financial services income rule, as well as the CFC look-through rule, to foreign corporations that are CFCs without regard to the repeal of section 958(b)(4) attribution from foreign persons. Further, the CFC look-through rule is further limited to apply only to U.S. shareholders that are United States shareholders without regard to the repeal of section 958(b)(4) attribution from foreign persons.[25] This rule sometimes benefits taxpayers and sometimes benefits the government.

Section 1297: PFIC asset test

Section 1297(e) provides rules for measuring a foreign corporation's assets to determine whether it is a passive foreign investment company ("PFIC") under the assets test in section 1297(a)(2). Under the assets test, a foreign corporation is a PFIC if the average percentage of assets held by the foreign corporation during the taxable year that produce passive income or that are held for the production of passive income is at least 50%.[26] If the foreign corporation is a non-publicly traded CFC, the adjusted basis rather than the value is used to determine this average percentage.[27] The adjusted basis rule often produced a more favorable answer than the value test. The Proposed Regulations provide that this rule does not apply to foreign corporations that are CFCs solely by reason of the repeal of section 958(b)(4).[28] This generally should be a government-favorable rule.

Section 6049: Chapter 61 reporting provisions

Section 61 generally requires a payor to report on Form 1099 certain payments or transactions with respect to U.S. persons that are not exempt recipients. The scope of payments or transactions subject to this reporting requirement depends in part on whether the payor is a U.S. payor, which generally includes U.S. persons, their foreign branches, and CFCs. However, the Proposed Regulations provide that CFCs that have no section direct or indirect United States shareholders are not U.S. payors for purposes of section 6049, and therefore, are not subject to the reporting and backup withholding requirements imposed by that section.[29] This generally should be a government-favorable rule.

The Revenue Procedure

The Revenue Procedure provides safe harbors whereby a U.S. person will be considered as having complied with its reporting obligations (and relieved of any penalties) with respect to its ownership in a CFC even if it does not have complete information. The safe harbors apply only to “foreign-controlled CFCs”, which are foreign corporations that are treated as CFCs solely as a result of the repeal of section 958(b)(4).

Safe harbor for determining CFC status

The Revenue Procedure recognizes that it may not be possible for a U.S. person to obtain information necessary to determine whether a foreign corporation is a CFC. Accordingly, the Revenue Procedure provides that the IRS will not challenge a U.S. person’s determination that a foreign corporation is not a CFC under the following circumstances:

- the U.S. person does not have actual knowledge, has not received statements, and cannot otherwise obtain reliable public information sufficient to make this determination, and
- the U.S. person asks a foreign entity in which it has a direct ownership stake (i) whether it is a CFC, and (ii) whether it directly or indirectly owns stock in any foreign corporations or any domestic entities.[30]

The Revenue Procedure provides that a U.S. person that directly or indirectly owns stock in a foreign entity is not required to perform a similar inquiry with respect to an unrelated foreign person that also has an ownership interest in that foreign entity.

Safe harbor for using alternative information

If the taxpayer cannot readily obtain information to accurately compute its subpart F income and GILTI with respect to a CFC and there is no U.S. shareholder that is directly or indirectly related to the CFC, the United States shareholders who, by reason only of direct and indirect ownership are unrelated to the CFC generally may use “alternative information” to determine their inclusion amounts.

Alternative information generally refers to readily available separate-entity financial statements, taking into account certain adjustments. The Revenue Procedure sets forth the financial statements that should be used in order of preference:

- Financial statements that are prepared in accordance with U.S. GAAP,
- Financial statements that are prepared in accordance with IFRS,

- ???Financial statements that are prepared in accordance with local-country GAAP,
- ???Audited financial statements, and
- ???Records for other tax reporting, regulatory or internal management purposes.[31]

United States shareholders may also use alternative information to comply with Form 5471 reporting requirements with respect to any unrelated foreign-controlled CFCs that do not have any direct or indirect U.S. shareholders.

Taxpayers are not permitted to use alternative information for purposes of claiming indirect foreign tax credits.

Safe harbor for section 965 transition tax amounts

Under section 965, pre-2018 earnings of foreign subsidiaries were subject to a one-time "deemed" repatriation tax on all of the pre-2018 earnings of foreign subsidiaries at 15.5% on cash and equivalents, and on 8% on all other assets.[32]

If information required to accurately compute section 965 transition tax amounts with respect to a foreign corporation is not readily available and the foreign corporation is a foreign-controlled CFC with respect to which there is no United States shareholder that is related to the CFC solely by reason of direct or indirect ownership, then each United States shareholder generally may determine its section 965 amount (but not any indirect foreign tax credits) using alternative information.[33]

Taxpayers may only use alternative information for amounts reported on a return both due and filed before October 1, 2019 or on a return both due and filed after October 1, 2019. Taxpayers who filed returns due after October 1, 2019 early and taxpayers who file returns due before October 1, 2019 late do not fall within the safe harbor.

U.S. shareholders can also use alternative information to comply with Form 5471 reporting requirements with respect to any foreign-controlled CFC with respect to which there is no direct or indirect related United States shareholders (i.e., the only related United States shareholders are those who own constructively).

Form 5471 Filing Requirements

The Revenue Procedure indicates that under certain circumstances, the IRS will reduce Form 5471 filing obligations for filers who are United States shareholders that directly, indirectly, or constructively own stock of a CFC on the last day in the year on which it is a CFC ("Category 5 filers"). A Category 5 filer will not be required to provide all of the Form 5471 schedules if (i) the filer is not a direct or indirect U.S. shareholder with respect to a foreign-controlled CFC, or (ii) the filer is not a direct or indirect U.S. shareholder (i.e. only constructively ownership) but is related to the foreign-controlled CFC.

A Category 5 filer that is unrelated to the foreign-controlled CFC and only constructively owns its stock will not be required to file the form.

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[1] All references to section numbers are to the Internal Revenue Code of 1986, as amended, or the Proposed Regulations.

[2] See section 881(c)(3)(c).

[3] Section 957(a).

[4] Section 951(b).

[5] The Proposed Regulations refer to a United States shareholder that directly or indirectly owns stock of a foreign corporation as a "section 958(a) U.S. shareholder."

[6] H.R. Rep. No. 115-466, at 633 (2017) (Conf. Rep.).

[7] Section 267(a)(2)-(3).

[8] Treas. Reg. § 1.267(a)-3(a)(2).

[9] Section 267(a)(3)(B)(i).

[10] Prop. Reg. § 1.267(a)-3(c)(4).

[11] Section 332(d).

[12] Prop. Reg. § 1.332-8(a).

[13] Treas. Reg. § 1.367(a)-8(k)(14).

[14] Prop. Reg. § 1.367(a)-(8)(k)(14)(ii).

[15] Grantor trusts are generally disregarded for U.S. federal income tax purposes.

[16] Prop. Reg. § 1.672(f)-2(a).

[17] Treas. Reg. § 1.706-1(b)(6)(i)-(ii).

[18] Prop. Reg. § 1.706-1(b)(6)(ii).

[19] Treas. Reg. § 1.863-8(b)(2)(ii).

[20] Treas. Reg. § 1.863-9(b)(2)(ii).

[21] Prop. Reg. §§ 1.863-8(b)(2)(ii); 1.863-9(b)(2)(ii).

[22] Sections 904(d)(2)(B)(i), 954(c)(1)(A).

[23] Section 904(d)(3).

[24] Treas. Reg. § 1.904-4(b)(2)(iii).

[25] Prop. Reg. § 1.904-5(a)(4)(i) and (vi).

[26] Section 1297(a)(2).

[27] Section 1297(e)(2).

[28] Prop. Reg. § 1.1297-1(d)(1)(iii)(A).

[29] Prop. Reg. § 1.6049-5(c)(5)(i)(C).

[30] Revenue Procedure, section 4.

[31] Revenue Procedure, section 5.

[32] This transition tax is payable over an eight year period, which reduces the present value of the transition tax.

[33] Revenue Procedure, section 6.

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