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# Treasury and IRS Release Proposed GILTI Guidance

On September 13, 2018, Treasury and the IRS released proposed regulations under section 951A. For the most part, the proposed regulations provide guidance with regard to various mechanical and computational aspects of the GILTI regime, as well as rules for reporting requirements. As discussed in this alert, however, the proposed regulations contain several very noteworthy features.

Importantly, the proposed regulations do not contain any rules on the foreign tax credit (including rules on expense allocation to the section 904(d)(1)(A) GILTI basket) as it relates to GILTI. The preamble states that Treasury will promulgate those rules in separate notices of proposed rulemaking. The preamble does provide that "it is anticipated" that the section 78 gross-up related to the section 951A inclusion will be assigned to the GILTI basket.

Citing to section 7805(b)(1)(B), the preamble states that the proposed regulations will apply to taxable years of foreign corporations beginning after December 31, 2017, and to taxable years of US shareholders in which the taxable of such foreign corporations end.

## New Rules on Shareholder-level Pro Rata Shares of GILTI Inclusion and CFC Tested Items

Proposed Regulation § 1.951A-1(b) and (c) set forth the general rules that a US shareholder should use for calculating and including the shareholder's "GILTI inclusion amount." The proposed regulation requires each person who is a US shareholder (as defined in section 951(b) of the Code) of any CFC and owns "section 958(a) stock" (i.e., stock that is held directly or held indirectly through a foreign entity) in such CFC to include in their gross income the shareholder's GILTI inclusion amount, if any, for the "US shareholder inclusion year." The "US shareholder inclusion year" is the taxable year of the US shareholder that includes the last day of any taxable year (after December 31, 2017) on which the relevant foreign corporation is a CFC (i.e., the "CFC inclusion date"). This means that, as is the case with a subpart F inclusion, the critical date as relevant to the inclusion in US taxable income is the last day of the CFC's taxable year. If a US shareholder's taxable year does not include a CFC inclusion date, then the US shareholder is not required to include any GILTI inclusion amount. The definitions of "US shareholder inclusion year" and "CFC inclusion date" in the proposed regulations are apparently an attempt to reflect, although in a roundabout way, the rule under section 951A(e)(2) of the Code that provides a person shall be a US shareholder of a CFC only if such person owns section 958(a) stock on the last day in the taxable year of such foreign corporation that such foreign corporation is a CFC.

**Observation:** Similarly to Subpart F inclusions, the CFC inclusion date (and associated GILTI inclusion) will be important to consider when negotiating M&A agreements to determine pre and post closing liabilities.

The proposed regulations calculate the GILTI inclusion amount in the same manner as section 951A of the Code. The GILTI inclusion amount is the excess, if any, of the shareholder's "net CFC tested income" over the shareholder's "net deemed tangible income return" ("DTIR"). Reflecting the statutory language, a US shareholder's net CFC tested income is generally the excess, if any of the aggregate of the shareholder's pro rata share of the "tested income" of each "tested income CFC" over the aggregate of the shareholder's pro rata share of the "tested loss" of "each tested loss CFC." The definitions of tested income and tested loss and the distinction between a tested income CFC and a tested loss CFC are described in Prop. Reg. 1.951A-2, discussed below. A shareholder's DTIR is equal to 10 percent of the shareholder's aggregate pro rata share of qualified business asset investment ("QBAI") for each tested income CFC less the shareholder's "specified interest expense." A shareholder's specified interest expense equals the aggregate of the shareholder's pro rata share of each CFC's tested interest expense over its pro rata share of each CFC's tested interest income. Notably, as suggested in the Conference Report to the TCJA, the proposed regulations ignore the QBAI of any CFC that does not have tested income in a given year. (See discussions of Prop. Reg. 1.951A-3 and -4 pertaining to QBAI, also discussed below.)

A US shareholder's pro rata share of CFC "tested items" is determined under Prop. Reg. 1.951A-1(d). We discuss each of these items in turn below. CFC tested items include a CFC's tested income, tested loss, QBAI, tested interest expense, and tested interest income.

## Tested Income

A US shareholder's pro rata share of tested income is (i) first determined by allocating tested income to each class of stock in the order of its liquidation priority to the extent that class of stock was allocated tested loss in a prior year, and (ii) second, to the extent there is any remaining tested income, determined by applying the pro rata share rules under Prop. Reg. § 1.951-1(e) and Treas. Reg. § 1.951-1(b), except the phrase "tested income" should be substituted for the phrase "subpart F income" and, for purposes of the hypothetical distribution under Prop. Reg. § 1.951-1(e), the amount of the current earnings and profits of the CFC is reduced by the amount of tested income allocated under the first step.

## Tested Loss

Prop. Reg. § 1.951-1(d)(4) provides, similar to the rules for tested income, that a US shareholder's pro rata share of tested loss is determined by applying the pro rata share rules under Prop. Reg. § 1.951-1(e) and Treas. Reg. § 1.951-1(b), except the phrase "tested income" is substituted for the phrase "subpart F income" and, similar to the rule for tested income, for purposes of the hypothetical distribution under Prop. Reg. § 1.951-1(e), the CFC's E&P is treated as being equal to the CFC's tested loss. The proposed regulation would make additional changes to the impact of the hypothetical distribution. First, the amount of the dividend "received by any other person" for purposes of section

951(a)(2)(B) of the Code and Treas. Reg. § 1.951-1(b)(1)(ii) is treated as being equal to the amount of the tested loss of the CFC regardless of whether, or the extent to which, the other person actually receives a dividend. Additionally, the hypothetical distribution is (a) first made to preferred shares if a tested loss CFC's accumulated earnings and profits are less than the amount necessary to satisfy any accrued but unpaid dividends on those preferred shares and (b) to the extent of any remaining tested loss, then made with respect to the CFC's common stock only. If, however, the CFC's common stock has zero liquidation value and there is at least one other class of stock with a liquidation preference, then tested loss is hypothetically distributed to the class or classes of stock with positive liquidation value in the order of their preference.

> **Observation:** The hypothetical "distribution" of tested loss is a strange concept, which is made more so due to the requirement to treat the hypothetical distribution as having been made "regardless of whether, or the extent to which, the other person actually receives a dividend". Take, for example, a mid-year transfer of the stock of a CFC with tested loss. Applying the "days held" concept in Treas. Reg. § 1.951-1(b), the result would seem to be that the transferee shareholder can access the tested loss of the acquired CFC only in proportion to the number of days between the transfer date and the CFC inclusion date. In the hands of the transferor, the tested loss would seem to be inaccessible. We would hope that in future regulations, Treasury will clarify that this is indeed the intended operation of the rule. We note that the preamble explains that the rule is intended to ensure that the tested loss of a CFC is allocated to each US shareholder in an amount commensurate with the economic loss borne by the shareholder by reason of the tested loss, but in the case of a mid-year disposition there is no clear policy justification for the transferee to include all of the CFC's tested income, but only part of a CFC's tested loss.

## QBAI

Generally, a US shareholder's pro rata share of QBAI is equal to the CFC's total QBAI, multiplied by the US shareholder's pro rata share of the CFC's tested income, and divided by the CFC's total tested income. An exception applies if a tested income CFC's QBAI is greater than 10 times its tested income. In such case, any amount of QBAI in excess of 10 times the CFC's tested income is allocated in the same manner but without regard to any tested income allocated to a share of preferred stock.

## Tested Interest Expense

A US shareholder's pro rata share of tested interest expense is equal to the amount by which the tested interest expense reduces that particular shareholder's pro rata share of tested income or increases that particular shareholder's pro rata share of tested loss.

## Tested Interest Income

A US shareholder's pro rata share of tested interest income is equal to the amount by which the tested interest income reduces that particular shareholder's

pro rata share of tested loss or increases that particular shareholder's pro rata share of tested income.

**New Rules on Shareholder-level Pro Rata Shares of Subpart F Inclusion.** In addition to the rules for determining pro rata shares under section 951A, the proposed regulation package also includes new proposed regulations under section 951 to implement some aspects of the TCJA that apply to both GILTI and subpart F inclusions. In addition, this section of the regulation package also proposes a new anti-abuse rule.

Proposed Regulation § 1.951-1(e), which provides rules for determining a US shareholder's pro rata share of subpart F income, would replace current Treas. Reg. § 1.951-1(e). Apart from describing the general rules for determining a US shareholder's pro rata share of subpart F income, the current regulations provide anti-avoidance rules that address certain structures that Treasury perceives result in inappropriate allocations of subpart F income to shareholders of CFCs that are not US shareholders. The proposed regulations generally retain the rules in the current regulations, but also (i) address additional avoidance structures, (ii) take into account new section 951A of the Code, and (iii) alter the definition of a "US shareholder" under section 951(b) of the Code to include US persons that hold at least 10% of the total value of all classes of stock.

Generally, Prop Reg. § 1.951-1(e)(1) provides that a US shareholder's pro rata share of a controlled foreign corporation's subpart F income for a taxable year is "the amount" that bears the same ratio to the CFC's subpart F income as (i) the amount of the CFC's current earnings and profits that would be distributed to the US shareholder on its "section 958(a)" stock bears to (ii) the total amount of the CFC's earnings and profits that would be distributed to all shareholders if all the current earnings and profits of the CFC were distributed on the last day of the tax year on which the foreign corporation was a CFC. As noted above, the proposed GILTI regulations contain pro rata share rules for the various provisions in new section 951A of the Code that require a US shareholder to determine its pro rata share (e.g., pro rata share of tested income, tested loss, or QBAI (the "CFC tested items")). The pro rata share definition can be represented as following (with "CFC tested items," as defined in the proposed GILTI regulations, substituted for subpart F income, as applicable):

$$\left(\frac{pro\ rata\ share}{CFC's\ subpart\ F\ income}\right) = \left(\frac{E\&P\ that\ would\ be\ dist.\ to\ US\ shareholder}{E\&P\ that\ would\ be\ dist.\ to\ all\ shareholders}\right)$$

The proposed regulations generally follow the current regulations for purposes of determining how the earnings and profits are distributed in the hypothetical distribution. In cases where the CFC has one class of stock outstanding, the hypothetical distribution is made pro rata to each share. In cases where the CFC has more than one class of stock, the hypothetical distribution is based on the distribution rights of each class of stock, with special rules that address various rights and/or restrictions that can be reflected in the different classes of stock.

The proposed regulations include an important anti-abuse rule in Prop. Reg. § 1.951-1(e)(6). The proposed regulation provides:

> For purposes of this paragraph (e), any transaction or arrangement that is part of a plan a principal purpose of which is the avoidance of Federal income taxation, including, but not limited to, a transaction or arrangement to reduce a United States shareholder's pro rata share of the subpart F income of a controlled foreign corporation, which transaction or arrangement would avoid Federal income taxation without regard to this paragraph (e)(6), is disregarded **in determining such United States shareholder's pro rata share of the subpart F income of the corporation**. This paragraph (e)(6) also applies for purposes of the pro rata share rules described in §1.951A-1(d) that reference this paragraph (e), including the rules in §1.951A-1(d)(3) that determine the pro rata share of qualified business asset investment based on the pro rata share of tested income (emphasis added).

This anti-abuse rule is designed to allow the IRS to ignore a transaction or arrangement that alters a US shareholder's ownership in, or rights with respect to, shares in a CFC if a principal purpose of the transaction or arrangement is the avoidance of federal income tax.

> **Observation:** The examples illustrating this rule suggest that the rule is aimed at transactions that create shares with varying distribution rights such as preferred shares with rights to distributions before other shareholders. Despite this apparent intent, the language of the rule is significantly broader. The potentially broad language of the rule creates ambiguity and will make it much harder in practice to apply the rule.

## CFC Tested Income and CFC Tested Loss

Moving on to the computation of the GILTI items themselves, the Proposed Regulations restate the language in section 951A(c)(2) that defines "tested income" and "tested loss" with respect to any CFC. A CFC's tested income is any excess of (i) the CFC's gross income for a CFC inclusion year, computed without taking into account the CFC's effectively connected income ("ECI"), subpart F income, income with respect to which the CFC elects the high tax exception to subpart F, dividends received from a related person or party, insurance income, and foreign oil and gas extraction income (such income being referred to as the CFC's "gross tested income"), over (ii) any allowable deductions that are allocable to the CFC's gross tested income. If the allowable deductions that are allocable to the CFC's gross tested income exceed the CFC's gross tested income, the CFC has a tested loss. A CFC that has tested income for a CFC inclusion year is considered a "tested income CFC". Similarly, a CFC that has tested loss for a CFC inclusion year is considered a "tested loss CFC".

To determine a CFC's tested gross income and allowable deductions for a CFC inclusion year, the Proposed Regulations require the taxpayer to apply the existing subpart F rules for calculating gross income and taxable income of a foreign corporation under Treas. Reg. § 1.952-2. The determination is made without applying section 952(c), which generally limits subpart F income to a CFC's current earnings and profits.

> **Observation:** While Treasury and the IRS acknowledged similarities between CFC gross tested income and subpart F income and apply the

subpart F rules to calculate the CFC's tested gross income and allowable deductions for a CFC inclusion year, the similarities exclude the subpart F income limitations under section 952(c). A CFC's gross tested income is not limited to the extent of such CFC's current earnings and profits (which is consistent with GILTI not being an earnings and profits based test). Furthermore, a CFC's earnings and profits cannot escape treatment as CFC gross tested income solely because such earnings and profits are recharacterized as subpart F income under section 952(c). An Example confirms that if a CFC has subpart F income under the recapture rules of section 952(c), such subpart F income is not excluded from the calculation of gross tested income. Perhaps the upcoming guidance on foreign tax credits will provide some clarity on how to allocate taxes in such situation to subpart F or GILTI.

In determining a CFC's tested income or tested loss, section 951A(c)(2)(A)(ii) requires that the allowable deductions for a CFC inclusion year be properly allocable to the CFC's gross tested income under rules similar to section 954(b)(5). The Proposed Regulations invoke the principles of Treas. Reg. § 1.954-1(c), which among other things, provide rules for determining the amount of net foreign base company income by allocating expenses against the enumerated items in Treas. Reg. § 1.954-1(c)(1)(iii). The Proposed Regulations adopt a similar approach to calculate gross tested income. More specifically, the Proposed Regulations require a CFC to allocate deductions to gross tested income, and treat CFC gross tested income that falls within a single foreign tax credit basket as an additional single item of gross income within Treas. Reg. § 1.954-1(c)(1)(iii).

**Observation.** There are no examples illustrating this rule. It is not clear why the drafters chose to include the reference to a "single separate category" (i.e., a single foreign tax credit basket) when the income in question is GILTI income, because it seems apparent that a CFC's gross tested income would "fall within" the GILTI basket even without this clarification. It could be that the drafters included the reference to foreign tax credit baskets because Treas. Reg. § 1.954-1(c)(1)(iii) uses that construct. It makes sense to segregate general basket items from passive basket items in the computation of net foreign base company income. Foreign base company sales income, for instance, is likely general limitation and foreign personal holding company income is likely passive basket income. It is not clear, however, why it is necessary to segregate GILTI basket items from other foreign tax credit basket items in allocating deductions to gross tested income because, as noted, any "gross tested income" under section 951A presumably will fall within the GILTI basket. If the reference was included because some items of CFC gross tested income do not fall within the GILTI basket, we would expect further guidance (perhaps proposed future regulations on foreign tax credits) to clarify when that situation could arise. The impact of the rule seems to be that a CFC (i) determines its aggregate amount of income that falls within a single foreign tax credit basket and also falls within a single category of either foreign base company income (or the enumerated types of foreign personal holding company income) or GILTI, and (ii) allocates and apportions expenses to such items.

An anti-abuse rule applies in determining a CFC's tested income or tested loss. Specifically, the Proposed Regulations disregard a deduction or loss attributable to the "disqualified basis" of any depreciable or amortizable property, i.e., specified property, allocated and apportioned to the CFC's gross tested income. Disqualified basis, defined in Prop. Reg. § 1.954A-3(h)(2)(ii), is any basis step up in specified property achieved in a related party transfer by the CFC between January 1, 2018 and the close of the CFC's last taxable year before its first GILTI inclusion year, i.e., a "disqualified transfer". Disqualified basis and disqualified transfers are discussed in more detail below. If the specified property in question has both disqualified basis and basis that is not disqualified, such deduction or loss is attributable to the disqualified basis based on the ratio of the disqualified basis to the total adjusted basis.

## Qualified Business Asset Investment

A significant component of the GILTI calculation is the amount of a CFC's '"QBAI. QBAI" is generally equal to the CFC's aggregate adjusted basis in its tangible property. Taxpayers normally want their CFCs to have large QBAI because QBAI can reduce the amount of a CFC's tested income that would otherwise be included in a US shareholder's GILTI.

The regulations broadly define tangible property that is included in QBAI as any tangible property that is eligible to be depreciated under Section 168 and that is used in the production of tested income. If tangible property produces both tested income and Subpart F income, then only a portion of the property's basis will increase the CFC's QBAI.

To determine a CFC's QBAI, taxpayers will need to calculate the basis of the CFC's tangible property using the alternative depreciation system described in section 168(g). To determine a CFC's basis in its tangible property that was acquired before Congress enacted the GILTI provisions, taxpayers are required to apply the accelerated depreciation provisions in section 168(g) as if the CFC's property had been subject to section 168(g) from the date the CFC originally put the property into use. The taxpayer then adds together the CFC's adjusted bases of all the CFC's tangible property at the end of each quarter, and the CFC's QBAI equals the average of the CFC's aggregate basis in tangible property at the end of quarter.

> **Observation:** Taxpayers may have to maintain two separate depreciation schedules for the tangible assets of its CFCs. This complication arises because a CFC's tested income under Prop. Treas. § Reg. 1.951A-2(c) is calculated using the same depreciation rules that apply for purposes of calculating subpart F income (which often closely aligns with the US GAAP depreciation provisions). However, a CFC's QBAI is determined based on the depreciation provisions in section 168(g).

Only a CFC that has positive tested income for the year can have QBAI. A CFC that has a tested loss for the year is deemed to have no QBAI, even though that CFC may own substantial tangible property.

**Observation**. Taxpayers may want to consider creating a "checked" structure to allow full utilization of QBAI and avoid some of the tracking issues created by the regulations (e.g., basis adjustments because of tested losses offsetting tested income).

## QBAI Anti-Abuse Rules

The proposed regulations contain two anti-abuse rules that disregard transactions that Treasury and the IRS view as inappropriately inflating a taxpayer's QBAI. The first anti-abuse rule excludes from a CFC's QBAI any basis from tangible property that is temporarily held by a CFC, if the CFC is holding the property for "a principal purpose" of reducing a US shareholder's GILTI inclusion (i.e., by increasing the CFC's QBAI). This anti-abuse rule prevents taxpayers from transferring property from a tested loss CFC to a tested income CFC.

Moreover, any tangible property that is acquired by a CFC and held for less than 12 months is automatically treated as being acquired with a principal purpose of increasing the taxpayer's QBAI provided that the acquired property has the effect of reducing the US shareholder's GILTI. For purposes of determining whether this anti-abuse rule applies, it is unclear whether a CFC can take into account the income produced by the acquired property when determining whether the acquired property reduces a US shareholder's GILTI inclusion. However, the preamble to the proposed regulations seems to indicate that any property held for less than 12 months will automatically be caught under this anti-abuse rule.

**Observation:** In effect, this anti-abuse rule has created a 12-month holding period for any tangible property in order for the tangible property to increase a CFC's QBAI. Practically speaking, it will be very difficult for taxpayers to determine the holding period for each item of tangible property that a CFC acquires in the ordinary course of its trade or business. Taxpayers should consider submitting comments, perhaps seeking an exception for any property that a CFC acquires in the ordinary course of its trade business. Without such an exception, the anti-abuse rule is over-encompassing and requires the CFC to create systems to track its holding period for countless items of tangible property.

The second anti-abuse rule targets basis step-up transactions that occur between January 1, 2018 and the date on which the acquiring CFC becomes subject to GILTI. Under this anti-abuse rule, any basis step-up for both tangible and intangible property is automatically disregarded if the basis step-up results from a transfer of property between related persons during the aforementioned period. "".

**Observation:** The QBAI anti-abuse rule on "disqualified basis" as a result of "disqualified transfers" is the foundation for the tested income anti-abuse rule described previously in this Alert.

The anti-abuse rule that addresses "disqualified basis" as it relates to the calculation of tested income does not depend on whether a taxpayer demonstrates any intent to avoid or reduce a GILTI inclusion or inclusions. The anti-abuse rule disregards for GILTI purposes amortization deductions and losses that would otherwise reduce tested

income. The rule applies without regard to the taxpayer's intent, and without regard to whether the transaction has economic substance or a business purpose. The proposed rule's broad reach goes well beyond anything in the legislative history, and indeed does not seem to invoke any specific grant of rule making authority. The only anti-abuse rule in the statute is section 951A(d)(4). Section 951A(d)(4) grants the Secretary authority to issue regulations or guidance to prevent the avoidance of the purposes of section 951A(d), which defines QBAI, which is limited to tangible property and has nothing to do with a taxpayer's intangibles. The proposed rule disregards the impact of transactions that taxpayers undertook before GILTI's effective date, without any regard to whether the taxpayer would have engaged in the transaction even if Congress had not enacted GILTI. As drafted, we believe that the rule's validity is highly questionable and we expect taxpayers will challenge the rule on validity grounds.

## CFC's Tested Interest Expense and Tested Interest Income

Under section 951A(b)(2), a US shareholder's DTIR is the excess of (A) ten percent of the aggregate of the shareholder's pro rata share of each CFC's QBAI over (B) the amount of interest expense taken into account under Section 951A(c)(2)(A)(ii) in determining such US shareholder's net CFC tested income for the taxable year, but only to the extent the interest income attributable to such expense is **not** taken into account in determining such US shareholder's net CFC tested income. Under the Proposed Regulations, this interest expense, ((B) in the preceding equation), is the shareholder's specified interest expense, i.e., the aggregate of the shareholder's pro rata share of a CFC's "tested interest expense" over the aggregate of the shareholder's pro rata share of the CFC's "tested interest income."

Generally, tested interest expense is any interest expense paid or accrued by a CFC that is taken into account in determining the CFC's tested income or tested loss, and tested interest income is any interest income of a CFC that is CFC's gross tested income. For certain CFCs engaged in a banking, financing, insurance or similar business ("qualified CFC") (i) tested interest expense does not include interest expense to the extent attributed to CFC income that is excluded from foreign personal holding company income under Section 954(h), i.e., qualified banking or financing income, or Section 954(i), i.e., qualified insurance income of a qualifying insurance company, and (ii) tested interest income does not include interest income included in CFC gross tested income but excluded from foreign personal holding company income under Section 954(h) or (i) ("qualified interest income").

The Proposed Regulations broadly define interest expense and interest income to capture items of expense, loss, income or gain that are either (i) treated as interest expense or interest income under the Code or Treasury regulations, or (ii) or incurred or recognized in a transaction or series of transactions in which the use of funds for any period if the expense or loss is predominately in consideration of the time value of money.

## Domestic Partnerships and Their Partners

The Proposed Regulations address GILTI inclusions with respect to partnerships (S Corporations are treated as partnerships for purposes of the Proposed Regulations) and their partners. The Proposed Regulations approach partnerships from two perspectives. First, the Proposed Regulations provide rules that apply the GILTI provisions to CFCs that hold interests in partnerships, and the second the Proposed Regulations provide rules that apply the GILTI provisions to domestic partnerships that hold an interest in a CFC.

### CFC Holding an Interest in a Partnership

Under the Proposed Regulations, a CFC holding an interest in a partnership is referred to as a CFC Partner. The Proposed Regulations adopt a reasonable standard to equitably apportion the adjusted basis of specified intangible property to a CFC Partner so that the CFC can calculate its GILTI inclusion. Specifically, a CFC Partner's share of specified intangible property is determined by reference to the partnership's average adjusted basis in this property as of the close of each quarter of the partnership's taxable year that ends with or within the CFC's taxable year. With respect to the CFC Partner, its share of the partnership's adjusted basis in the specified intangible property is determined in accordance with its distributive share of gross income associated with the property. The Proposed Regulations do not address the impact of any special allocations with respect to specified intangible property, but presumably the Proposed Regulations' request for comments will result in commentary on this important point.

### Domestic Partnerships that are CFC Shareholders

For federal income tax purposes, a domestic partnership is treated as an entity shareholder in making CFC determinations. As a result, a domestic partnership can be a US Shareholder with respect to a CFC. This construct results in unintended applications of GILTI with respect to partners that may have interests in separate CFCs that require GILTI inclusions. This result occurs because the computation of GILTI at the partnership level without specifying to each partner its separate GILTI items (as if the partner were a direct shareholder) results in that partner having a GILTI inclusion even though the aggregate approach may result in a different answer because the partner would aggregate all of its stock holdings for this purpose.

For example, if domestic corporation X holds 100% of CFC-1, and a 50% interest in US-Partnership, which in turn holds 50% of CFC-2, the domestic corporation is subject to GILTI with respect to both CFCs, but whether the attributes of each CFC are taken into account by the domestic corporation is not clear. Under an entity approach, the domestic partnership would make its own separate GILTI computation with respect to CFC-2 and pass the inclusion to the domestic corporation. Without separately stated GILTI-derivative items for the domestic corporation partner, it is not clear that the domestic corporation can use any of those attributes to offset, or supplement its GILTI attributes from CFC-1. This result occurs even though on an aggregate basis the domestic corporation is a US Shareholder with respect to both CFC-1 and CFC-2. Conversely, the Proposed Regulations suggest that using a pure aggregate approach may be

interpreted by some taxpayers such that small partners are exempt from the GILTI rules.

In response to the foregoing, the Proposed Regulations use a hybrid aggregate-entity approach that treats a domestic partner as directly holding CFC stock held by a domestic partnership if the domestic partner is indirectly a US Shareholder with respect to the CFC. Partners that do not indirectly own a sufficient interest to be US Shareholders are subject to entity treatment for GILTI purposes with respect to their interest in the domestic partnership. More specifically, if a domestic partner that indirectly is a US Shareholder of the partnership's CFC, then the Proposed Regulations treat the domestic partnership as a foreign partnership with respect to that US Shareholder. As a result of this construct, such domestic partner is allocated a proportionate share of the domestic partnership's GILTI amounts (e.g., QBAI, tested income, and tested loss) with respect to the CFC. In this regard, the domestic partner is treated as directly owning a proportionate share of the CFC stock with the result that it can take into account all of its direct and indirect CFC attributes in making its GILTI computations.

## Treatment of GILTI Inclusion Amount

Section 951A(f) provides that a GILTI inclusion is treated in the same manner as a subpart F inclusion for purposes of certain specified Code sections, including for purposes of sections 959 and 961. The Proposed Regulations add that a GILTI inclusion is also treated in the same manner as a subpart F inclusion for purposes of the net investment income rules in section 1411. The preamble to the Proposed Regulations requests comments on whether it is appropriate to add any other Code sections to this list.

Unlike subpart F inclusions, which are determined on a CFC-by-CFC basis, GILTI is calculated on an aggregate basis at the US shareholder level. Thus, a US shareholder's GILTI inclusion must be allocated among the CFCs that it owns for purposes of the Code sections that treat GILTI inclusions in the same manner as subpart F inclusions. None of the GILTI inclusion is allocated to CFCs with tested losses. For a CFC with tested income, the GILTI inclusion allocated to the CFC is based on the ratio of the tested income of the CFC to the total tested income of all CFCs with positive tested income.

The portion of the GILTI inclusion that is allocated to a CFC under this rule is translated into the functional currency of the CFC using the average exchange rate for the CFC's taxable year.

## Interaction of Inclusion of Tested Income with Sections 267(a)(3)(B) and 163(e)(3)(B)(i)

Section 267(a)(3)(B) states that an amount payable to a related CFC is deductible by the US shareholder / obligor in the year prior to payment only to the extent that a US shareholder of the related CFC includes an amount with respect to the payment in gross income (e.g., under prior law, as a subpart F inclusion). section 163(e)(3)(B)(i) includes a similar rule for original issue discount on debt instruments held by related CFCs.

Prop. Reg. § 1.951A-6(c) provides that for purposes of these provisions, an item is treated as includible in the gross income of a US shareholder if it increases the US shareholder's pro rata share of the tested income of the related CFC (or if it decreases the US shareholder's pro rata share of a tested loss). For US shareholders that are domestic partnerships, this rule applies only if a US person (other than a partnership) that is a partner in the domestic partnership includes its distributive share of the GILTI inclusion of the domestic partnership in gross income.

## Impact of Tested Loss on Section 952(c)(1)(A)

Section 952(c)(1)(A) states that the subpart F income of a CFC is limited to the CFC's current year E&P. The Proposed Regulations (repeating the rule in section 951A(c)(2)(B)(ii)) provide that for purposes of section 952(c)(1)(A), the E&P of a CFC with a tested loss is increased by the amount of the CFC's tested loss. As a result of this rule, tested losses cannot be used to reduce current year subpart F income by virtue of lowering the E&P limitation.

> **Observation:** This proposed rule is firmly based in the statute. Nonetheless, the policy foundation is unclear. While there may be an appreciation for Congressional' concern that a US shareholder should not receive a "double benefit" from a CFC tested loss that both reduces the shareholder's net CFC tested income and reduces the subpart E&P limitation, the statute, as drafted is overbroad. For example, consider a US shareholder with a single CFC that in each of Year 1 and Year 2 has US$50 of E&P, US$100 of subpart F income, and a CFC tested loss of US$50. In Year 1, the US shareholder's section 951(a) inclusion is limited to US$50, the amount of the CFC's E&P. For purposes of applying the E&P limitation in Year Two, however, the US$50 of E&P is increased by US$50 (the amount of the CFC's tested loss) to US$100. As a result, the US shareholder must include US$100 in subpart F income even though it has not benefited, in either year, from the CFC's tested loss.

## Reductions to Stock Basis For the Use of Tested Losses

Prop. Reg. § 1.951A-6(e) provides that if a domestic corporation directly or indirectly owns stock of a CFC and a shareholder of the CFC directly or indirectly disposes of the CFC stock, the shareholder's basis in the CFC stock is reduced immediately before the disposition. The amount of the basis reduction is the domestic corporation's "net used tested loss amount" with respect to the CFC's stock that is disposed of. If this basis reduction exceeds the shareholder's basis in the CFC stock, the excess is treated as gain from the sale or exchange of the CFC stock. For this purpose, the "net used tested loss amount" with respect to a CFC is, broadly speaking, the aggregate amount of tested losses of the CFC that previously offset tested income of other CFCs owned by the domestic corporation, reduced by the aggregate amount of tested income of the CFC that was previously offset by tested losses of other CFCs owned by the domestic corporation.

> **Observation:** These basis reduction rules are limited to dispositions of CFC stock owned directly or indirectly by a domestic corporation. The

preamble notes that in many cases, the incremental gain resulting from the basis reduction will be eligible for the dividends received deduction under section 245A (on account of the gain being recharacterized as a dividend under section 964(e) or section 1248). Treasury requested comments on whether the basis reduction rules should be extended to non-corporate shareholders. Doing so could have a material impact on these shareholders, as non-corporate shareholders would not be eligible for a dividends received deduction on any portion of the incremental gain that is recharacterized as a dividend.

**Observation:** The basis reduction rules described in this section could put taxpayers in a worse position than they would have been in had they not generated any tested losses. For example if a CFC generates a US$100 tested loss that offsets US$100 of tested income, the US shareholder would receive a US$10.5 benefit from the tested loss if the US shareholder's effective US tax rate on GILTI is 10.5%. If the US shareholder then sells the CFC shares and recognizes US$100 of additional gain, the gain would give rise to US$21 of incremental US tax (assuming that the CFC did not have any E&P to support recharacterizing a portion of the gain as a dividend or if the US shareholder was otherwise ineligible for the Section 245A dividends received deduction on any amounts recharacterized as a dividend).

In the case of a disposition of a CFC that owns lower-tier CFCs, the required basis reduction is (i) increased by the "net used tested loss amount" with respect to each lower-tier CFC, and (ii) reduced by the "net offset tested income amount" with respect to each lower-tier CFC (as well as the "net offset tested income amount" with respect to the CFC that is disposed of, if any). The "net offset tested income amount" with respect to a CFC is, broadly speaking, the aggregate amount of tested income of the CFC that was previously offset by tested losses of other CFCs owned by the domestic corporate shareholder, reduced by the aggregate amount of tested losses of the CFC that previously offset tested income of other CFCs owned by the domestic corporate shareholder.

**Observation:** These tax attributes (e.g., "net used tested loss amount" and "net offset tested income amount") are entirely new concepts that will require US shareholders of CFCs to design and maintain accounting processes to track them.

By way of example, suppose that USP, a domestic corporation, wholly owns CFC 1, which in turn wholly owns CFC 2. Suppose further that the "net used tested loss amount" with respect to CFC 1 is US$100, and the "net offset tested income amount" with respect to CFC 2 is US$20. If USP sells the stock of CFC 1 in a taxable transaction, USP would be required to reduce its basis in its CFC 1 stock by US$80 (i.e., US$100 – US$20) immediately prior to the sale.

Similar basis reductions apply if a domestic corporation owns interests in a foreign entity that is not a CFC (such as a foreign partnership) and the foreign entity in turn owns stock of one or more CFCs. In that case, the domestic corporation would be required to reduce its basis in the interests in the foreign entity immediately prior to a sale of interests in the foreign entity. The amount of

the basis reduction is the "net used tested loss amount" of each CFC owned by the foreign entity, reduced by the "net offset tested income amount" of each CFC owned by the foreign entity.

The basis reductions summarized above are required in the case of any "disposition" of CFC stock for which a domestic corporation is a US shareholder. The Proposed Regulations define a "disposition" as any transfer (including by way of sale, exchange, contribution, or distribution) of the CFC stock that is taxable, in whole or in part, including a deemed sale or exchange by reason of the CFC stock becoming worthless within the meaning of Section 165(g). A "disposition" also includes an indirect disposition of stock of a lower-tier CFC as a result of a taxable direct disposition of stock of an upper-tier CFC.

> **Observation:** The effect of this rule is that if a domestic corporation sells stock of a CFC that owns lower-tier CFCs, basis reductions may be required at multiple levels. For example, suppose that USP, a domestic corporation, wholly owns CFC 1, which in turn wholly owns CFC 2. Suppose further that the "net offset tested income amount" with respect to CFC 1 is US$20, and the "net used tested loss amount" with respect to CFC 2 is US$100. If USP sells the stock of CFC 1 in a taxable transaction, this is treated as a "disposition" of the CFC 2 stock as well, which requires that CFC 1 reduce its basis in its CFC 2 stock immediately prior to the disposition by US$100 (i.e., CFC 2's "net used tested loss amount"). In addition, USP must reduce its basis in its CFC 1 stock by US$80 (i.e., CFC 2's "net used tested loss amount" reduced by CFC 1's "net offset tested income amount"). The Proposed Regulations provide that when basis reductions are required on multiple tiers (as in this example), the basis reductions are made first at the level of the lowest-tier CFC and then at successively higher tiers. The Proposed Regulations also make clear that duplicative basis adjustments are not required if an item has already been taken into account to reduce the basis of CFC stock, but this rule does not prevent basis adjustments from occurring at multiple tiers within an ownership structure. Instead, this rule merely prevents multiple reductions in the stock of the same CFC stock based on the same used tested loss.

The preamble indicates that Treasury is considering broadening the term "disposition" to include transactions that do not involve an actual transfer of stock, but that could give rise to taxable gain based on the basis in the stock (such as distributions with respect to stock governed by section 301 that exceed current and accumulated E&P).

Finally, the Proposed Regulations include a special rule in the case of a domestic corporation that owns less than 100% of the stock of a CFC. In that case, if the CFC sells the stock of a lower-tier CFC and a basis reduction is required on account of a "net used tested loss amount" attributable to the domestic corporation, any incremental subpart F income resulting from the sale of the lower-tier CFC stock is allocated solely to the domestic corporation, and not to any other shareholders of the CFC. This situation is illustrated in Example 7 of Prop. Reg. § 1.951A-6(e)(9).

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**Observation:** Neither the Code nor the Conference Report specifically contemplates that regulations would require basis reductions as a result of using tested loss. The preamble to the Proposed Regulations states that the purpose of these basis reduction rules is to prohibit taxpayers from recognizing the benefit of a tested loss twice by first using the tested loss to offset tested income and then recognizing a loss (or reduced gain) when stock of the relevant CFC is sold. This rationale for the rule apparently assumes that the tested loss reduces the value of the CFC on a dollar-for-dollar basis. This policy rationale for the rule is questionable. First, there is no direct connection between the value of a CFC and the amount of its tested losses. Moreover, under section 961(a), a US shareholder is permitted to increase its basis in CFC stock by the amount of its GILTI inclusion with respect to the CFC. When a tested loss offsets tested income and thus reduces the US shareholder's GILTI inclusion, the amount of the basis increase permitted under section 961(a) is similarly reduced. Accordingly, the use of a tested loss is arguably already appropriately reflected in the stock basis for a related CFC, and the additional basis reductions in the Proposed Regulations should not be required.

## Consolidated Returns

Treasury also introduced a new regulation, Proposed Regulation §1.1502-51 to describe the application of section 951A and the regulations thereunder to each member of a consolidated group. Generally, the determination of a consolidated group member's GILTI inclusion is done on a separate entity rather than a consolidated basis. To prevent distortions of consolidated taxable income, however, the members' pro rata shares of QBAI, tested loss, tested interest expense, and tested interest income are aggregated and then reallocated among those members having tested income for the inclusion year in the ratio of each such member's pro rata share of tested income to the aggregate tested income of all members for the inclusion year. This approach is designed to prevent distortion from, for example, locating a CFC with significant QBAI under a member with no tested interest expense or a case in which one member owns only a CFC with a tested loss while another member owns only a CFC with tested income.

Like Proposed Regulation § 1.951A-6(e), Proposed Regulation § 1.1502-51(c) provides guidance for making similar adjustments to the basis of CFC stock immediately before its disposition where there has been a "used tested loss amount" with respect to the stock. Finally, the proposed regulations include guidance regarding adjustments to the basis of member stock described in Treas. Reg. § 1.1502-32 for the offset (and net offset) tested income amount with respect to CFC stock owned by the member, the used tested loss amount with respect to CFC stock owned by the member, and gain inherent in a CFC stock owned by the member that, upon a sale of the stock, would be offset by a dividend received deduction under section 245A without application of section 1059(a). The latter adjustment is made to the basis of member stock only upon a disposition of the stock and is designed to avoid a tax incentive favoring dispositions of CFC stock over disposition of member stock.

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## Final Thoughts

Treasury and the IRS will publish two additional regulatory packages in the coming months that will provide a fuller understanding of the operation of GILTI. The next package is a foreign tax credit package that should explain the operation of the GILTI foreign tax credit basket (e.g., expense allocation). We expect the foreign tax credit package within the next six weeks. The final GILTI package will describe the distribution of the deduction under section 250. We expect the last guidance item by the end of the year.

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