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KPMG report: Initial impressions of final and proposed regulations, relief concerning repeal of section 958(b)(4)

The U.S. Treasury Department and IRS today released for publication in the Federal Register final regulations (T.D. 9908) and a related notice of proposed rulemaking (REG-110059-20) concerning the ownership attribution rules under section 958 that apply for purposes of determining the status of a controlled foreign corporation (CFC) or U.S. shareholder.

The **final regulations** [PDF 294 KB] adopt regulations that were proposed in October 2019 with certain modifications.

The **notice of proposed rulemaking** [PDF 295 KB] proposes regulations under section 954(c)(6) to provide that the operation of section 954(c)(6) is consistent with its application before repeal of section 958(b)(4) by the 2017 tax law (Pub. L. No. 115-97), or the law that is often referred to as the "Tax Cuts and Jobs Act" (TCJA). The notice of proposed rulemaking also modifies the regulations under section 367(a) regarding the direct or indirect transfer of stock or securities of a domestic corporation by a "United States person" (as defined in section 7701(a)(30)) to a foreign corporation so that the attribution rules are applied consistently following the TCJA's repeal of section 958(b)(4).

This report provides initial impressions and observations about the final regulations and the proposed regulations.

Background

The 2017 U.S. tax law (Pub. L. No. 115-97, enacted December 22, 2017, that is often referred to as the "Tax Cuts and Jobs Act" (TCJA)) modified the stock attribution rules under section 958(b) that apply for subpart F purposes, including determining whether a person is a U.S. Shareholder under section 951(b) ("U.S. Shareholder") of a controlled foreign corporation ("CFC"), and whether a foreign corporation is a CFC. Specifically, the TCJA repealed the statutory rule under section 958(b)(4) that had prevented

"downward attribution" of stock from a foreign person to a U.S. person under section 318(a)(3), effective beginning with the last tax year of foreign corporations that began before January 1, 2018.
The repeal of section 958(b)(4) by the TJCA increased the number of U.S. persons that are U.S. Shareholders and, therefore, the number of foreign corporations that are CFCs. U.S. Shareholders are required to include amounts in income under the provisions of subpart F, including the global intangible low-taxed income ("GILTI") rules, based on the CFC's income, but only if they own stock in the CFC directly or indirectly under section 958(a) which, unlike constructive ownership under section 958(b), is determined without regard to downward attribution.

A number of rules outside of subpart F cross-reference the subpart F definition of CFC, which is determined under the section 958 constructive ownership rules, or directly reference the section 958(b) constructive ownership rules. The change to the section 958(b) constructive ownership rules impacted these rules, by expanding or contracting their applicability in a manner not contemplated when the underlying rules were enacted. Treasury published proposed regulations on October 2, 2019 ("2019 proposed regulations") that modified the section 958 ownership regulations as well as nine regulations outside of subpart F that were affected by the section 958(b)(4) repeal, generally by providing that the downward attribution rules are not taken into account for a particular provision, or otherwise by revising the rule to more closely align with its application prior to the repeal of section 958(b)(4). For a detailed discussion of the 2019 proposed regulations read: ***TaxNewsFlash***

Final regulations

Overview of the final regulations

The final regulations finalize nine of the 10 rules in the 2019 proposed regulations. The final regulations do not finalize the passive foreign investment company ("PFIC") proposed rule because Treasury intends to finalize the proposed rule in connection with finalizing PFIC proposed regulations issued on July 11, 2019 (REG-105474-18).

- Treasury rejected a comment to add additional regulations addressing the repeal of section 958(b)(4) for purposes of the section 881(c) portfolio interest rules because of a lack of authority in the portfolio interest rules for such regulations.
- Treasury rejected a comment to provide guidance under section 1442 for withholding agents that are required to withhold on portfolio interest, explaining that the withholding agent standards appropriately address withholding for portfolio interest, and noting that it was beyond the scope of the section 958(b)(4) regulation project to provide diligence guidance for withholding agents.
- Treasury rejected a comment to revise the existing section 1248(a) rules to take into account the repeal of section 958(b)(4) and decided instead to continue to apply section 958(b) for section 1248 purposes.

Provisions addressed in the final regulations

Treasury modified the rule in the 2019 proposed regulations that addressed the application of section 267(a)(3)(B).

- **Section 267(a)(3)(B) (Deduction of amounts owed to related foreign persons).** In general, accrual basis taxpayers are allowed a deduction with respect to accrued but unpaid amounts owed to a CFC only to the extent the amount is included in a U.S. Shareholder's income. The repeal of section 958(b)(4) expanded the application of the section 267(a)(3) timing rule by increasing the number of entities treated as CFCs. Under the 2019 proposed regulation, amounts (other than interest) that were exempt from tax under a treaty and owed to a CFC were not subject to the special timing rule if the CFC did not have any U.S. Shareholders that own stock in the CFC under section 958(a). The final regulations expand the proposed rule by providing that all amounts (including interest) owed to a CFC that does not have any U.S. Shareholders that own stock in the CFC under section 958(a) are not subject to the special timing rule in section 267(a)(3)(B). Instead, the rules in section 267(a)(3)(A) apply as if the amounts were owed to a related foreign person that is not a CFC.

KPMG observation

Tax professionals view the final regulation as a welcomed change from the 2019 proposed regulation, which was relatively narrow. The application of the 2019 proposed rule to CFCs that were not exempt from tax under a treaty but nonetheless not subject to U.S. withholding tax (for instance, foreign source non-effectively connected amounts) was difficult to justify from a policy perspective. Unlike certain of the other rules in the final regulations, the application of the section 267(a)(3)(B) rule depends on whether any U.S. Shareholder own any stock in the CFC under section 958(a), rather than on whether the foreign corporation is a CFC without regard to downward attribution from foreign entities.

The following rules in the 2019 proposed regulations were modified without any substantive changes:

- **Section 958 (Constructive ownership).** The final regulations modify the section 958(b) constructive ownership regulations to be consistent with the repeal of section 958(b)(4).
- **Section 367 (Gain recognition agreements).** In general, a U.S. transferor can avoid the application of the section 367(a) rules for certain transfers of foreign stock or securities if it enters into a gain recognition agreement ("GRA"). In that case, the U.S. transferor recognizes gain under the GRA upon a "triggering event", as determined under the regulations. In determining whether a disposition of the foreign stock or securities is a triggering event, certain dispositions are not treated as triggering events if they meet certain requirements including qualification as a nonrecognition transaction and the satisfaction of certain ownership requirements. In particular, the "catch-all" triggering event exception in Reg. §1.367(a)-8(k)(14) generally provides an exception for a nonrecognition transaction if, immediately after the transaction, the U.S. transferor owns at least 5% of the foreign corporation applying the constructive ownership rules of section 958(b). For this purpose, the final regulations provide that the U.S. transferor's ownership is determined without regard to the downward attribution rules.
- **Section 706 (Tax year of partnership).** Under the rules for determining a partnership's tax year, a foreign partner's interest generally is disregarded unless the partner is allocated a share of the partnership's effectively connected income. Prior to modification by the final regulations, for this purpose, the regulations excluded a CFC from the definition of foreign partner. The final regulations exclude from the definition of foreign partner only CFCs that have a U.S. Shareholder that owns stock in the CFC under section 958(a).

The final regulations revise the definition of CFC in seven rules to be consistent with the definition prior to the repeal of section 958(b)(4).

- **Section 332 (Recognition of gain on liquidation of certain holding companies).** The general rule in section 332 that allows nonrecognition treatment for gain derived in connection with property received in a complete liquidation of a corporation is subject to an exception for certain distributions to foreign corporations. This exception is itself subject to a special rule that applies when the corporation receiving the property in the liquidation is a CFC. For this purpose, the final regulations provide that CFC status is determined without taking into account the downward attribution rules.
- **Section 672 (Definitions relating to trusts).** Certain trust rules apply only to the extent that amounts are included in income of certain U.S. persons or a CFC. For this purpose, the final

regulations provide that CFC status is determined without taking into account the downward attribution rules.

- **Section 863 (Source of income: Space and ocean activities).** The determination of the source of income from space and ocean activities generally depends in part on whether the income is derived by a U.S. person or a foreign person. Under a special rule, income derived by a CFC may not be treated as foreign source income. For this purpose, the final regulations provide that CFC status is determined without taking into account the downward attribution rules.
- **Section 863 (Source of income: International communication income)**. International communication income derived by a foreign person generally is foreign source income. Nonetheless, a CFC's international communication income generally is treated as 50% U.S. source and 50% foreign source. For this purpose, the final regulations provide that CFC status is determined without taking into account the downward attribution rules.
- **Section 904 (FTC look-through rules and affiliated group rules).** Under the foreign tax credit ("FTC") rules, a U.S. person's foreign source income is assigned to a separate limitation category. Under a special FTC look-through rule, an item of income received by a U.S. Shareholder from a CFC is assigned to the passive category only to the extent that the item is allocable to income of the CFC that is passive. Under a separate rule, rents and royalties received from a CFC are excluded from the passive category under an active rents and royalties exception that depends in part on the activities of an affiliated group, which includes CFCs. Further, a rule that applies to determine whether financial services income is treated as general category depends on the activities of an affiliated group, which includes CFCs. For all of these purposes, the final regulations provide that CFC status is determined without taking into account the downward attribution rules. In addition, the final regulations provide that the U.S. Shareholder determination is made without taking into account the downward attribution rules.
- **Section 6049 (Form 1099).** CFCs that make payments to certain U.S. persons are required to report information to the recipient using a Form 1099. For this purpose, the final regulations provide that CFC status is determined without taking into account the downward attribution rules.

Applicability dates and reliance

As relevant, the final regulations apply to tax years of foreign corporations or shareholders ending on or after October 1, 2019, or to relevant transactions (payments accrued, distributions in complete liquidation, transfers, or payments made) that occur on or after October 1, 2019. In addition, a particular proposed regulation can be applied to certain earlier tax years, generally determined by reference to the last tax year of a foreign corporation that begins before January 1, 2018, provided that the taxpayer and related persons consistently apply the rule.

Proposed regulations

Overview of the proposed regulations

The proposed regulations revise regulations under section 367(a) and add a new regulation under section 954(c)(6) that address the repeal of section 958(b)(4) for purposes of each provision, consistent with the rules in the 2019 proposed regulations.

- **Section 367(a) (Transfers of property from the united states).** In general, among other conditions, the following four requirements must be satisfied in order for nonrecognition treatment to apply to an outbound transfer of a domestic corporation ("U.S. target company") by a U.S. person:

- o 50% or less of the voting power and value of the transferee foreign corporation must be received in the aggregate by U.S. transferors
- o 50% or less of the voting power and value of the transferee foreign corporation must be owned in the aggregate, immediately after the transfer by U.S. persons that are either officers or directors of the U.S. target company or that are 5% target shareholders
- o Either the U.S. person must not be a 5% transferee shareholder or, if the U.S. person is a 5% transferee shareholder, the U.S. person must enter into a GRA, and
- o The active trade or business test must be satisfied

For this purpose, the section 958(b) ownership rules are applied for purposes to determine ownership or the receipt of stock, securities or other property. The proposed regulations provide that the requirements in (i), (ii), and (iv) are determined without regard to downward attribution from foreign entities to U.S. persons. The proposed requirement further provides that the requirement in (iii) does take into downward attribution from foreign entities to U.S. persons. Treasury noted in the preamble that allowing downward attribution from foreign entities for (iii) is consistent with an existing rule under which a U.S. transferor that transfers foreign stock in an outbound transfer must enter into a GRA if immediately after the transfer it owns, taking into account section 958(b), at least 5% of the transferee corporation.

- **Section 954(c)(6) (Look-thru rule for related controlled foreign corporations).** Under section 954(c)(6), dividends, interest, rents, and royalties received or accrued by a CFC from a CFC that is a related person is excluded from the CFC's foreign personal holding company income ("FPHCI") if certain conditions are satisfied. Under the proposed regulations, the determination of whether a foreign corporation is a CFC for section 954(c)(6) purposes is determined without regard to downward attribution from a foreign entity to a U.S. person. Thus, amounts received or accrued from a CFC that would not be a CFC without the downward attribution rule are not eligible for the section 954(c)(6) exception, even if the payor CFC has U.S. shareholders that own stock in the CFC under section 958(a). Treasury requested comments on the extent to which the proposed regulation should be modified if the payor CFC has any U.S. shareholders under section 958(a).

KPMG observation

Although the preamble refers to interest payments between related CFCs (resulting in subpart F income instead of tested income), the more significant impact may come from the interaction of the proposed rule to CFC-to-CFC dividends and section 245A. Prior to the proposed regulations, a dividend paid to a CFC from a related CFC could be excluded from the CFC's subpart F income under section 954(c)(6) as well as being excluded from tested income under section 951A(c)(2)(A)(i)(IV), with the result that earnings and profits in the recipient CFC would be eligible for a dividend received deduction ("DRD") under section 245A when distributed to a U.S. shareholder. Under the proposed regulations, when applicable, unless the recipient CFC can exclude the dividend under another exception (such as the related-party dividend rule in section 954(c)(3)) a dividend from a related CFC will be included in the CFC's subpart F income, thus eliminating the availability of the section 245A DRD.

Applicability dates and reliance

The proposed regulations under section 367(a) apply to transfers occurring on or after September 21, 2020, and the proposed regulations under section 954(c)(6) apply to payments or accruals of dividends, interest, rents, and royalties made by a foreign corporation during tax years of foreign corporations ending on or after September 21, 2020. In addition, each of the proposed regulations can be applied to certain earlier tax years, generally determined by reference to the last tax year of the relevant foreign corporation that begins before January 1, 2018, provided that the taxpayer and related persons (as determined under section 267 or 707) consistently apply the proposed regulation.

Comment period and hearing

Comments or requests for a public hearing on the proposed regulations must be submitted by November 20, 2020.

For more information, contact a tax professional with KPMG's Washington National Tax practice:

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