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International Tax ADVISORY ■

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Down the Rabbit Hole: Guidance Addressing Downward Attribution After Repeal of Section 958(b)(4)

The Tax Cuts and Jobs Act (TCJA) cast a wide net when it repealed Section 958(b)(4), which turned off downward attribution to avoid considering a U.S. person as constructively owning stock owned by a foreign person. As a result, many more foreign corporations are likely to be treated as controlled foreign corporations (CFCs). Recognizing this impacts many provisions of the Code beyond the core anti-deferral provisions of Subpart F, GILTI, and Section 965, Proposed Regulations released on October 1, 2019 (REG-104223-18) limit its application in certain contexts. Rev. Proc. 2019-40, released on the same date, provides safe harbors taxpayers can use for determining when a foreign corporation is a CFC and for obtaining information necessary to compute income inclusions under Subpart F, GILTI, and Section 965, and also provides modifications to Form 5471.

Proposed Regulations

In crafting the Proposed Regulations, the IRS appears to have surveyed various provisions outside Subpart F, GILTI, and Section 965 impacted by the repeal of Section 958(b)(4) and takes shot at only a few for corrections – some favorable and some unfavorable for taxpayers.

One favorable change was proposed for Section 267. That section provides matching rules that delay the timing of deductions to related persons. It also applies to certain payments to related persons that are CFCs but contains a limited exception when the CFC is exempt from U.S. tax on the amount under a treaty if the amount is includable in the same year by a person treated as a "U.S. shareholder" of the CFC under the direct and indirect ownership rules of Section 958(a) (Section 958(a) U.S. inclusion shareholders). However, a foreign corporation may be treated as a CFC after the TCJA's effective expansion of the constructive ownership rules of Section 958(b) and yet have no Section 958(a) U.S. inclusion shareholders and thus no opportunity for the income to be includable by any such person. The Proposed Regulations acknowledge this and exempt from delay deductions for payments (other than interest) to CFCs that have no Section 958(a) U.S. inclusion shareholders, provided the CFC is exempt from U.S. tax on the amount under a treaty.

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One unfavorable change was proposed for Section 332 liquidations to neutralize a presumably unintended benefit of Section 958(b)(4)'s repeal. Section 332(d) overrides the general nonrecognition rule in Section 332(a) and treats liquidating distributions by certain domestic holding companies to their foreign corporate parents as distributions subject to Section 301 (and thus potentially as a dividend). However, if the foreign parent is a CFC, the distribution is instead treated as an exchange under Section 331 that gives rise to Subpart F income. Only Section 958(a) U.S. inclusion shareholders would have Subpart F income inclusions though, and, as demonstrated above, a foreign corporation treated as a CFC under the expanded constructive ownership rules may have no Section 958(a) U.S. inclusion shareholders that would have Subpart F inclusions. Thus, income inclusions could be avoided completely under Section 332(d) in an applicable liquidation. The Proposed Regulations address this by effectively reinstating Section 958(b)(4) solely for purposes of Section 332(d).

Similarly, the Proposed Regulations restore the status quo ante for the purposes of (1) determining exceptions to triggering events under gain recognition agreements entered into to avoid the application of Section 367(a)(1); (2) determining grantor trust status for trusts owned by CFCs; (3) determining a partnership's taxable year when a CFC is a partner; (4) determining the source of space and ocean income and international communications income derived by a CFC; (5) applying certain affiliated group rules and the CFC look-through rule to the foreign tax credit limitation rules in Section 904; (6) applying the asset test under Section 1297(e) to determine if certain CFCs are passive foreign investment companies; and (7) determining whether a CFC is subject to Form 1099 reporting and backup withholding (which in particular provides welcome relief to foreign banks whose information-reporting burdens were expanded).

The Proposed Regulations notably omit any reference to the portfolio interest exemption, which is unavailable to CFCs. The repeal of Section 958(b)(4) means that many more foreign corporations are treated as CFCs and thus ineligible for the full exemption from U.S. withholding for U.S.-source portfolio interest.

Revenue Procedure

The Revenue Procedure offers an objective safe harbor that permits U.S. persons to conclude certain foreign-controlled foreign corporations are not CFCs when limited information is available. Another safe harbor allows U.S. shareholders to rely on certain alternative information to determine Subpart F, GILTI, and Section 965 inclusions of certain foreign-controlled CFCs when limited information is available. If a taxpayer makes a determination using a safe harbor, the IRS will suspend the application of penalties under Sections 6038 (for failure to timely furnish information required to be reported on Form 5471) and 6662 (for substantial understatements). The Revenue Procedure also eases Form 5471 filing requirements for certain U.S. shareholders of CFCs, but a complete exemption only applies in limited circumstances.

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