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TEI Virtual Midyear: Downward attribution under Section 958 - New guidance and practical considerations

June 30, 2020

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Learning objectives

1. Describe the repeal of section 958(b)(4) by the Tax Cuts & Jobs Act.

2. Identify the regulatory/sub-regulatory guidance provided by the Internal Revenue Service addressing the application of section 958(b)(4) repeal.

3. Cite the impact on multinational business operations of the repeal of section 958(b)(4) and the IRS's guidance, including reporting and compliance obligations.

Agenda

Consequences of Section 958(b)(4) Repeal

The Proposed Regulations

Other Administrative Guidance

Practical Considerations

TCJA Repeal of Section 958(b)(4)

- Section 958(b) provides stock ownership rules for purposes of:
  - the U.S. shareholder definition of section 951(b)
  - the definition of a related person under the foreign base company sales income rules of section 954(d)(3)
  - exceptions to the definition of U.S. property under section 956(c)
  - the controlled foreign corporation (CFC) definition of section 957
- Former section 958(b)(4) had prevented attribution of stock owned by a non-U.S. person to a U.S. person (i.e., "downward attribution"). Such attribution is now required for the purposes set forth above, most notably the definition of a U.S shareholder under section 951(b) and a CFC under section 957
- **NOTE!** Retroactive effective date for the elimination of section 958(b)(4): the last taxable year of foreign corporations beginning before Jan. 1, 2018 and for the taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end

TCJA Repeal of Section 958(b)(4)

- Not intended to cause a foreign corporation to be treated as a CFC with respect to a U.S. shareholder as a result of attribution of ownership to a **U.S. person that is not a related person to such U.S. shareholder**

- Is intended to render ineffective certain transactions used to avoid the subpart F rules

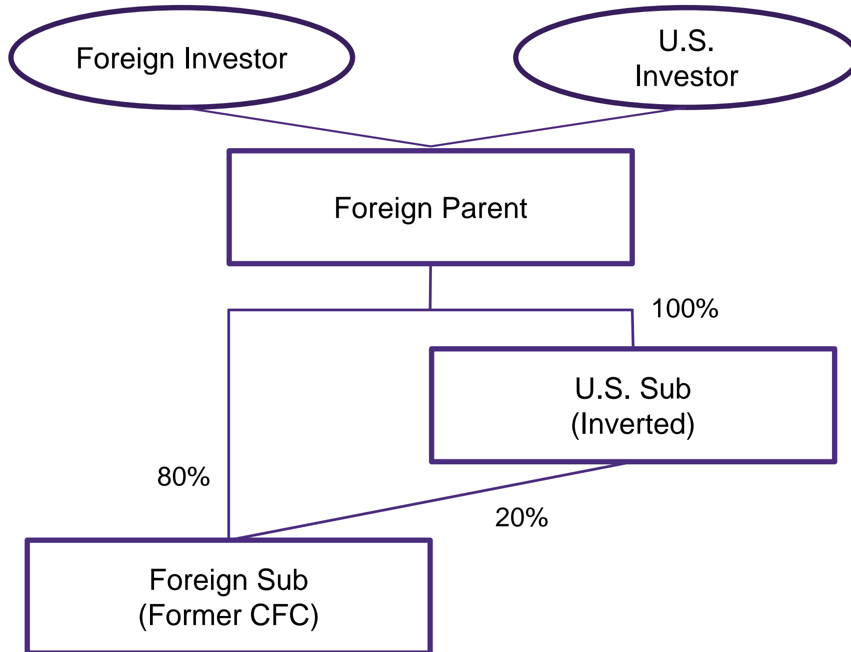
  - <u>For example</u>: A “de-control” transaction following an inversion to convert former CFCs to non-CFCs by taking advantage of the attribution rule effectively turning off the constructive stock ownership rules, despite continuous ownership of the foreign corporations by U.S. shareholders

Poll 1

How has the repeal of section 958(b)(4) impacted your organization?

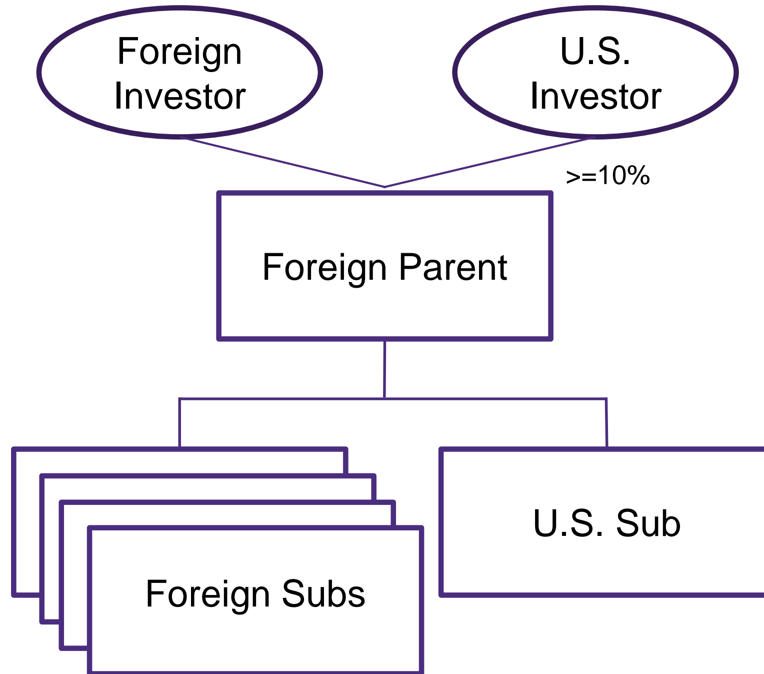
a) Not at all/not applicable
b) Low level of impact
c) High level of impact
d) Not sure

Example 1: Changes to section 958(b)(4)



U.S. Sub treated as owning 100% of Foreign Sub for determining whether Foreign Sub is a CFC (i.e., downward attribution from a foreign person)

Example 2: Unintended Consequences



U.S. Sub treated as owning 100% of Foreign Subs for determining whether Foreign Sub is a CFC (i.e., downward attribution from a foreign person).

Because the section 954 related party requirement was not codified, U.S. Investor may become a U.S. shareholder in Foreign Subs and thus, subject to subpart F, GILTI, and section 965 transition tax (if a specified foreign corporation).

Consider whether the full legislative history can be relied upon for an alternative position?

Repeal of 958(b)(4): Unintended Consequences

- The JCT summary provides that the amended rule “is not intended to cause a foreign corporation to be treated as a controlled foreign corporation with respect to a U.S. shareholder as a result of attribution of ownership under section 318(a)(3) to a U.S. person that is not a related person (within the meaning of section 954(d)(3)) to such U.S. shareholder as a result of the repeal of section 958(b)(4).” (emphasis added)

    - The final conference agreement follows the Senate amendment.

- However, the TCJA simply repeals paragraph (4) of section 958(b) and does not amend any relevant provision to include the definitional relatedness requirement under section 954(d)(3).

Repeal of 958(b)(4): Unintended Consequences

- During Senate's TCJA floor debate, Senator Perdue raised this issue and had previously raised the issue under Senate amendment No. 1666, which would have codified the explanatory text of the Finance Committee report.

- Senator Hatch stated on the floor "the bill does not change or modify the intended scope of the statement [Senator Perdue] cites…[t]he Treasury Department and the Internal Revenue Service should interpret the stock attribution rules consistent with this explanation, as released by the Senate Budget Committee."

- Senator Hatch also noted the reason the Senate did not adopt amendment No. 1666 was because it was neither needed to reflect the intent of the Senate Finance Committee nor the intent of the TCJA conferees.

Administrative Downward Attribution Relief

- Proposed regulations [REG-104223-18] and Rev. Proc. 2019-40 relieve some of the unintended consequences of section 958(b)(4) repeal (both published on October 1, 2019)
- The regulations provide targeted relief in situations where foreign entities became CFCs solely as a result of “downward attribution” (but only in circumstances where Treasury had regulatory authority for such relief)
- The Proposed Regulations provide a downward attribution example
- The revenue procedure includes certain information reporting safe harbors for taxpayers with a limited ability to obtain the required information on certain corporate foreign investments as to CFC status and reporting
- **NOTE**: The Proposed Regulations provide relief to foreign-owned multinationals in some areas, but U.S. multinationals may be negatively impacted in others

Administrative Downward Attribution Relief

Section 958 provides stock ownership rules for purposes of sections 951-964, including determining CFC and U.S. shareholder status, which were amended by the TCJA

Prior to the TCJA, a U.S. person was a U.S. shareholder for CFC definitional purposes if the person owned 10% of the voting stock of a CFC

- After the TCJA amendment, a U.S. person owning 10% of the vote ***or*** value of a CFC is considered a U.S. shareholder for CFC definitional purposes

The amendment was intended to address inbound group transactions targeted to eliminate the CFC status of the group's foreign subsidiaries. However, Congress repealed the limitation on downward attribution from foreign persons previously found in section 958(b)(4) rather than target these narrow groups of transactions

The repeal of section 958(b)(4), combined with the new vote or value CFC definition, unintentionally broadened the universe of foreign corporations treated as CFCs. As a result, stock owned (directly, indirectly, or constructively) by a foreign person became subject to downward attribution to a U.S. person

Poll 2

Was full repeal of section 958(b)(4) intended by Congress when passing TCJA?

a) Yes, words matter, and the words are clear
b) Yes, but the IRS should interpret it consistent with legislative history notwithstanding the words on the page
c) No, Congress intended to impact a narrow set of transactions
d) Not sure/No opinion

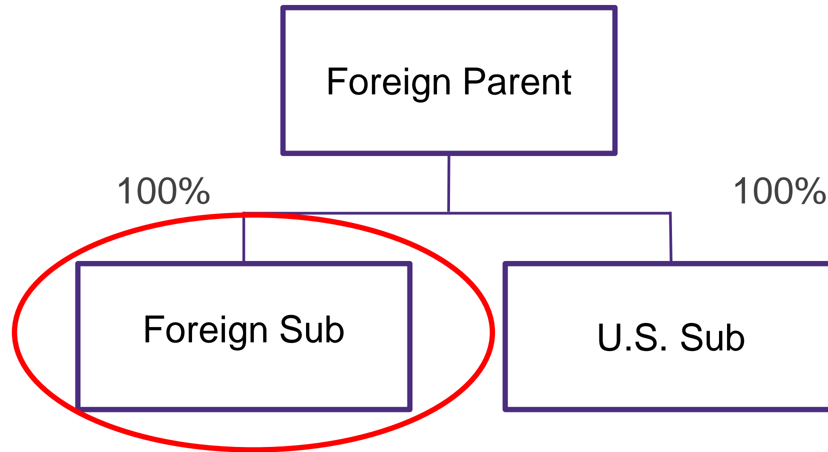
Section 958 Proposed Regulations

- The Proposed Regulations amend the CFC definition to address situations where application of downward attribution causes unintended results

- Treasury views its regulatory authority to make such modifications as coming under various provisions, including sections 267, 332, 367, 672, 863, 706, 904, 1297, and 6049 (the preamble to the Proposed Regulations cited the Regulations as being issued under these sections)

- Key provisions are sections 267 and 904

CFC Downward Attribution: Prop. Treas. Reg. § 1.958-2(g)(4) – Example 4

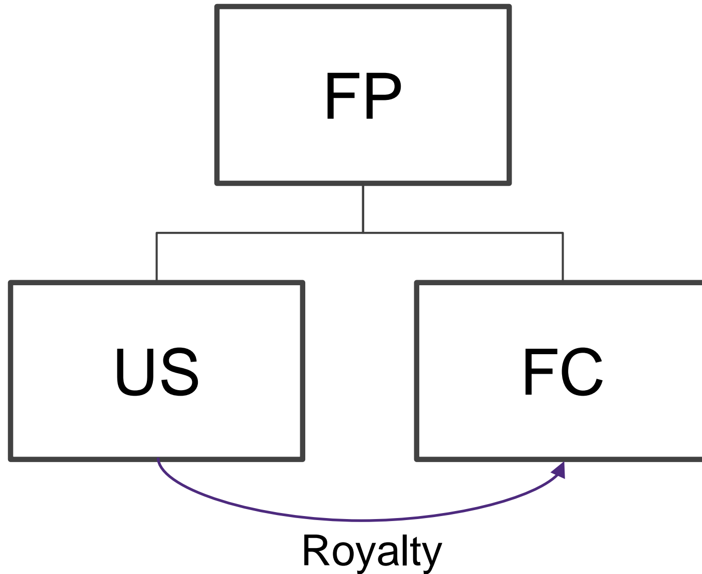


Proposed Regulations: Section 267(a)(3)(B)

- Section 267(a)(3)(B) provides that an item paid to a CFC is deductible by the payor only to the extent that it is includible in the gross income of a section 958(a) U.S. shareholder

- The Proposed Regulations provide that an amount (other than interest) of income of a related foreign person with respect to which the related foreign person is exempt from U.S. taxation on the amount owed pursuant to a treaty obligation of the United States is exempt from the application of section 267(a)(3)(B)(i) if the related foreign person is a CFC that does not have any section 958(a) U.S. shareholders. Prop. Reg. § 1.267(a)-3(c)(4).

Example of Prop. Reg. § 1.267(a)-3(c)(4)



- As a result of section 318(a)(3), downward attribution to US of FC causes FC to be a CFC
- Tax treaty between US and FC jurisdictions has 0% royalty withholding tax
- Proposed Regulations apply; therefore royalty is currently deductible (if no section 958(a) U.S. shareholder above FP).

Section 904 Look-thru Rules Under Prop. Reg. § 1.904-5(a)(4)

- Section 904(a) limits the amount of foreign income taxes that a taxpayer, including a U.S. shareholder, may claim as a credit against its U.S. income tax based on the taxpayer's foreign source income and the character of such foreign income

- Under this limitation, 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 (the "section 904 active rents and royalties exception"), taking into account activities of affiliated group members

- Financial services income received by certain CFCs or a domestic corporation is treated as general category income (the "financial services income rule")

Section 904 Look-thru Rules Under Prop. Reg. § 1.904-5(a)(4)

- The section 904 Proposed Regulations limit the application of the affiliated group rules in the section 904 active rents and royalties exception and the financial services income rule, as well as the CFC look-thru rule, to foreign corporations that are CFCs without regard to downward attribution from foreign persons (See Prop. Reg. §§1.904-4(a)(4) and 1.904-5(a)(4))

- If the foreign entity is not a CFC, and the old rules apply, then the look-thru rules are inapplicable.

- The Proposed Regulations limit the scope of the look-thru rules under section 904 (e.g., they do not include regulations addressing the section 954(c)(6) look-thru rule for payments between related CFCs)

Proposed Regulations Under Section 332(d)(3)

- Section 332(a) provides that no gain or loss is recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation. Section 332(d)(1), however, provides that section 301, and not sections 332(a)/331, applies to a distribution to a foreign corporation in complete liquidation of an applicable holding company.
- And yet, section 332(d)(3) provides for the nonrecognition exchange treatment under section 331 if the distributee corporation in a distribution in complete liquidation of an applicable holding company is a CFC. Thus, the repeal of section 958(b)(4) broadened the application of section 332(d)(3) to foreign corporations that are CFCs because of downward attribution from a foreign person
- As an unintended result, any gain realized on an exchange of stock of an applicable holding company under section 331 by a foreign corporation that is a CFC due to downward attribution could avoid U.S. tax if the CFC does not have U.S. shareholders that have current income inclusions under section 951(a).
- The proposed regulation modifies the definition of a CFC, and uses the definition of a CFC in effect immediately before the repeal of section 958(b)(4) by the TCJA, for purposes of applying section 332(d)(3). (*See* Prop. Reg. § 1.332-8(a))

Proposed Regulations under sections 367, 672, and 706

- Treas. Reg. § 1.367(a)-8(k)(14) provides a gain recognition agreement triggering event exception if certain requirements are met immediately after the transfer of stock or securities
- The proposed regulations revise Treas. Reg. § 1.367(a)-8(k)(14) to apply section 958(b) without regard to the repeal of section 958(b)(4)
- Prop. Reg. § 1.672(f)-(1) addresses the application of the special rules treating CFCs as domestic corporations where such CFCs are owners in a grantor trust
- The Proposed Regulations provide that the only CFCs taken into account for purposes of section 672(f) are those that are CFCs without regard to downward attribution from foreign persons

Section 958 Proposed Regulations

- The source of income derived from space, ocean, and communications activity is determined under sections 863(d) and (e). The Proposed Regulations provide that whether a foreign corporation is a CFC for purposes of the rules under sections 863(d) and (e) is determined without regard to downward attribution from a foreign person. (*See* Prop. Reg. §§ 1.863-8(b)(2)(ii) and 1.863-9(b)(2)(ii))
- Under Section 1297(e)(2), if a non-publicly traded foreign corporation is a CFC, adjusted basis (rather than value) of the assets must be used when determining whether the average percentage of the corporation's assets that produce passive income is at least 50%. The proposed regulations modify the definition of a CFC for purposes of Section 1297(e) to disregard downward attribution from foreign persons

Section 958 Proposed Regulations

- Section 706 addresses the determination of the taxable year of a partnership with CFC partners
- The Proposed Regulations modify the rule to provide that CFC's, which are CFC's solely by reason of downward attribution, are not to be treated as CFCs. (*See* Prop. Reg. § 1.706-1(b)(6)(ii))
- In some cases, Form 1099 reporting requirements depend on CFC status. The Proposed Regulations provide that only a CFC that is a CFC without regard to downward attribution from a foreign person should be included

Effective Dates

- The Proposed Regulations are generally proposed to apply to tax years ending on or after October 1, 2019
- The Proposed Regulations also apply to certain transactions occurring on or after October 1, 2019
- Each individual Proposed Regulation can be applied to taxable years beginning before January 1, 2018, provided that the taxpayer and related persons consistently apply such Proposed Regulation

What's Not in the Proposed Regulations?

- Portfolio interest exemption: repeal of section 958(b)(4) may cause many typical inbound financing structures to fail to qualify for the portfolio interest exemption
- Section 898: the Proposed Regulations also do not address section 898, which generally requires conformity of a CFC's tax year to its controlling U.S. shareholder's tax year
- The CFC look-thru rules under section 954(c)(6)

Takeaways from the Proposed Regulations

- In acknowledging the concerns and challenges created by the repeal of section 958(b)(4), the Proposed Regulations seek to limit the impact of the repeal in areas of the Code where Treasury concluded it had regulatory authority to do so

- Taxpayers should assess the impact of section 958(b)(4) repeal on their business operations

- The ability to adopt the Proposed Regulations for prior years may provide refund claim opportunities

- The ability to adopt the Proposed Regulations for prior years also carries financial statement implications

Poll 3

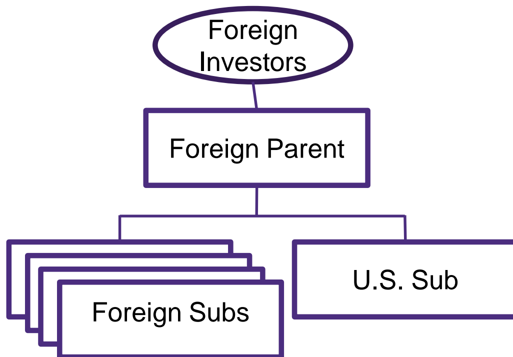
Which aspect of the Proposed Regulations most significantly impacts your business operations?

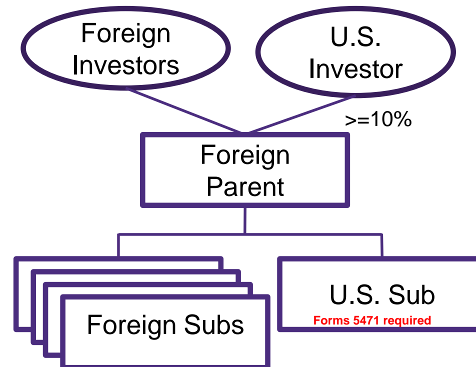
a) The 267 related party deduction rules
b) The 904 look-thru rule changes
c) The 332(d)(3) rules on liquidations
d) Other aspects of the Proposed Regulations
e) Don’t know/Not applicable

Notice 2018-13 (filing exception)

- Form 5471 reporting issue: but for an exception, repeal of section 958(b)(4) would require the controlled U.S. subsidiary/entity to file Forms 5471 reporting each of the foreign brother/sister entities that it was deemed to control.
- The Notice states the IRS intends to amend the Instructions for Form 5471 to prevent this unintended consequence
- The amended instructions would provide an exception from Category 5 filing under Form 5471 for a U.S. person that is a U.S. shareholder with respect to a CFC if:
  - no U.S. shareholder (including such U.S. person) owns, within the meaning of section 958(a), stock in such CFC; and
  - the foreign corporation is a CFC solely because such U.S. person is considered to own the stock of the CFC owned by a foreign person under section 318(a)(3)

Example 3 – Exception to Form 5471 Reporting





1. No U.S. shareholder, and
2. Foreign subs are CFCs solely because of constructive ownership under Sec. 318(a)(3).

Exception applies, no Forms 5471 required.

1. U.S. shareholder, and
2. foreign subs are CFCs solely because of constructive ownership under Sec. 318(a)(3).

Exception does not apply, Forms 5471 required.

Rev. Proc. 2019-40

- As noted, after section 958(b)(4) repeal, foreign corporations that were not previously treated as CFCs may become CFCs

- Once becoming a CFC, taxpayers may face income inclusions and reporting requirements related to sections 951 and 951A (subpart F and GILTI), but without an ability to collect the information needed to compute and report these amounts

- Rev. Proc. 2019-40 provides guidance to taxpayers in applying the impact of the repeal of section 958(b)(4) by:
    - Providing three safe harbor rules
    - Addressing the applicability of certain penalties, and
    - Revising the requirements for certain U.S. shareholders to file or report certain information on Form 5471.

Rev. Proc. 2019-40

- The Rev. Proc. 2019-40 are generally limited to:

  - U.S. shareholders of “foreign-controlled CFCs”, which are foreign corporations that would not be CFCs without downward attribution from a foreign entity under section 318(a)(3) (i.e., foreign corporations that would not be CFCs but for the repeal of section 958(b)(4)).

- Thus, foreign corporations that would be CFCs even absent the repeal of section 958(b)(4) are not afforded relief under the revenue procedure.

Rev. Proc. 2019-40

- The revenue procedure provides:
  - A safe harbor for the determination of CFC status* where certain facts are unknown and other conditions are met.
    - Conditions for the safe harbor are satisfied only if the relevant U.S. person does not have:
      - actual knowledge that the entity is a CFC
      - a statement that the entity is a CFC; or
      - reliable publicly available information that the entity is a CFC
  - An allowance for the use of alternative information to compute GILTI and subpart F income under sections 952 and 964, where the usual information is not readily available. Alternative information includes audited and/or unaudited GAAP, IFRS, or local accounting financial statements.

* an entity is a CFC if it meets the CFC definition on any day during the year

Rev. Proc. 2019-40

- Further, the safe harbor allows for the use of alternative information to compute section 965 inclusion amounts where the usual information is not readily available.
    - Alternative information under the guidance includes audited and/or unaudited GAAP, IFRS, or local accounting financial statements.

- The revenue procedure provides penalty relief under sections 6038 and 6662 if a taxpayer uses alternative information

Rev. Proc. 2019-40 - Alternative information

"Alternative information" includes:

- Audited separate-entity financial statements of the foreign corporation prepared in accordance with U.S. generally accepted accounting principles (U.S. GAAP)
- Audited separate-entity financial statements of the foreign corporation prepared on the basin accordance with international financial reporting standards (IFRS)
- Audited separate-entity financial statements of the foreign corporation in accordance with generally accepted accounting principles of the jurisdiction in which the foreign corporation is organized
- Unaudited separate-entity financial statements of the foreign corporation prepared in accordance with U.S. GAAP.
- Unaudited separate-entity financial statements of the foreign corporation prepared on the basis of IFRS.

Rev. Proc. 2019-40

- **Form 5471 reporting.** Repeal of section 958(b)(4) significantly increased taxpayer compliance burdens under the information reporting provisions triggered by U.S. shareholder or CFC status, including the requirement that U.S. shareholders file Form 5471.
- The revenue procedure provides reduces or eliminates the Form 5471 reporting requirements for certain minority U.S. shareholders and constructive owners of CFCs
- The Form 5471 instructions state that a Category 5 filer need not file Form 5471 if (i) no U.S. shareholder (including the filer) owns, within the meaning of section 958(a), stock in the foreign corporation, and (ii) the foreign corporation is a specified foreign corporation or CFC solely because one or more U.S. persons is considered to own the stock of the foreign corporation owned by a foreign person under section 318(a)(3)
- The revenue procedure also adds an additional exception to the Category 5 filing requirement, while also reducing the number of schedules Category 5 filers must submit in certain circumstances

Effective Dates

- The revenue procedure allows taxpayers to use the safe harbors with respect to the last taxable year of a foreign corporation beginning before Jan. 1, 2018, and tax years of U.S. Shareholders in which or with which such tax year ends.

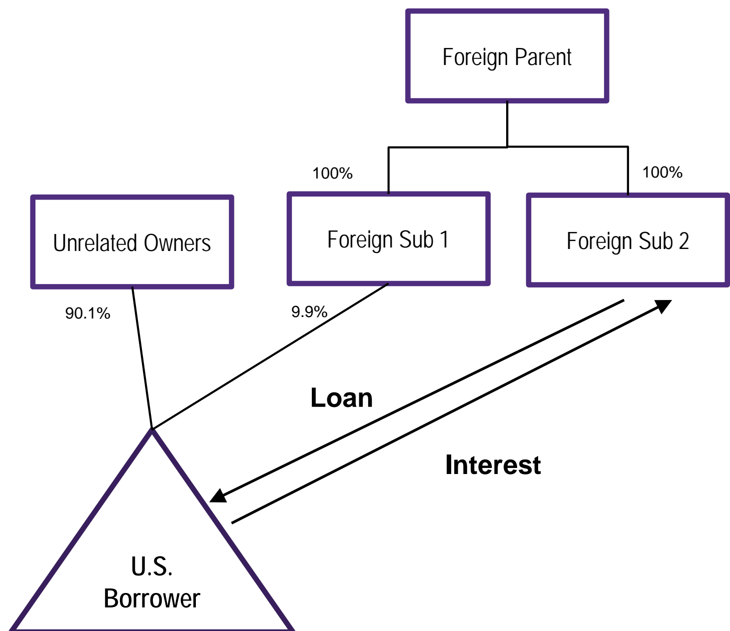
- Taxpayers also may apply the rules relating to filing and information reporting on Form 5471 for the last tax year of a foreign corporation beginning before January 1, 2018, and tax years of U.S. Shareholders in which or with which such tax year ends.

Poll 4

How much relief has Revenue Procedure 2019-40 provided to your company?

a) None/not applicable
b) Limited relief
c) Substantial relief
d) Not sure

Portfolio Interest Exemption



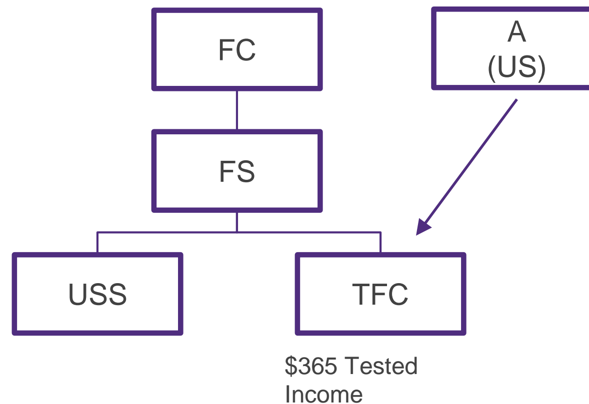
- TCJA makes the portfolio interest exemption inapplicable in some structures
- Non-U.S. lenders benefit from the reduced withholding tax on payments qualifying for the exception
- The portfolio interest exemption does not apply to interest received by a 10% shareholder of the borrower
- The portfolio interest exemption also does not apply to interest received by a CFC from a related person
- As a result of section 958(b)(4) repeal, Foreign Sub 2 becomes a CFC, disallowing the portfolio interest exemption
- Restructuring should be considered
- Lender/borrower will need to determine whether the borrower is required to "gross-up" the lender for additional taxes due under the agreement

M&A Considerations

<u>Section 958(b)(4) "Hot Potato" Rule</u>

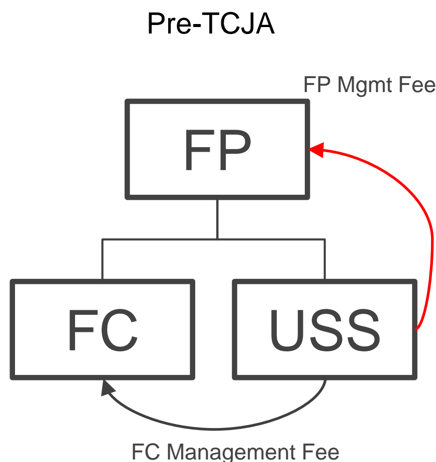
If a foreign corporation is a CFC (solely because of downward attribution) and is acquired by a U.S. shareholder, the so-called “hot potato” rule applies.

Buyer must include in it’s U.S. taxable income the CFC’s entire year’s worth of income (even if it is acquired on the last day of the year and had no Section 958(a) U.S. shareholders pre-sale)



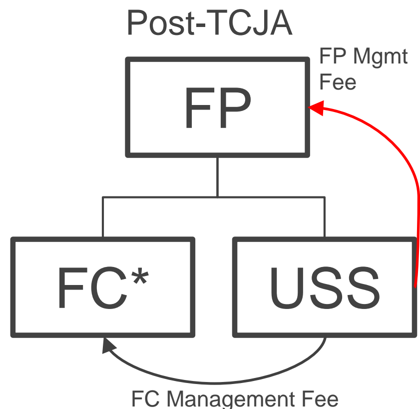
If Target Foreign Corporation wasn't a CFC (because of downward attribution or otherwise), A's GILTI inclusion would be limited to $1.

Intercompany Transactions

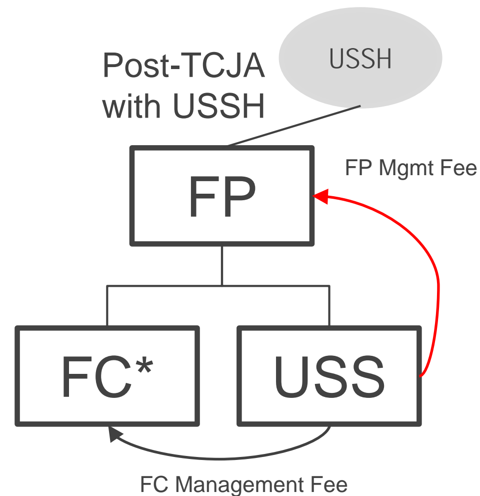


*FC is not a CFC

Assumption: Assume that across all three scenarios the FC and FP management fees otherwise meet an exception under Treas. Reg. Sec. 1.267(a)-3 (e.g. payments owed are FSI to the recipient)



*FC is a CFC due to repeal of Section 958(b)(4) – The FC management fee is subject to the rules of Section 267(a)(3).



*FC is a CFC due to repeal of Section 958(b)(4) – The FC management fee is included in tested income of USSH. Therefore, USS may deduct some or all of the payment upon inclusion in income.

Intercompany Transactions

Impact of Section 267(a)(3)

	Year 1	Year 2	
Revenue	$ 1,000	$ 1,000	
Expense	$ (950)	$ (950)	
Book Income	$ 50	$ 50	
267(a)	$ 950	$ (950)	*
Taxable Income	$ 1,000	$ (900)	

* Assume all amounts are paid in Year 2, and there are no amounts accrued at year end. Consider future utilization of the NOL.

Any final questions?

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