KPMG report: Regulations under sections 245A, 951A, 954 (GILTI); treatment of dividends from foreign corporations

September 3, 2020

The U.S. Treasury Department and IRS (collectively, "Treasury") released final regulations under sections 245A and 954(c)(6) (the "final regulations") (T.D. 9909) and proposed regulations under sections 245A and 951A (the "proposed regulations") (REG-124737-19). These regulations were published in the Federal Register on August 27, 2020.

The final regulations finalize proposed regulations under sections 245A and 954(c)(6) (the "2019 proposed regulations"), which were filed with the Federal Register on June 14, 2019, and published on June 18, 2019. The final regulations also withdraw temporary regulations that accompanied, and served as the text of, the 2019 proposed regulations (the "temporary regulations") (T.D. 9865).

Read the **final regulations** [PDF 406 KB] (30 pages as published in the Federal Register).

Read the **proposed regulations** [PDF 376 KB] (27 pages as published in the Federal Register).

For a more detailed discussion of the temporary regulations, read ***TaxNewsFlash***.

Below is a description of the key provisions of the final regulations and the proposed regulations, including key insights and observations.

Contents

Background ... 2
Procedural and substantive validity ... 3
Applicability dates and reliance ... 3
The final regulations ... 4
Overview ... 4
Extraordinary disposition rules ... 5
Extraordinary dispositions ... 5
Extraordinary disposition accounts ... 6
Extraordinary reduction rules ... 9
Non-application to same-country exception ... 11
Reporting requirements ... 12
The proposed regulations ... 12
Overlap between sections 951A and 245A ... 12
Proposed coordination rules ... 13
Coordination rule methods ... 13
Corresponding specified property ... 16
DQB reduction rule ... 16
EDA reduction rule ... 19
Other rules ... 23
Comment period and hearing ... 24

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. The KPMG name and logo are registered trademarks or trademarks of KPMG International.

Background

Section 245A allows a United States shareholder ("U.S. shareholder") that is a domestic corporation (a "section 245A shareholder") a 100% dividends received deduction (a "section 245A DRD") with respect to the foreign-source portion of a dividend received from a specified 10% owned foreign corporation (an "SFC"). The section 245A DRD is statutorily conditioned on certain requirements, including that the taxpayer satisfy the holding period in section 246(c) and that the dividend is not a "hybrid dividend" (as defined in section 245A(e)) (a dividend eligible for a section 245A DRD, a "section 245A-eligible dividend"). The foreign-source portion of a dividend is the amount of the dividend multiplied by the ratio of an SFC's undistributed foreign earnings to the SFC's total undistributed earnings (the "section 245A ratio"). An SFC's undistributed foreign earnings are all its earnings and profits ("E&P") other than E&P attributable to income that is effectively connected with the conduct of a trade or business within the United States and subject to U.S. federal income tax ("U.S. tax" and such income, "ECI") or dividends from 80%-owned domestic corporations (other than RICs and REITs). An SFC's undistributed earnings are its total E&P as of the end of its tax year in which it distributes the dividend, determined without diminution by reason of dividends distributed during such tax year. Section 954(c)(6) excludes from the subpart F income of a controlled foreign corporation ("CFC") dividends, interest, rents, and royalties received from a related CFC to the extent properly allocable to income of the related CFC which is neither subpart F income nor ECI.

The temporary regulations provided rules that disallowed all or a portion of a section 245A DRD with respect to an otherwise section 245A-eligible dividend received by a section 245A shareholder attributable to gain recognized by an SFC by reason of certain "gap period" transactions while it was a CFC (the "first-tier extraordinary disposition rules"), or received by the shareholder from a CFC in a tax year that the shareholder's interest in the CFC is significantly reduced (the "first-tier extraordinary reduction rules").

In addition, the temporary regulations provided rules that limited the applicability of section 954(c)(6) with respect to a CFC-to-CFC dividend to the extent such dividend would have not been a section 245A-eligible dividend under the first-tier extraordinary disposition rules or first-tier extraordinary reduction rules if received by a section 245A shareholder (respectively, the "tiered extraordinary disposition rules" and "tiered extraordinary reduction rules," and the tiered extraordinary disposition rules with the first-tier extraordinary disposition rules, the "extraordinary distribution rules," and the tiered extraordinary reduction rules with the first-tier extraordinary reduction rules, the "extraordinary reduction rules"). The extraordinary disposition rules and extraordinary reduction rules, including the reasons for such rules and noteworthy changes thereto in the final regulations, are discussed in further detail below in the discussion of the final regulations.

On the same day as the temporary regulations, Treasury finalized regulations implementing the global intangible low-taxed income ("GILTI") regime of section 951A (the "GILTI regulations"). The GILTI regulations contain a rule that effectively disallows deductions and losses related to basis created during the gap period for purposes of calculating GILTI (the "disqualified basis rule"). The proposed regulations propose to coordinate the extraordinary disposition rules in the final regulations and the disqualified basis rule in the GILTI regulations. The disqualified basis rule is discussed in more detail below in the discussion of the proposed regulations.

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. The KPMG name and logo are registered trademarks or trademarks of KPMG International.

Procedural and substantive validity

The temporary regulations were criticized from both a procedural and substantive standpoint. Procedurally, public comments questioned whether Treasury, in making the temporary regulations effective immediately, complied with the "notice and comment" rules in the Administrative Procedures Act ("APA"). Treasury did not address the substance of these comments in the preamble to the final regulations, asserting that the APA issues were fully discussed in the preamble to the temporary regulations and that such comments were irrelevant to the final regulations for which adequate notice and comment was provided.

Substantively, the temporary regulations were criticized for exceeding the scope of Treasury's delegated authority. In particular, several comments noted that the concurrent application of the extraordinary disposition rules in the temporary regulations and the disqualified basis rule in the GILTI regulations could potentially result in double taxation. Treasury rejected these comments in the final regulations, arguing that it had sufficient authority under sections 245(g), 954(c)(6)(A), and 7805(a) to issue the regulations. However, as discussed in more detail below, in the proposed regulations, Treasury has proposed to address this double taxation concern by coordinating the extraordinary disposition rules with the disqualified basis rule.

Applicability dates and reliance

The temporary regulations were adopted as immediately effective on June 18, 2019 (the date the Treasury Decision was published in the Federal Register), and had stated applicability retroactive to the effective date of section 245A (distributions from SFCs made after December 31, 2017) because they were issued within 18 months of section 245A's enactment. Although the temporary regulations were removed as part of the issuance of the final regulations, the final regulations cross-reference to the temporary regulations (as contained in the Code of Federal Regulations prior to the issuance of the final regulations) as applicable to distributions made after December 31, 2017 and before the final regulations are applicable.

The final regulations apply to tax years ending on or after June 14, 2019, the date the 2019 proposed regulations were filed with the Federal Register. Distributions made after December 31, 2017, and before the final regulations apply, continue to be subject to the rules set forth in the temporary regulations. In situations where the temporary regulations and the final regulations could both apply, only the final regulations apply. A taxpayer may choose to apply the final regulations, instead of the temporary regulations, to distributions made during a tax year ending before June 14, 2019, provided the taxpayer and all related parties consistently apply the final regulations in their entirety.

KPMG observation

The procedural validity of the temporary regulations may continue to be a significant point of contention for taxpayers with CFCs that experienced extraordinary reductions, or engaged in extraordinary dispositions and made distributions of the associated E&P, in tax years ending before June 14, 2019.

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. The KPMG name and logo are registered trademarks or trademarks of KPMG International.

The proposed regulations are proposed to apply to tax years of foreign corporations beginning on or after the date the final regulations adopting the proposed regulations are published in the Federal Register (the "future final regulations"), and to tax years of U.S. persons in which or with which such tax years end. However, the proposed regulations propose to permit taxpayers to apply the future final regulations for tax years beginning before the date of the future final regulations, provided that the taxpayer and all related parties consistently apply the future final regulations to such tax years.

KPMG observation

In the context of describing the effective date of the proposed regulations, the preamble to the proposed regulations cites to section 7805(b)(7), which provides Treasury the authority to permit taxpayers to elect to apply a final regulation retroactively. This citation, in conjunction with the relevant language in the proposed regulations, is a clear signal that Treasury intends that taxpayers be permitted to apply the future final regulations retroactively to tax years beginning before the date of the future final regulations, including presumably tax years otherwise subject to the temporary regulations. However, the preamble does not explicitly permit taxpayers to rely on the proposed regulations.

The final regulations

Overview

The final regulations adopt the general framework of the temporary regulations, with a few noteworthy changes. The final regulations, like the temporary regulations, disallow a section 245A DRD with respect to a dividend received by a section 245A shareholder from an SFC to the extent of the "ineligible amount" of the dividend. The ineligible amount of a dividend is generally the amount of the dividend that is equal to the sum of (1) 50% of the extraordinary disposition amount and (2) 100% of the extraordinary reduction amount.

In general, the "extraordinary disposition amount" is the amount of a dividend received out of E&P generated by a fiscal-year SFC while it was a CFC by reason of a disposition of tested income-producing assets ("specified property") to a related party outside the ordinary course of the SFC's activities during the period between December 31, 2017, and the close of the SFC's tax year that begins before January 1, 2018, and ends after December 31, 2017 (such period, the "disqualified period," such disposition, an "extraordinary disposition," and such E&P, "extraordinary disposition E&P"). In Treasury's view, the partial disallowance of a section 245A DRD with respect to an extraordinary disposition amount is appropriate because Congress intended for section 245A to apply only with respect to "residual" E&P that remained after the application of the interrelated regimes of section 965, subpart F, and GILTI to CFC income. Under this view, E&P arising from "highly-structured" transactions by CFCs during the disqualified period, and thus not subject to any of these regimes, should not be afforded a full section 245A DRD.

In general, the "extraordinary reduction amount" of a dividend received by a section 245A shareholder is the portion of a dividend from a CFC arising in a year of an extraordinary reduction with respect to the CFC equal to the amount of the subpart F income and tested income that was not taken into account by the section 245A shareholder or another U.S. shareholder, because the CFC has no U.S. shareholder that owns (within the meaning of section 958(a)) stock in the CFC as of the last day of the tax year of the CFC when it is a CFC (generally, the final day of the CFC's tax year), or as a result of the application of section

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. The KPMG name and logo are registered trademarks or trademarks of KPMG International.

951(a)(2)(B). For instance, assume a section 245A shareholder sells all its stock in a CFC (FS) to a publicly traded foreign corporation with no US shareholder (FP) but that wholly owns a domestic corporation (USS). FS remains a CFC after the sale solely by reason of the fact that, after the repeal of section 958(b)(4) under the "Tax Cuts and Jobs Act," FP's ownership of FS is attributed to USS. Absent the first-tier extraordinary reduction rules, any dividend the section 245A shareholder receives from FS (either through an actual pre-sale distribution or a deemed dividend by reason of section 1248(j)) would be eligible for a full section 245A DRD even though such dividend is sourced out of E&P generated during the year arising from income that would have been included by such shareholder, in the absence of such disposition, under either the GILTI or subpart F regime. Furthermore, after the sale, there is no U.S. shareholder of FS to take into account its pro rata share of FS's subpart F income or tested income at the end of FS's tax year (i.e., the last day in FS's tax year in which it is a CFC).

Alternatively, if the section 245A shareholder sells all of its stock in FS to another U.S. shareholder (USP), USP would be required to take into account its pro rata share of FS's subpart F income and tested income as of the close of FS's tax year, but such pro rata share would be reduced for any dividend received by the section 245A shareholder under section 951(a)(2)(B), which dividend would, but for the first-tier extraordinary reduction rule, be eligible for a full section 245A DRD. In either scenario, but for the application of the first-tier extraordinary reduction rules, the subpart F income or tested income of FS generated during the tax year of disposition, including any income generated by reason of a related-party transaction (e.g., a "busted" section 351 exchange) undertaken in anticipation of the disposition for the purpose of generating E&P or stepping-up the basis in the assets of FS, would escape taxation under the GILTI and subpart F regimes.

In addition to the rules limiting the application of the section 245A DRD, the final regulations, like the temporary regulations, include the tiered extraordinary disposition rules and tiered extraordinary reduction rules (together, the "tiered distribution rules"), which limit the applicability of section 954(c)(6) in an amount equal to the sum of (1) 50% of the tiered extraordinary disposition amount and (2) 100% of the tiered extraordinary reduction amount. In general, a "tiered extraordinary disposition amount" and a "tiered extraordinary reduction amount" with respect to a dividend received by a CFC is the amount that would be an extraordinary disposition amount or an extraordinary reduction amount, respectively, if such dividend were instead received by a section 245A shareholder of the CFC. According to the preamble to the temporary regulations, the approach of the tiered distribution rules "prevents deferral of tax with respect to the applicable subpart F income or tested income and minimizes the administrative and compliance burdens that would be created by continuing to track the relevant earnings at the upper-tier CFC."

The following sections discuss these two scenarios in more detail. The final regulations also impose reporting requirements on taxpayers that have engaged in such transactions.

Extraordinary disposition rules

Extraordinary dispositions

The extraordinary disposition rules apply to dividends from an SFC only if the SFC (or a predecessor) engaged in an extraordinary disposition, and an extraordinary disposition occurred only if an SFC sold specified property outside of the ordinary course of its activities to a related party during the disqualified period. In general, the determination as to whether a disposition is undertaken outside of the ordinary course of an SFC's activities is made under a "facts and circumstances" test. However, the temporary regulations provided that an SFC's sale of intangible property described in section 367(d)(4) to a related party during the disqualified period was per se outside of the ordinary course of the SFC's activities and thus was an extraordinary disposition (the "IP per se rule").

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. The KPMG name and logo are registered trademarks or trademarks of KPMG International.

Treasury received several comments requesting exceptions to narrow the scope of the transactions covered by the extraordinary disposition rules, including the application of the IP per se rule. Although most of these comments were rejected, Treasury added one limited exception to the IP per se rule for intangible property that was transferred to a related party during the disqualified period with a reasonable expectation that such property would be sold to an unrelated customer within one year of the transfer. However, transfers of intangible property described in section 367(d)(4)(C) or (F), such as trademarks and goodwill, are not eligible for this exception. Additionally, transfers of copyright rights within the meaning of Reg. § 1.861-18 or intangible property described in section 367(d)(4)(A) (a patent, invention, formula, process, design, pattern, or know-how) that qualify for the exception to the IP per se rule are still subject to a presumption that they occur outside the ordinary course of the SFC's activities.

KPMG observation

Under the "catch-all" definition of section 367(d)(4)(G), intangible property includes any "item the value or potential value of which is not attributable to tangible property or the services of any individual." Therefore, under the IP per se rule in the temporary regulations, a transfer to a related party during the disqualified period of a copyrighted article in a digital medium, such as a digital download of software, music, video, etc., could have been a per se extraordinary disposition, while a transfer to a related party of the same copyrighted article in a physical medium would not have constituted an extraordinary disposition if such transfer occurred in the ordinary course of the SFC's activities. The final regulations generally eliminate this disparity.

Extraordinary disposition accounts

The final regulations, like the temporary regulations, provide that the amount of an SFC's dividend that is not eligible for a full section 245A DRD is the amount that is paid out of the section 245A shareholder's "extraordinary disposition account" with respect to the SFC. For an SFC that engaged in an extraordinary disposition while a CFC during the disqualified period, a section 245A shareholder's balance in its extraordinary disposition account with respect to the SFC for any tax year is generally equal to (1) the product of the percentage of stock (by value) of the SFC that the section 245A shareholder owned directly or indirectly at the beginning of the disqualified period or, if later, on the first day during the disqualified period on which the SFC was a CFC (the "extraordinary disposition ownership percentage"), multiplied by the SFC's extraordinary disposition E&P, (2) reduced by prior dividends paid out of the extraordinary disposition account (cumulatively, the "prior extraordinary disposition amount").

Dividends are treated as paid out of the section 245A shareholder's non-extraordinary disposition E&P with respect to the SFC before being treated as paid out of the section 245A shareholder's extraordinary disposition account. For this purpose, non-extraordinary disposition E&P are generally the section 245A shareholder's share of the section 959(c)(3) E&P (i.e., non-taxed E&P) with respect to the SFC in excess of the amount of the section 245A shareholder's extraordinary disposition account with respect to the SFC.

KPMG observation

In order to ameliorate the "lock-out" effect of the extraordinary disposition rules, the final regulations, like the temporary regulations, provide a taxpayer-favorable stacking rule, whereby each dividend from an SFC is sourced out of non-extraordinary disposition E&P before extraordinary

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. The KPMG name and logo are registered trademarks or trademarks of KPMG International.

disposition E&P. The consequence of this rule is that an SFC can generally distribute all of its post-disqualified period E&P (as well as any "ordinary course" E&P earned in the disqualified period) without implicating the extraordinary disposition rules.

As discussed below, Treasury responded to a number of comments and made several changes in the final regulations related to extraordinary disposition accounts.

Measurement of non-extraordinary disposition E&P

The temporary regulations provided that the amount of a section 245A shareholder's non-extraordinary disposition E&P with respect to an SFC was determined based on the percentage of stock owned directly or indirectly by the section 245A shareholder "immediately after the distribution." In response to comments, the final regulations provide that non-extraordinary disposition E&P is determined based on the percentage of stock of the CFC that the section 245A shareholder owns, directly or indirectly, in the SFC immediately before the distribution.

KPMG observation

Under the temporary regulations, if, for example, a section 245A shareholder sold all of its stock in an SFC and the gain was treated as a dividend under section 1248(j), no portion of the resulting dividend would be treated as paid out of the section 245A shareholder's non-extraordinary disposition E&P. This would be the result because the selling section 245A shareholder's non-extraordinary disposition E&P would be determined immediately after the sale, at which time the shareholder owned no stock in the SFC. The final regulations change this result by providing that the section 245A shareholder's non-extraordinary disposition E&P is determined based on its pre-sale ownership.

Coordination with section 956 inclusions

As discussed above, a section 245A shareholder reduces the balance of its extraordinary disposition account with respect to an SFC by the prior extraordinary disposition amount. A comment noted that the definition of a prior extraordinary disposition amount in the temporary regulations did not appropriately take into account section 956, with the result that, in effect, the section 245A DRD could be denied for amounts attributable to the same extraordinary disposition E&P more than once. Under the final regulations issued under section 956, the amount of a U.S. shareholder's section 956 inclusion with respect to a CFC is reduced to the extent that a tentative amount under section 956 would have qualified for the section 245A DRD if such tentative amount were instead distributed as a dividend. If the U.S. shareholder has an extraordinary disposition account with respect to the stock of the CFC from which it is treated as receiving such tentative amount under section 956, the amount of the U.S. shareholder's section 956 inclusion would not be reduced under the final section 956 regulations. Nevertheless, the definition of prior extraordinary disposition amount in the temporary regulations failed to make any adjustment for this section 956 inclusion, with the result that such inclusion, though attributable to the extraordinary disposition account, would not reduce the extraordinary disposition account. In response to the comment, the final regulations modify the definition of a prior extraordinary disposition amount to account for inclusions under section 956 that arise from applying the extraordinary disposition rules to the hypothetical distribution construct set forth in the final section 956 regulations.

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. The KPMG name and logo are registered trademarks or trademarks of KPMG International.

Effect of losses

A comment requested that a section 245A shareholder's extraordinary disposition account with respect to an SFC be reduced by losses incurred by the SFC in tax years following the creation of the account. Treasury rejected this recommendation on the grounds that extraordinary disposition E&P offset by losses still provide a tax benefit to a section 245A shareholder in the form of reducing the amount of future basis recovery under section 301(c)(2) or capital gain under section 301(c)(3). Accordingly, the final regulations continue to preserve an extraordinary disposition account until recapture.

KPMG observation

Losses cannot reduce or eliminate an extraordinary disposition account, but they can reduce or eliminate non-extraordinary disposition E&P. As a result, current year losses of an SFC with respect to which a section 245A shareholder has an extraordinary disposition account will generally increase the possibility that a dividend from the SFC to such section 245A shareholder will be treated as paid out of the shareholder's extraordinary disposition account.

In the context of the discussion on the effect of losses, the preamble notes that Treasury is "studying the extent to which nimble dividends should qualify for the section 245A deduction generally." A "nimble dividend" is a dividend out of current year E&P of a distributing corporation under section 316(a)(2), where such corporation, even taking account its current year E&P, has an accumulated E&P deficit. The concern obliquely referred to in the preamble is that the section 245A ratio with respect to a nimble dividend paid by an SFC is either negative or undefined, because the denominator of the ratio (the total undistributed earnings of the SFC) is negative, and therefore arguably a nimble dividend is not a section 245A-eligible dividend, even if all the E&P out of which the dividend is paid is "foreign." This language in the preamble represents the first formal public acknowledgement that a nimble dividend may not be a section 245A-eligible dividend under the statute, but also indicates that Treasury is considering rules that would permit a section 245A DRD. One approach, which would be consistent with the House version of section 245A, would be to calculate the section 245A ratio with respect to a nimble dividend paid by an SFC solely by reference to the SFC's current year E&P.

Successor rules

The temporary regulations included successor rules that required that the extraordinary disposition account of a section 245A shareholder with respect to an SFC carry over to a section 245A shareholder transferee that directly or indirectly received stock in the SFC in certain taxable sales and nonrecognition exchanges. The final regulations expand upon these successor in several important ways.

First, the final regulations include additional rules on the attribution of extraordinary disposition accounts in the case of standalone section 355 distributions and triangular reorganizations. The successor rule in the temporary regulations applicable to section 355 distributions only covered section 355 distributions that are pursuant to a reorganization described in section 368(a)(1)(D) (a "D/355 distribution"). Under this successor rule, the section 245A shareholder's extraordinary disposition account with respect to the distributing SFC is attributed to the controlled SFC in a manner similar to the allocation of the distributing corporation's E&P to the controlled corporation under Reg. § 1.312-10(a). In a D/355 distribution, the distributing corporation's E&P are generally allocated between the distributing corporation and the controlled corporation based on their respective fair market values. The final regulations expand the successor rule to also cover "any section 355 distribution in which E&P of the distributing SFC are decreased and the E&P of the controlled SFC are increased by reason of §1.312-10."

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. The KPMG name and logo are registered trademarks or trademarks of KPMG International.

KPMG observation

In a section 355 distribution that is not pursuant to a reorganization under section 368(a)(1)(D)(a "standalone 355 distribution"), under Reg. § 1.312-10(b), the distributing corporation's E&P are reduced to the same extent as in a D/355 distribution, but the controlled corporation's E&P are increased only to the extent the amount of such E&P prior to the standalone 355 distribution is less than the amount of the decrease with respect to the distributing corporation's E&P as a result of the standalone 355 distribution. Therefore, even if a distributing SFC's E&P, including its extraordinary disposition E&P, are reduced in a standalone 355 distribution, a section 245A shareholder's extraordinary disposition account with respect to the distributing SFC will not be attributed to the controlled SFC (and will remain an extraordinary disposition account with respect to the distributing SFC) if the controlled SFC's E&P are not increased under Reg. § 1.312-10(b). As a result, similar to the effect of current year losses discussed above, a standalone 355 distribution may increase the possibility that any future distributions by a distributing SFC could be treated as paid out of a section 245A shareholder's extraordinary disposition account.

In addition, the final regulations revised the rules relating to the treatment of an extraordinary disposition account when the stock of the SFC is transferred and no section 245A shareholder owns the SFC stock following the transfer. The temporary regulations provided that a section 245A shareholder's extraordinary disposition account with respect to the stock of a lower-tier SFC moved to an upper-tier SFC upon the upper-tier SFC's sale of the stock of the lower-tier SFC. The final regulations amended this rule by eliminating the section 245A shareholder's extraordinary disposition account with respect to the stock of an SFC if all of the stock of an SFC is transferred (directly or indirectly) and following the transfer there is no section 245A shareholder with respect to the stock of the SFC (the "EDA elimination rule"). If the section 245A shareholder transfers all of the stock of the SFC and after the transfer a related party is a section 245A shareholder of the SFC, the EDA elimination rule does not apply, and instead the related party will succeed to the transferor section 245A shareholder's extraordinary disposition account. In addition, the final regulations add a rule that, for purposes of applying the general anti-abuse rule in Reg. § 1.245A-5(h) (the "general anti-abuse rule"), a transfer of stock of an SFC otherwise subject to the EDA elimination rule is deemed to have been undertaken with a "principal purpose," if stock of the SFC is transferred to a section 245A shareholder within one year after the transaction.

Finally, the final regulations provide a rule that treats domestic corporations that are related under sections 267(b) or 707(b) as a single domestic corporation for purposes of determining the extent to which a dividend is an extraordinary disposition amount or a tiered extraordinary disposition amount. The preamble provides an example to explain the purpose and application of this rule. In the example, US1 wholly owns CFC1 and has an extraordinary disposition account of $100 with respect to its CFC1 stock. US2, which is related to US1 under section 267(b), transfers property to CFC1 in exchange for 99% of the stock of CFC1. Following the transfer, CFC1 pays a dividend of $100 pro rata to US1 and US2. Absent the application of the general anti-abuse rule, the temporary regulations did not have a mechanism to prevent the $99 dividend from CFC1 to US2 from qualifying as a section 245A-eligible dividend. The final regulations prevent this result by treating US1 and US2 as a single corporation with respect to US1's $100 extraordinary disposition account.

Extraordinary reduction rules

The extraordinary reduction amount, with respect to a dividend paid by a CFC to a section 245A shareholder that owns directly or indirectly more than 50% (by vote or value) of the stock of the CFC in a tax year in which an extraordinary reduction occurs (the "controlling section 245A shareholder"), is equal

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. The KPMG name and logo are registered trademarks or trademarks of KPMG International.

to the lesser of (1) the amount of the dividend, or (2) the pro rata share of subpart F income and tested income the controlling section 245A shareholder would have otherwise included in its gross income if there had been no extraordinary reduction and determined without the application of section 951(a)(2)(B) (the "pre-reduction pro rata share").

Because a dividend that is not a section 245A-eligible dividend is subject to U.S. tax at a rate of 21% versus the potentially lower effective U.S. tax rate for GILTI of as low as 10.5%, U.S. shareholders may instead desire to close the tax year of the CFC involved in the extraordinary reduction and include its pro rata share of the CFC's tested income in its gross income. The final regulations, like the temporary regulations, permit the U.S. shareholder to make an election to close the books of the CFC in connection with an extraordinary reduction (the "closing of the books election").

KPMG observation

The final regulations retained the rule in the temporary regulations that, prior to making a closing of the books election with respect to a CFC, the controlling section 245A shareholder must enter into a written, binding agreement with each U.S. tax resident that, on the end of the date that the extraordinary reduction occurs, directly or indirectly owns shares in the CFC and is a U.S. shareholder of the CFC to elect to close the CFC's tax year. In practice, this requirement has been one of the more significant obstacles to making the election. Nonetheless, Treasury declined to include rules in the final regulations permitting the closing of the books election to be made without a binding agreement from the parties on grounds that "closing the taxable year of a CFC affects the tax consequences of both the transferors and transferees in an extraordinary reduction, and inconsistent treatment could give rise to inappropriate results (for example, both a transferor and transferee could claim to have income inclusions under section 951(a) or 951A(a) and claim deemed-paid foreign credits under section 960(a) or (d), with respect to the same income of the CFC)." The implication here is that Treasury does not believe that it has the authority to permit an election by one taxpayer (the transferor) to be binding upon another taxpayer (the transferee) absent consent by the latter.

Although Treasury in most instances rejected taxpayer comments regarding the extraordinary reduction rules, there were several clarifications regarding the procedural aspects of making the closing of the books election. In particular, the preamble to the final regulations confirms that a controlling section 245A shareholder must have an extraordinary reduction amount greater than zero in order to make the closing of the books election.

KPMG observation

The preamble confirms that the closing of the books election is not available when the CFC generates a tested loss in its tax year that includes the extraordinary reduction. Thus, a controlling section 245A shareholder that disposes of the stock of a tested loss CFC in an extraordinary reduction cannot elect to close the tested loss CFC's books in order to avail itself of the tested loss for purposes of determining its GILTI for its tax year. This could be particularly detrimental to a controlling section 245A shareholder that sells multiple CFCs (including tiers of CFCs), some of which are tested income CFCs and others are tested loss CFCs. In such a case, the closing of the books election can be made with respect to the tested income CFCs, but not the tested loss CFCs, resulting in an amount of GILTI to the section 245A shareholder in excess of the amount that would have been calculated if no sale had taken place.

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. The KPMG name and logo are registered trademarks or trademarks of KPMG International.

Because an extraordinary disposition amount with respect to a CFC is limited by the amount of dividends received from the CFC by the controlling section 245A shareholder in the shareholder's tax year that includes the extraordinary reduction, the controlling section 245A shareholder may not make a closing of the books election with respect to the CFC if it did not receive and was not deemed to receive a dividend from the CFC during such tax year (for example, if the extraordinary reduction occurs pursuant to a "dilutive" transaction, such as a third-party investment in the CFC).

Treasury recently released final regulations that permit a U.S. shareholder to exclude from gross tested income a CFC's income that is subject to a foreign effective tax rate of greater than 90% of the highest U.S. corporate tax rate (that is 18.9% with the current 21% corporate tax rate) (the "GILTI high-tax exclusion"). The final regulations include no specific coordination rule with the GILTI high-tax exclusion. In particular, there is a potential circularity problem, if, for instance, a controlling section 245A shareholder makes a closing of the books election for a CFC with respect to which it experiences an extraordinary reduction and then also makes a GILTI high-tax election with respect to such CFC for the resulting stub year. As a result of the GILTI high-tax election, the CFC would have no tested income and thus, arguably, the controlling section 245A shareholder would have no extraordinary reduction amount with respect to the CFC, thus potentially invalidating the closing of the books election. However, if the closing of the books election were invalid, the GILTI high-tax election would also be invalid, because the controlling section 245A shareholder would no longer be the controlling domestic shareholder (as of the close of the CFC's tax year) authorized to make the GILTI high-tax election, in which the controlling section 245A shareholder would have an extraordinary reduction amount with respect to the CFC. While the final regulations do not address this circularity, for purposes of making a closing of the books election, a reasonable approach would be to determine a shareholder's extraordinary reduction amount with respect to a CFC without regard to the closing of the books election and the GILTI high-tax election.

Under the temporary regulations, a controlling section 245A shareholder that desired to make the closing of the books election was required to consistently make the election with respect to all extraordinary reductions that occurred with respect to its CFCs during the controlling section 245A shareholder's tax year. It was unclear, however, whether this rule required a controlling section 245A shareholder to make this election with respect to all its CFCs involved in extraordinary reductions, including those without an extraordinary reduction amounts, or only those CFCs with extraordinary reduction amounts. The final regulations clarify that the consistency requirement only requires the controlling section 245A shareholder to make the closing of the books election with respect its CFCs with an extraordinary reduction amount.

Non-application to same-country exception

The tiered distribution rules prevent section 954(c)(6) from applying to a dividend paid out of a section 245A shareholder's extraordinary disposition account or to dividends received from a CFC with respect to which a section 245A shareholder experiences an extraordinary reduction. However, nothing in the temporary regulations or final regulations prevents a tiered extraordinary disposition amount or a tiered extraordinary reduction amount of a CFC-to-CFC dividend from qualifying for the same-country exception under section 954(c)(3). Indeed, the preamble to the final regulations confirms that the tiered distribution rules do not apply to deny qualification under section 954(c)(3), noting that "similar benefits may be obtained in the case of same-country dividends under section 954(c)(3)" as under section 954(c)(6), but that such transactions are "relatively infrequent." Nonetheless, the preamble warns that transactions structured to use section 954(c)(3) to avoid the purposes of the final regulations are subject to adjustments under the general anti-abuse rule.

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. The KPMG name and logo are registered trademarks or trademarks of KPMG International.

KPMG observation

In the preamble to the final regulations, Treasury references an example 10 that is intended to illustrate the application of the general anti-abuse rule to a transaction that is structured to improperly qualify under section 954(c)(3). However, the final regulations do not contain this example 10. It is unclear if the example was mistakenly omitted or whether the example was intentionally removed but Treasury failed to update the preamble discussion. Even without the example, it is clear that Treasury believes that an "appropriate adjustment" in the case of a transaction entered into with a "principal purpose" of avoiding the purposes of the tiered distribution rules by qualifying for section 954(c)(3) would be to disregard such qualification.

Reporting requirements

The final regulations also impose certain reporting requirements on taxpayers, generally through a disclosure statement that must be attached to the Form 5471 for CFCs with respect to which a section 245A shareholder has an extraordinary disposition account. In particular, these new disclosure rules apply to a section 245A shareholder to the extent any of the following requirements are met: (1) the section 245A shareholder receives a dividend that gives rise to an ineligible amount or owns a CFC that has a tiered extraordinary disposition amount or tiered extraordinary reduction amount; (2) the section 245A shareholder has an extraordinary disposition account; or (3) the section 245A shareholder is relying on the exception from the per se rule for intangible property transferred in what would otherwise be an extraordinary disposition or tiered extraordinary disposition.

The proposed regulations

Overlap between sections 951A and 245A

The disqualified basis rule allocates and apportions deductions and losses attributable to basis created by extraordinary dispositions ("disqualified basis") to "residual CFC gross income," which is income other than gross tested income, subpart F income, or ECI, and provides that amortization, depreciation, and cost recovery allowances attributable to disqualified basis are not properly allocable to inventory or self-constructed property for purposes of calculating tested income and tested loss. The disqualified basis rule, therefore, prevents taking into account deductions and losses attributable to disqualified basis in calculating a CFC's tested income or tested loss. The disqualified basis rule generally applies with respect to the same transactions subject to the extraordinary disposition rules, except that instead of disallowing the section 245A DRD and the application of section 954(c)(6) to CFC dividends, the disqualified basis rule disallows the GILTI benefit related to basis created by extraordinary dispositions.

The disqualified basis rule and the extraordinary disposition rules can, when applied concurrently, result in excess taxation. As Treasury acknowledges in the preamble to the proposed regulations, if one SFC while a CFC (the "transferor SFC") recognizes gain on the sale of an item of specified property to a related SFC (the "transferee CFC") in an extraordinary disposition, a single amount of gain gives rise to both extraordinary disposition E&P of the transferor SFC (and a corresponding extraordinary disposition account with respect to the transferor SFC) and disqualified basis in the item of specified property held by the transferee CFC. If the transferor SFC and the transferee CFC are wholly owned by a single section 245A shareholder, that section 245A shareholder effectively could be taxed twice with respect to this single item of gain—directly under the extraordinary disposition rules on a dividend paid by the transferor SFC out of the section 245A shareholder's extraordinary disposition account, and then again indirectly

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. The KPMG name and logo are registered trademarks or trademarks of KPMG International.

under the disqualified basis rule "as a result of not being offset or reduced by deductions or losses of the transferee CFC attributable to the disqualified bases (because, but for the disqualified basis rule, such deductions or losses would have offset or reduced the amount and sheltered it from U.S. tax)." Additionally, the disqualified basis, though not taken into account for purposes of computing a section 245A shareholder's GILTI, may nonetheless have the effect of reducing the transferee CFC's E&P eligible for the section 245A DRD, "because, in general, deductions or losses that are subject to the disqualified basis rule nevertheless reduce E&P." The reduction in E&P eligible for the section 245A DRD increases the likelihood that a distribution from the transferee CFC will result in basis recovery to the section 245A shareholder under section 301(c)(2) or capital gain under section 301(c)(3).

KPMG observation

The allocation of amortization, depreciation, or other cost-recovery allowances to residual CFC gross income reduces the transferee CFC's total E&P, which could adversely affect the transferee CFC's ability to repatriate its section 959(c)(1) and (c)(2) previously taxed E&P ("PTEP") to the section 245A shareholder. For example, if the allocation of amortization deductions to residual CFC gross income results in a deficit in the transferee CFC's section 959(c)(3) non-taxed E&P, the transferee CFC will not be able to distribute all of its PTEP to the section 245A shareholder, because the transferee CFC cannot distribute an amount of PTEP in a tax year in excess of its available E&P under section 316—i.e., the transferee CFC will have "trapped" PTEP.[1]

Proposed coordination rules

The proposed regulations include two coordination rules that would synchronize the disqualified basis rule and the extraordinary disposition rules to mitigate the potential for excess taxation in certain circumstances. One coordination rule would reduce a CFC's disqualified basis with respect to an item of specified property to the extent the gain related to the basis is subject to U.S. tax by reason of the extraordinary disposition rules—i.e., when a dividend is paid out of the section 245A shareholder's extraordinary disposition account (the "DQB reduction rule"). The other coordination rule would reduce a section 245A shareholder's extraordinary disposition account with respect to an SFC to the extent the disqualified basis attributable to the gain related to the account gives rise to deductions or losses that are allocated and apportioned to residual CFC gross income and reduce the CFC's section 959(c)(3) E&P—i.e., to the extent the depreciation, amortization, or other cost-recovery allowances attributable to disqualified basis reduce the CFC's capacity to pay section 245A-eligible dividends (the "EDA reduction rule").

Coordination rule methods

Similar to the approach in Reg. §§ 1.1248-2 and -3 for determining E&P attributable to stock, the proposed regulations would apply the two coordination rules to a section 245A shareholder's tax year using one of two methods: one method for "simple" cases (the "simple method"), and the other method for "complex" cases (the "complex method"). Although the simple method and the complex method have different mechanics, both methods are intended to reach the same result. A section 245A shareholder can only use the simple method for a tax year if certain conditions are satisfied; otherwise it must use the complex method for such tax year and all subsequent tax years. A section 245A shareholder that satisfies the conditions to apply the simple method for a tax year may nonetheless elect to use the complex method for such tax year; in this case, the section 245A shareholder can apply the simple method in a subsequent tax year, if eligible. The determination of whether the conditions to apply

[1] *See* Notice 2019-01, 2019-02 I.R.B. 275.

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. The KPMG name and logo are registered trademarks or trademarks of KPMG International.

the simple method are satisfied is made separately with respect to each extraordinary disposition account of a section 245A shareholder with respect to an SFC and disqualified basis of all items of specified property that correspond to such extraordinary disposition account (such property, "corresponding specified property").

For a tax year, a section 245A shareholder may apply the simple method to an extraordinary disposition account for an SFC and the disqualified bases of the items of corresponding specified property if two conditions are satisfied. The first condition addresses the ownership of the transferor SFC in the extraordinary disposition (the "SFC ownership condition"). The second condition addresses the ownership of the items of corresponding specified property and the transferee CFCs holding such items (the "specified property ownership condition").

A section 245A shareholder satisfies the SFC ownership condition for a tax year if:

- The section 245A shareholder owned (within the meaning of section 958(a)) all the stock in the transferor SFC (by vote and value) on January 1, 2018, and on each day during the tax year; and

- At no time during the tax year did the transferor SFC either participate in a section 355 transaction as the distributing corporation or controlled corporation, or acquire the assets of another corporation with an extraordinary disposition account in a section 381 transaction—i.e., an acquisitive asset reorganization or section 332 liquidation.

A section 245A shareholder satisfies the specified property ownership condition for a tax year if:

- All the items of corresponding specified property with disqualified basis were held by transferee CFCs immediately after the extraordinary disposition; and

- For each transferee CFC holding items of corresponding specified property with disqualified basis:

    - All the stock in the transferee CFC (by vote and value) was owned (within the meaning of section 958(a)) by the section 245A shareholder or domestic corporations that have a section 267(b) or section 707(b) relationship to the section 245A shareholder ("domestic affiliates") immediately after the extraordinary disposition;

    - For each tax year of the transferee CFC that ends with or within the section 245A shareholder's tax year, there is not an extraordinary disposition account with respect to the transferee CFC, and the sum of the balance of the hybrid deduction accounts for the transferee CFC's stock at the end of its tax year is zero;

    - On each day of each tax year of the transferee CFC that either begins or ends within the section 245A shareholder's tax year:

        - The transferee CFC holds the items of corresponding specified property with disqualified basis;

        - The section 245A shareholder or its domestic affiliates own (within the meaning of section 958(a)) all the stock (by vote and value) in the transferee CFC;

        - The transferee CFC does not hold any item of specified property with disqualified basis that corresponds to another extraordinary disposition account;

        - The transferee CFC does not own (directly or indirectly) an interest in a partnership, trust,

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. The KPMG name and logo are registered trademarks or trademarks of KPMG International.

or estate that holds an item of specified property with disqualified basis; and

- The transferee CFC does not have ECI or an E&P deficit described in Reg. § 1.381(c)(2)-1(a)(5) (a "hovering deficit").

For purposes of determining whether the conditions to apply the simple method are satisfied, a reference to a section 245A shareholder, SFC, or CFC does not include a successor of such section 245A shareholder, SFC, or CFC. Therefore, the simple method does not apply if the section 245A shareholder's extraordinary disposition account for an SFC has been adjusted pursuant to the successor rules in Reg. § 1.245A-5(c)(4) (the "successor rule").

KPMG observation

The preamble suggests that the simple method and the complex method make the DBQ reduction rule and EDA reduction rule less burdensome and facilitate compliance. However, in practice, some taxpayers may find it difficult from the outset to determine whether the conditions to apply the simple method are satisfied, whereas other taxpayers may always choose to apply the complex method. Additionally, a U.S. multinational that engages in frequent restructurings with respect to its foreign assets will often fail to satisfy the strict conditions for applying the simple method and thus will be required to apply the complex method. Indeed, the conditions to apply the simple method will only be satisfied in situations where, *inter alia*, (i) the transferor SFC was, at the time of the extraordinary disposition and at all times thereafter, wholly owned by the section 245A shareholder, (ii) the transferor SFC has not been a party to a section 355 distribution, an acquisitive asset reorganization, or tax-free liquidation, (iii) the transferee CFC was, at the time of the extraordinary disposition and at all times thereafter, wholly owned by the same section 245A shareholder and its domestic affiliates, and (iv) the transferee CFC has held the items of corresponding specified property with disqualified basis at all times after the extraordinary disposition.

The conditions for applying the simple method will not be satisfied if either a section 245A shareholder transfers ownership of the transferor SFC to a related U.S. person, even a member of the same U.S. consolidated group, or the transferee CFC transfers an item of specified property to related party (e.g., a wholly owned subsidiary CFC). However, transfers of the ownership of the transferee SFC among the section 245A shareholder and its domestic affiliates will not cause a section 245A shareholder to fail to satisfy the conditions for applying the simple method.

If, for a tax year, the conditions to apply the simple method are not satisfied with respect to an extraordinary disposition account and the corresponding specified property, the section 245A shareholder must apply the complex method for that tax year and all future tax years. This is the case even if the conditions to use the simple method are satisfied in a later tax year, for example, by curing the circumstances that originally caused the section 245A shareholder to fail to satisfy a condition to use the simple method. For instance, if a hovering deficit of the transferee CFC prevented the use of the simple method, the transferee CFC earning out the hovering deficit will not permit the section 245A shareholder to use the simple method. Similarly, if the transferee CFC transferred an item of corresponding specified property to a related person, an "unwinding" of the transfer in a subsequent year—i.e., a transfer of the item back to the transferee CFC—will not cause the section 245A shareholder to qualify for the simple method.

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. The KPMG name and logo are registered trademarks or trademarks of KPMG International.

Corresponding specified property

For purposes of the simple method, an item of specified property "corresponds" to a section 245A shareholder's extraordinary disposition account if gain was recognized on the extraordinary disposition of the item and taken into account in determining the account's initial balance. The specified property ownership condition's first requirement effectively limits the application of the simple method to situations where a transferee CFC has owned an item of specified property at all times after an extraordinary disposition. Thus, the complex method applies to situations where a transferee CFC transfers an item of specified property to another person after an extraordinary disposition.

To address the treatment of subsequent transfers of specified property in nonrecognition transactions, the complex method provides that items of substituted basis property and exchanged basis property with respect to an item of corresponding specified property are also corresponding specified property. The complex method also includes a rule intended to prevent items of exchanged basis property from duplicating the amount of disqualified basis with respect to an extraordinary disposition account.

DQB reduction rule

Simple method

The simple method application of the DQB reduction rule provides that if, for a section 245A shareholder's tax year, an extraordinary disposition account of the section 245A shareholder gives rise to one or more extraordinary disposition amounts or tiered extraordinary disposition amounts (collectively, "extraordinary disposition amounts"), then the disqualified bases of items of corresponding specified property are, solely for purposes of the disqualified basis rule, reduced (but not below zero) by the sum of such extraordinary disposition amounts. If a single extraordinary disposition account has multiple items of corresponding specified property, then the reduction amount is allocated pro rata to the disqualified basis of each item of corresponding specified property based on the amount of its disqualified basis as compared to the aggregate amount of disqualified bases of all items of corresponding specified property, generally determined using the disqualified basis of each item of corresponding specified property as of the beginning of the CFC's tax year and without regard to current year basis reductions under the DQB reduction rule.

The preamble to the proposed regulations states that the DQB reduction rule is intended to ensure that when the extraordinary disposition rules effectively cause gain attributable to extraordinary disposition E&P to be subject to U.S. tax (i.e., as dividend income or subpart F income for which the section 245A shareholder is only entitled to a 50% deduction), the disqualified basis rule does not apply to the bases of items of corresponding specified property attributable to such gain, because that basis is no longer generated at no U.S. tax cost. As a result, to the extent the DQB reduction rule applies, items of deduction or loss attributable to the former disqualified bases of the items of corresponding specified property become eligible to reduce a transferee CFC's tested income or increasing a transferee CFC's tested loss for purposes of computing a section 245A shareholder's GILTI.

The reduction amount under the simple method application of the DQB reduction rule is determined using the disqualified bases of items of corresponding specified property, as of the beginning of the transferee CFC's tax year that includes the date on which the section 245A shareholder's tax year ends. Once the reduction amount for the section 245A shareholder's tax year is determined under the DQB reduction rule, the disqualified bases of a transferee CFC's items of corresponding specified property are reduced as of the beginning of the transferee CFC's tax year (to avoid circularity, these reductions are not considered in determining the reduction amount under the DQB reduction rule in the first instance). Thus, the disqualified bases of the transferee CFC's items of corresponding specified property are reduced *before* the transferee CFC allocates and apportions its depreciation, amortization, and other cost

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. The KPMG name and logo are registered trademarks or trademarks of KPMG International.

recovery allowances in computing its tested income or tested loss for the year.

Complex method

The complex method application of the DQB reduction rule uses the same architecture as the simple method application, but provides additional rules to address situations where a transferee CFC transfers items of corresponding specified property after an extraordinary disposition (the "DQB ownership requirement"), and situations where disqualified bases of items of corresponding specified property give rise to U.S. tax benefits (the "basis benefit rule"). Specifically, the complex method application of the DQB reduction rule provides that if, for a section 245A shareholder's tax year, an extraordinary disposition account of the section 245A shareholder gives rise to one or more extraordinary disposition amounts *and* the DQB ownership requirement is satisfied, then the disqualified bases of items of corresponding specified property are, solely for purposes of the disqualified basis rule, reduced (but not below zero) by the sum of such extraordinary disposition amounts *minus* the balance of the basis benefit account (defined below) with respect to the extraordinary disposition account. Like the simple method application of the DQB reduction rule, the complex method application provides that if a single extraordinary disposition account has multiple items of corresponding specified property, then the reduction amount is allocated pro rata to the disqualified basis of each item of corresponding specified property based on the amount of its disqualified basis as compared to the aggregate amount of disqualified bases of all items of corresponding specified property, generally determined using the disqualified basis of each item of corresponding specified property as of the beginning of the CFC's tax year and without regard to current year basis reductions under the DQB reduction rule. The complex method application of the DQB reduction rule also includes rules that prevent "duplicated" disqualified basis—i.e., disqualified basis of an item of corresponding specified property reflected in exchanged basis property—from being taken into account in applying the DQB reduction rule.

DQB ownership requirement

The DQB ownership requirement addresses situations where a transferee CFC transfers items of corresponding specified property to an unrelated party after an extraordinary disposition. Specifically, the DQB ownership requirement provides that the DQB reduction rule only applies to reduce the disqualified basis of an item of corresponding specified property if, on one or more days during the section 245A shareholder's tax year, the item is held by—

- The section 245A shareholder;
- Any person that, on at least one day within the section 245A shareholder's tax year, has a section 267(b) or section 707(b) relationship to the section 245A shareholder (a "qualified related party"); or
- Any partnership, trust (other than a trust treated as a corporation for U.S. tax purposes), or estate (in each case, domestic or foreign), or any foreign corporation (each, a "specified entity") at least 10% of which, on at least one day within the section 245A shareholder's tax year, is owned directly or indirectly through another specified entity by the section 245A shareholder or a qualified related party.

The preamble to the proposed regulations explains that the DQB ownership requirement is intended to ensure that the DQB reduction rule only applies to situations where it is likely that the section 245A shareholder or a related party would be "meaningfully affected" by the concurrent application of the disqualified basis rule and the extraordinary disposition rules—i.e., the section 245A shareholder and its related parties, viewed as a whole, would likely be subject to meaningful excess taxation.

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. The KPMG name and logo are registered trademarks or trademarks of KPMG International.

KPMG observation

The proposed regulations only coordinate the disqualified basis rules and the extraordinary disposition rules to mitigate excess taxation with respect to a single taxpayer, including related persons. Thus, subsequent changes in the direct or indirect ownership of a transferor SFC or transferee CFCs or of items of specified property may still result in excess taxation overall. For example, if a section 245A shareholder sells a transferee CFC but retains the transferor SFC, and the purchaser does not make a section 338(g) election with respect to the transferee CFC, the section 245A shareholder and the purchaser, if a U.S shareholder, may both be subject to U.S. tax with respect to the same item of gain: the section 245A shareholder because it retains the extraordinary disposition account with respect to the transferor SFC, and the purchaser because the transferee CFC retains the disqualified basis.

Basis benefit rule

The basis benefit rule is intended to adjust the reduction amount determined under the complex method application of the DQB reduction rule to reflect the extent to which disqualified bases of items of corresponding specified property have provided a U.S. tax benefit by offsetting or reducing income that otherwise would have been subject to U.S. tax (the amount of such benefit, a "basis benefit amount"). According to the preamble to the proposed regulations, the basis benefit rule addresses situations in which an item of corresponding specified property with disqualified basis is transferred after an extraordinary disposition in a transaction that does not result in excess taxation to a section 245A shareholder. The proposed regulations include an example in which a transferee CFC sells an item of corresponding specified property to an unrelated party; because third-party sales of items of corresponding specified property are not subject to the disqualified basis rule, the item's disqualified basis is taken into account to reduce the transferee CFC's tested income from the sale, and thus the disqualified basis produces a U.S. tax benefit.

A basis benefit amount is, with respect to an item of corresponding specified property, the portion of the item's disqualified basis that, for a section 245A shareholder's tax year, is directly (or indirectly through a passthrough entity) taken into account for U.S. tax purposes by a U.S. tax resident, a CFC with a 10% section 958(a) U.S. shareholder, or a foreign person engaged in a U.S. trade or business to reduce U.S. taxable income, subpart F income or tested income (or create or increase a tested loss or qualified deficit), or ECI, respectively. A section 245A shareholder accounts for and tracks the basis benefit amounts for each of its extraordinary disposition accounts through separate accounts (each, a "basis benefit account"). The initial balance of a basis benefit account is $0. Thereafter, at the end of each tax year, the section 245A shareholder applies a series of complicated rules to adjust the balance of the account to reflect the section 245A shareholder's share of the current year basis benefit amounts for the items of corresponding specified property with respect to the account, including rules that prevent the same basis benefit amount from being taken into account in multiple tax years of the CFC.

KPMG observation

The DQB reduction rule only applies to reduce the disqualified basis of an item of corresponding specified property for purposes of the disqualified basis rule. In the event that an item of specified property with disqualified basis is transferred to a U.S. person (e.g., through an inbound liquidation of the transferee CFC), the disqualified basis rule does not apply to disregard any basis in that property, since that rule only applies for purposes of computing tested income, subpart F income,

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. The KPMG name and logo are registered trademarks or trademarks of KPMG International.

or ECI. Therefore, upon the onshoring of the property, the disqualified basis of such item of specified property may continue to provide U.S. tax benefits through, e.g., amortization, depreciation, or other cost-recovery deductions, because such basis remains, in general, "real" basis for U.S. tax purposes. In this situation, the basis benefit rule prevents the section 245A shareholder of the transferee CFC from potentially obtaining a double benefit with respect to the onshored item of specified property by reducing the reduction amount that otherwise would be computed under the DQB reduction rule for any items of specified property that remain offshore to reflect the U.S. tax benefits of the onshored item of specified property.

Timing and mechanics

The timing and mechanics of the complex method and simple method applications of the DQB reduction rule are substantially similar, except the complex method application uses the current owner of items of corresponding specified property. This modification is necessary because the complex method application of the DQB reduction rule addresses situations where a transferee CFC transfers an item of corresponding specified property after an extraordinary disposition.

EDA reduction rule

Simple method

The simple method application of the EDA reduction rule provides that if, for a transferee CFC's tax year, the transferee CFC holds items of corresponding specified property, then the section 245A shareholder's extraordinary disposition account with respect to the transferor SFC is reduced (not below zero) by the lesser of the following amounts:

- The *excess* of the transferee CFC's adjusted earnings (as defined below) *over* the sum of the transferee CFC's PTEP accounts, determined at the end of the transferee CFC's tax year and taking into account current year PTEP account adjustments; and

- The balance of the section 245A shareholder's RGI account (as defined below) with respect to the transferee CFC, determined at the end of the transferee CFC's tax year and *without regard to* the current year *decreases* to the account that are described below.

A transferee CFC's "adjusted earnings" for a tax year are its E&P, determined at end of the tax year, without regard to E&P attributable to ECI or dividends from 80%-owned domestic corporations (i.e., E&P that cannot support section 245A-eligible dividends), and taking into account current year distributions by the transferee CFC and the following adjustments:

- The transferee CFC's E&P are *increased* by deductions or losses that are or have been allocated or apportioned to residual CFC gross income under the disqualified basis rule; and

- The transferee CFC's E&P are *decreased* by the sum of the prior year decreases to section 245A shareholder's RGI account with respect to the transferee CFC.

Essentially, a transferee CFC's adjusted earnings are its cumulative non-taxed E&P that could support section 245A-eligible dividends, determined without regard to deductions allocated or apportioned to residual CFC gross income under the disqualified basis rule.

A section 245A shareholder's residual gross income account ("RGI account") with respect to a transferee CFC for any tax year is determined by:

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. The KPMG name and logo are registered trademarks or trademarks of KPMG International.

- *Increasing* the account for the transferee CFC's deductions and losses that, but for the disqualified basis rule, would have either decreased the transferee CFC's subpart F income or tested income, or given rise to or increased the transferee CFC's tested loss or qualified deficit; and

- *Decreasing* the account to the extent that the section 245A shareholder's extraordinary disposition account is decreased because of the application of the simple method application of the EDA reduction rule for the transferee CFC's tax year.

The balance of the RGI account generally reflects items of deduction or loss allocated and apportioned to the transferee CFC's residual CFC gross income solely by reason of the disqualified basis rule, to the extent that the allocation and apportionment is likely to increase income of the CFC that is subject to U.S. taxation at the level of the section 245A shareholder and any domestic affiliates pursuant to sections 951 or 951A.

The simple method application of the EDA reduction rule reduces a section 245A shareholder's extraordinary disposition account at the end of the shareholder's tax year that includes the date on which the transferee CFC's tax year ends. The amount of this reduction is determined after the application of the final regulations—i.e., after the transferee CFC's current year extraordinary disposition amounts and the extraordinary disposition account adjustments for prior extraordinary disposition amounts have been determined—and, to avoid circularity, after the simple method application of the DQB reduction rule.

Complex method

The complex method application of the EDA reduction rule is based on the same fundamental concepts as the simple method application. The complex method, therefore, generally reduces a section 245A shareholder's extraordinary disposition account to the extent the disqualified basis rule has reduced the ability of the owner of items of corresponding specified property to distribute section 245A-eligible dividends. The complex method builds on the simple method by adding several steps to the EDA reduction rule to address situations that are outside the simple method's scope. For example, the additional steps in the complex method address the following situations: (i) where the section 245A shareholder and its domestic affiliates do not, in the aggregate, own 100% (by vote and value) of a transferor SFC and a transferee CFC, and (ii) a transferee CFC has a hovering deficit or the amortization and depreciation deductions attributable to the disqualified bases of items corresponding specified property have been included in a hovering deficit.

The complex method application of the EDA reduction rule provides that if, for a CFC's tax year, there is an RGI account with respect to the CFC that relates to a section 245A shareholder's extraordinary disposition account with respect to an SFC *and* the section 245A shareholder or one of its domestic affiliates is a U.S. shareholder of the CFC on the last day of the CFC's tax year, then, subject to the two special rules described below, the extraordinary disposition account is reduced (not below zero) by the lesser of the following amounts:

- The excess of:

  - The amount of the CFC's current year adjusted earnings attributable to stock in the CFC directly or indirectly owned, in the aggregate, by the section 245A shareholder and its domestic affiliates on the last day of the CFC's tax year (based on the relative value of such stock as compared to the total value of all the stock in the CFC), over

  - The sum of the following amounts with respect to the CFC, determined at the end of the CFC's tax year:

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. The KPMG name and logo are registered trademarks or trademarks of KPMG International.

  - The PTEP accounts of the section 245A shareholder and its domestic affiliates, taking into account current year PTEP account adjustments,

  - The hybrid deduction accounts with respect to stock in the CFC owned (within the meaning of section 958(a), treating domestic partnerships as foreign partnerships) by the section 245A shareholder and its domestic affiliates, taking into account current year hybrid deduction account adjustments, and

  - The balances of extraordinary disposition accounts of the section 245A shareholder and its domestic affiliates, taking into account the current year adjustments to the accounts; and

- The balance of the RGI account, determined at the end of the CFC's tax year and without regard to the current year decreases to the account (described below).

The adjusted earnings computation in the complex method application of the EDA reduction rule is substantially similar to the simple method computation, but includes additional steps to account for situations where a CFC has a hovering deficit or is the successor to another CFC with respect to which there was an extraordinary disposition account. Specifically, under the complex method, a CFC's adjusted earnings for a tax year are its E&P, determined at the end of the tax year, without regard to E&P attributable to ECI or dividends from 80%-owned domestic corporations, and taking into account current year distributions by the CFC and the following adjustments:

- The CFC's E&P are increased by deductions or losses that:

  - Are or were attributable to the disqualified bases of items of corresponding specified property, but only to the extent gain recognized with respect to the items was included in the initial balance of the extraordinary disposition account;

  - Are or were allocated or apportioned to the CFC's (or a predecessor's) residual CFC gross income because of the disqualified basis rule; and

  - Give rise or have given rise to a hovering deficit as of the end of the CFC's tax year;[2] and

- The CFC's E&P are *decreased* by the sum of the prior year decreases to the RGI account.

The RGI account adjustments in the complex method application of the EDA reduction rule are substantially similar to the simple method adjustments, but include additional steps to account for situations where either (i) the extraordinary disposition ownership percentage is less than 100, or (ii) the section 245A shareholder and its domestic affiliates, in the aggregate, do not own 100% (by value) of the CFC at the end of the CFC's tax year. Specifically, under the complex method application of the EDA reduction rule, for a CFC's tax year, a section 245A shareholder determines the balance of its RGI account with respect to the CFC that relates to the shareholder's extraordinary disposition account with respect to an SFC by:

- *Increasing* the RGI account for the amount equal to the product of

[2] As provided in the preamble to the proposed regulations, the complex method application of the EDA reduction rule increases adjusted earnings for hovering deficits, because a hovering deficit does not affect or limit a CFC's ability to distribute its E&P as a dividend.

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. The KPMG name and logo are registered trademarks or trademarks of KPMG International.

  - The CFC's deductions and losses attributable to the disqualified bases of items of corresponding specified property that, but for the DBQ reduction rule, would have either decreased the CFC's subpart F income or tested income, or given rise to or increased the CFC's tested loss or qualified deficit, multiplied by

  - The *lesser* of

    - the percentage of the CFC's subpart F income or qualified deficit and tested income or tested loss attributable to the stock in the CFC directly or indirectly owned, in the aggregate, by the section 245A shareholder and its domestic affiliates,[3] and

    - the extraordinary disposition ownership percentage applicable to the section 245A shareholder's extraordinary disposition account;

- *Decreasing* the RGI account to the extent the extraordinary disposition account is decreased because of the application of the complex method application of the EDA reduction rule for the CFC's tax year; and

- *Adjusting* the RGI account to reflect adjustments to the section 245A shareholder's extraordinary disposition account under the successor rule.

Special rules relating to reduction amount

The complex method application of the EDA reduction rule includes two special rules that address situations where: (i) the section 245A shareholder and its domestic affiliates have multiple extraordinary disposition accounts with respect to a CFC (the "multiple EDA rule"), and (ii) the reduction amount otherwise determined under the complex method would result in the balance of an extraordinary disposition account being less than the balance of the basis benefit account with respect to the extraordinary disposition account (the "EDA reduction limitation rule").

The reduction amount determined under the complex method application of the EDA reduction rule may be attributable to a CFC's E&P that are not reflected in an extraordinary disposition account with respect to the CFC. Thus, without a rule providing otherwise, a CFC's adjusted earnings could reduce multiple extraordinary disposition accounts with respect to the CFC by an amount that, in aggregate, exceeds the CFC's adjusted earnings. The multiple EDA rule is intended to prevent this result. Specifically, the multiple EDA rule provides that if, for a CFC's tax year, the total reduction amount determined under the complex method application of the EDA reduction rule to multiple extraordinary disposition accounts of the section 245A shareholder and its domestic affiliates (without regard to the multiple EDA rule and the EDA reduction limitation rule) would exceed the portion of the CFC's adjusted earnings attributable to the section 245A shareholder and its domestic affiliates (the "excess amount"), the reduction amount for each excess disposition account is equal to the *excess of*:

- The reduction amount for the excess disposition account determined by applying the complex method application of the EDA reduction rule (without regard to the multiple EDA rule and the EDA reduction limitation rule), *over*

[3] For these purposes, tested losses and qualified deficits are treated as positive numbers and ECI is treated as subpart F income.

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. The KPMG name and logo are registered trademarks or trademarks of KPMG International.

- The portion of the excess amount attributable to the excess disposition account, based on the account's balance as compared to the total balance of all extraordinary disposition accounts with respect to the CFC.

Successor coordination rules

The proposed regulations provide two rules (the "successor coordination rules") that coordinate the application of the proposed regulations and the successor rule. The first successor coordination rule provides that if a section 245A shareholder's extraordinary disposition account with respect to an SFC (the "transferor EDA") is adjusted because of the successor rule, and such adjustment increases the balance of an extraordinary disposition account with respect to another SFC (the "transferee EDA"), then the proposed regulations are applied by treating a ratable portion of the transferee EDA as part of the transferor EDA (such ratable portion, the "deemed transferor EDA"), based on the amount of such increase as compared to the transferee EDA balance. Thus, ratable portions of amounts determined for the transferee EDA are considered attributable to the transferor EDA, based on the balance of the deemed transferor EDA as compared to the balance of the transferee EDA. As a result, the transferor EDA may be reduced to reflect the allocation or apportionment of deductions or losses attributable to disqualified bases of items of corresponding specified property with respect to the transferee EDA.

The second successor coordination rule provides that if a section 245A shareholder's extraordinary disposition account with respect to an SFC is reduced because of the successor rule, then, except as provided by the first successor coordination rule, the extraordinary disposition ownership percentage with respect to such account (and any other extraordinary disposition account for the SFC that is increased by reason of the reduction) is similarly adjusted.

Timing and mechanics

The timing and mechanics of the complex method and simple method applications of the EDA reduction rule are the same.

Other rules

The proposed regulations contain additional coordination rules and an anti-avoidance rule. For example, there are coordination rules for currency translation and the disqualified payment rules in proposed regulations addressing the calculation of GILTI, which were issued on April 8, 2020 (REG-106013-19). The anti-avoidance rule applies broadly and requires adjustments if a transaction or arrangement has a principal purpose of avoiding the purposes of the proposed regulations. The preamble explains that the anti-avoidance rule applies, for example, if a section 245A shareholder causes its tax year to end with a principal purpose of assigning a basis benefit amount to another tax year.

The proposed regulations also acknowledge that certain taxpayers may have elected under the GILTI regulations to reduce the basis of an item of specified property to eliminate the item's disqualified basis (the "disqualified basis elimination election") before the proposed regulations were released. Accordingly, the proposed regulations permit taxpayers to revoke a disqualified basis elimination election during a transition period – 90 days after the proposed regulations are finalized – if the future final regulations provide a more favorable outcome for the taxpayer. If making such a revocation, the proposed regulations require the controlling domestic shareholders to file a revocation statement, as well as amended returns for any tax years that are affected by the revoked election—i.e., any tax years reflecting the election to eliminate basis.

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. The KPMG name and logo are registered trademarks or trademarks of KPMG International.

KPMG observation

A taxpayer that made the disqualified basis elimination election may prefer to revoke this election because the proposed regulations do not provide for a corresponding reduction to the taxpayer's extraordinary disposition account. Rather than eliminating the disqualified basis through the election, a taxpayer may prefer to have the disqualified basis eliminated "naturally" (e.g., through depreciation or amortization), which would then generally reduce the taxpayer's extraordinary disposition account under the EDA reduction rule. As noted above, the proposed regulations are proposed to apply to tax years beginning on or after the date they are finalized, and therefore a taxpayer cannot make this election before the date of the future final regulations. However, assuming that the future final regulations adopt the proposed effective date provisions, the taxpayer will be permitted to make this revocation with retroactive effect once the future finale regulations are issued.

Comment period and hearing

Comments or requests for a public hearing on the proposed regulations must be received by October 26, 2020.

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. The KPMG name and logo are registered trademarks or trademarks of KPMG International.

Contact us

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

Seth Green
T: +1 202 533 3022
E: sethgreen@kpmg.com

Gary Scanlon
T: +1 202 533 4651
E: gscanlon@kpmg.com

Douglas Holland
T: +1 202 533 5746
E: dholland@kpmg.com

Stephen Massed
T: +1 202 533 4738
E: smassed@kpmg.com

Brett Bloom
T: +1 202 533 4061
E: bbloom@kpmg.com

Seevun Kozar
T: +1 408 367 2865
E: skozar@kpmg.com

www.kpmg.com

kpmg.com/socialmedia

The information contained herein is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

KPMG is a global network of professional services firms providing Audit, Tax and Advisory services. We operate in 147 countries and territories and have more than 219,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. Each KPMG firm is a legally distinct and separate entity and describes itself as such.

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. The KPMG name and logo are registered trademarks or trademarks of KPMG International. NDPPS 811721