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KPMG report: Final regulations under sections 245A and 954(c)(6) and correcting amendments

Final regulations under sections 245A and 954(c)(6) and correcting amendments were released in November 2020.

The U.S. Treasury Department and IRS (collectively "Treasury") published in the Federal Register on November 13, 2020, correcting amendments (the "November correcting amendments") to the final regulations (T.D. 9909) under sections 245A and 954(c)(6) as published in the Federal Register on August 27, 2020 (the "August final regulations"). Read the **November correcting amendments** [PDF 237 KB]

The IRS on November 20, 2020, posted to its website a version of final regulations (T.D. 9934) (the "November final regulations") that finalize the proposed regulations (REG-124737-19) under sections 245A and 951A (the "August proposed regulations") that were published in the Federal Register on August 27, 2020. Read the **November final regulations** [PDF 381 KB] 62 pages as posted on the IRS website on November 20, 2020). The version of the final regulations posted by the IRS includes the following statement:

> *This document has been submitted to the Office of the Federal Register (OFR) for publication and will be pending placement on public display at the OFR and publication in the Federal Register. The version of the final rule released today may vary slightly from the published document if minor editorial changes are made during the OFR review process. The document published in the Federal Register will be the official document.*

For a more detailed discussion of the August final regulations and August proposed regulations, read ***TaxNewsFlash*** [PDF 439 KB]

November correcting amendments

The November correcting amendments were generally limited to corrections of typographical errors in the August final regulations. However, the November correcting amendments included one substantive correction described below.

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The August final regulations include a rule that disallows all or a portion of the section 245A dividends received deduction ("DRD") with respect to dividends paid by a CFC in connection with certain transactions in which a controlling U.S. shareholder's direct or indirect interest in the CFC is significantly reduced—defined as an "extraordinary reduction"—and the extraordinary reduction results in reduction in the U.S. shareholder's pro rata share of subpart F income or tested income with respect to such CFC—defined as an "extraordinary reduction amount." However, the August final regulations provide an exception to this rule if the U.S. shareholder makes an election to close the tax year of the CFC (the "closing-of-the-books election").

A U.S. shareholder that makes a closing-of-the-books election with respect to a CFC includes its pro rata share of the CFC's tested income in computing its GILTI as of the date of the extraordinary reduction, thus potentially subjecting that income to the lower 10.5% GILTI rate rather than the 21% rate for a taxable dividend. The August final regulations clarify that a U.S. shareholder can only make a closing-of-the-books election for a CFC that has subpart F income or tested income. Thus, an election cannot be made with respect to a CFC that has no tested income or subpart F income, including a CFC that has a tested loss.

The August final regulations did not include a rule to coordinate the closing-of-the-books election with the regulations issued by Treasury that permit a U.S. shareholder to elect to exclude from its CFCs' tested income any item of income that is subject to foreign tax at an effective rate of greater than 18.9% (the GILTI high-tax or HTE election). In particular, the availability of the two elections could result in circularity if, for instance, a U.S. shareholder makes a closing-of-the-books election for a CFC with respect to which it experiences an extraordinary reduction amount and then also makes a GILTI HTE election with respect to such CFC for the resulting stub year. As a result of the GILTI HTE election, the CFC would have no tested income, and thus arguably, the U.S. shareholder would have no extraordinary reduction amount with respect to the CFC, thereby potentially invalidating the closing of the books election. However, if the closing-of-the-books election were invalid, the GILTI HTE election would also be invalid because the U.S. shareholder would no longer be the CFC's controlling domestic shareholder as of close of the CFC's tax year.

The November correcting amendments remove this potential for circularity by providing that the determination of whether there is an extraordinary reduction amount is made without taking into account any elections that may be available, or other events that may occur, solely by reason of a closing-of-the-books election, including the application of the GILTI HTE election to a short tax year created as a result of such election. Thus, a U.S. shareholder may still be eligible to make the closing-of-the-books election with respect to a CFC even if it also makes a GILTI HTE election for the resulting stub year which causes the CFC to have no tested income for such year.

November final regulations

The November final regulations adopt the rules from the proposed regulations with one notable change.

The proposed regulations provided rules to mitigate the instances of excess taxation arising from the concurrent application of the extraordinary disposition rules in the August final regulations and the disqualified basis rule from the final global intangible low-taxed income ("GILTI") regulations. The extraordinary disposition rules disallow 50% of the section 245A DRD to the extent that a dividend is paid by a specified foreign corporation ("SFC") to its section 245A shareholder out of earnings and profits ("E&P") within its extraordinary disposition account.

An SFC's extraordinary disposition account is generally equal to the 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

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after December 31, 2017 (such period, the "disqualified period," such disposition, an "extraordinary disposition," and such E&P, "extraordinary disposition E&P"). A section 245A shareholder's extraordinary disposition account is reduced by prior dividends paid out of the extraordinary disposition account that are treated as extraordinary disposition amounts as well as certain other amounts defined in Reg. § 1.245A-5(c)(3)(i)(D)(1)(i) through (iv) when the E&P of the SFC is taxed under another provision of the Code (e.g., by reason of deemed inclusions under sections 951(a)(1)(B) and 956).

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 resulting in the potential for excess taxation.

One of the rules included in the August proposed regulations to mitigate the potential for excess taxation as a result of the concurrent application of the extraordinary disposition rules and the disqualified basis rule was the disqualified basis ("DQB") reduction rule. Under this rule, if an extraordinary disposition account of the section 245A shareholder gives rise to one or more 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.

In the preamble to the proposed regulations, Treasury requested comments on whether prior extraordinary disposition amounts described in Reg. § 1.245A-5(c)(3)(i)(D)(1)(i) through (iv) should also reduce disqualified basis under the DQB reduction rule. While these amounts are subject to U.S. federal income tax by reason of a provision other than the extraordinary disposition rules, the gain to which the extraordinary disposition E&P and disqualified basis are attributable could be subject to excess U.S. federal income tax—once under the disqualified basis rule and again under another provision of the Code. No comments were received on this issue. Nonetheless, the November final regulations adopt the proposed modification to the DQB reduction rule, with the result that affected taxpayers' disqualified basis amounts are now reduced by prior extraordinary disposition amounts described in Reg. § 1.245A-5(c)(3)(i)(D)(1)(i) through (iv).

The November final regulations are applicable for tax years of foreign corporations beginning on or after the date the November final regulations are published in the Federal Register, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end. Nevertheless, taxpayers may choose to apply the November final regulations to tax years beginning before the date the final regulations are published in the Federal Register, subject to certain limitations.

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