ANTI-ABUSE RULES OF TEMP. REG. §1.245A-5T – A NEW CERBERUS FOR THE U.S. TAX SYSTEM

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"Ay, sir, there's no more trick is there! You are not, like Cerberus, three gentlemen at once, are you?"

–Mrs. Malaprop to Captain Absolute in Richard Brinsley Sheridan's The Rivals (1775), Act IV, scene 2

A participation exemption is a feature of many territorial systems and eliminates incremental tax on foreign-source income. Under the Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, ("T.C.J.A."), the U.S. tax law acquired a 100% dividends received deduction ("D.R.D.") for foreign-source dividends received by domestic U.S. corporations from 10%-owned foreign subsidiaries arising in tax years beginning after December 31, 2017.[1]

The new D.R.D. applies to a certain limited class of taxable distributions by a C.F.C. to its U.S. corporate parent. It also applies to certain other distributions by a foreign corporation to a U.S. corporation owning a 10% or greater interest, where (i) all such 10% U.S. shareholders in the aggregate own shares representing not more than 50% of the value or voting power of the foreign corporation and (ii) the foreign corporation is are not considered to be a P.F.I.C. The new D.R.D. extends to capital gain on certain dispositions of foreign corporation stock, provided that the gain is attributable to retained earnings and for that reason is converted to dividend income under Code §1248.[2]

As background, the U.S. imposes tax on the worldwide income of its citizens and U.S.-incorporated companies. This feature was retained after the T.C.J.A. and has always been coupled with (i) deferral of foreign earnings earned through corporate form and (ii) provisions eliminating deferral under the C.F.C. rules of Subpart F. Confusingly, these elements are retained, the global low tax intangible income rules of Code §951A have been added, and the participation exemption has been grafted on top of the whole lot. Prior to the T.C.J.A., former Code §902 provided that when a domestic corporation received a dividend from a foreign corporation in which it

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[1] Separately, see the fourth article in this edition of *Insights* by Neha Rastogi and Nina Krauthamer, titled "Heads I Win, Tails You (I.R.S.) Lose – Not Any More: Hybrid Dividends and Code §245A(e)," addressing the hybrid provisions of Code §245A, including the relevant regulations issued this spring. A pre-existing D.R.D. under Code §245 further discussed in this article applied only to U.S.-source dividends, and not deemed dividends arising from the sale or exchange of C.F.C. stock.

[2] This, through the back door of Code §1248. According to a 2017 blog posting, approximately 29 countries in the O.E.C.D. offer a participation exemption or deduction for dividend income, and 26 offer it for capital gains arising from the sale of shares of subsidiaries in which a minimum participation exists, with 25 countries offering both. See Kyle Pomerlau, "Designing a Territorial Tax System: A Review of OECD Systems" (Aug. 1, 2017), available here.

owned at least 10% of the voting shares, the domestic corporation was deemed to pay a proportional share of the foreign corporation's foreign taxes. The gross taxable dividend to the U.S. corporation equaled the sum of the dividend declared and the accompanying taxes that were "grossed-up" into the dividend.[3] The T.C.J.A. repealed Code §902 and now provides the D.R.D. instead when the U.S. corporation is not taxed under Subpart F and G.I.L.T.I. rules. In such case, the indirect foreign tax credit remains in existence.[4]

Enter 105 pages of temporary regulations, issued on June 14, 2019 under Temp. Reg. §1.245-5T ("Temporary Regulations"), adopted in T.D. 9865, which provides rules to address certain base erosion concerns identified by the I.R.S., in the context of Code §245A's purpose in the broader tax system.[5]

The Temporary Regulations seem to serve a role like that of Cerberus,[6] the multi-headed canine who watched over the gates of Hades in Greek mythology. They address very specific concerns relating to erosion of Subpart F and G.I.L.T.I. This article reviews the D.R.D provisions, including the Temporary Regulations, so that their Cerberus-like complexity can be understood — transforming the task from a labor worthy of Herakles to a walk in the park.

MAIN FEATURES OF CODE §245A

The Code §245A D.R.D. applies where a U.S. domestic corporation (the "Code §245A shareholder") owns at least 10% of a foreign corporation, by vote or value – with the foreign corporation referred to as a "specified 10-percent owned foreign corporation" ("S.F.C.") – from which a dividend is received.

The ownership of the distributing's stock must be effective for a one-year holding period. The D.R.D. applies only to the foreign-source portion of a dividend received.

The foreign-source portion of a distribution is determined by multiplying the amount of the distribution described in Code §301(c)(1) (a dividend out of earnings and profits ("E&P")) by a fraction, the numerator of which is the S.F.C.'s undistributed foreign earnings, and the denominator of which is the S.F.C.'s total undistributed earnings. Congress defined "undistributed foreign earnings" as undistributed earnings that are neither effectively connected income ("E.C.I.") nor dividends received from a U.S. domestic corporation in which at least 80% is owned, directly or indirectly, by the S.F.C. The term "undistributed earnings" means total earnings at the close of the year, excluding previously-taxed earnings under Code §959(c)(1) and (c)(2) ("P.T.I.").[7] In broad terms, P.T.I. means the earnings that have been taxed in the

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3 Code §78.

4 Code §960.

5 A proposed version of the same rules was issued at the same time in REG-106282-18. Also proposed were a further 55 pages of final regulations under Code §§245A(e) and 267A, relating to hybrid dividends. Minor corrections were published at 84 Fed. Reg. 38866.

6 In Greek, "Kerberos," the offspring of the monsters Echidna and Typhon, the etymology of the name is uncertain but includes "Ker," a Valkyrie-like goddess of violent death.

7 Under Code §959(d), a distribution of previously taxed income does not constitute a dividend even if it reduces E&P, therefore Code §245A is inapplicable.

hands of the U.S. corporate shareholder under the Subpart F or G.I.L.T.I. provisions of U.S. tax law. Meanwhile, the U.S.-source portion potentially may separately also be eligible for a D.R.D. under the pre-T.C.J.A. D.R.D. provided for in Code §245(a), which has been part of the tax law for many years.[8]

A comparison of the Code §245A D.R.D. for foreign source dividends with the pre-existing Code §245 D.R.D. for U.S.-source dividends is instructive. The two provisions are similar in several ways. Both deductions

- may be claimed by only domestic corporations (not R.I.C.'s, R.E.I.T.'s, or S-corporations) with respect to foreign corporations that are not passive foreign investment company ("P.F.I.C.") with respect to the recipient,
- require 10% minimum ownership[9] in the corporation making the distribution,
- require forsaking any associated foreign tax credits or deductions, and
- limit the D.R.D.'s availability based on the source of the underlying earnings.

The two provisions differ in several ways:

- The old Code §245 D.R.D. applies only to actual dividends, whereas new Code §245A also applies to the portion of a capital gain treated as dividend under Code §1248(a) plus deemed dividends from indirectly-owned C.F.C.'s.
- The new Code §245A D.R.D. includes a longer minimum holding period. It is one year for a dividend from an S.F.C. compared to 45 days for a dividend from a domestic corporation. It is not clear what difference in policy justifies this change, although a 12-month holding period is not uncommon, globally.
- The new Code §245A D.R.D. includes provisions applicable in an adverse way to hybrid dividends.[10] Presumably the need for anti-hybrid rules is unnecessary when both corporations are incorporated in the U.S.
- The old Code §245(a) D.R.D. specifically permits a taxpayer to take advantage of treaty resourcing provisions[11] and includes provisions relating to distributions out of earnings attributable to foreign trade income under former Code §923, though the latter rules may no longer be of relevance.

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[8] P.L. 83-591, Ch. 736. Code §245 refers to a "qualified 10-percent owned foreign corporation." See also Code §243(e), which extends a domestic D.R.D. to distributions received from a foreign subsidiary attributable to E&P accumulated by a domestic corporation.

[9] Though Code §245 requires at least 10% by vote and value, Code §245A keys off of the U.S. shareholder definition in Code §951(b), meaning 10% ownership by vote or value — meaning a foreign-source D.R.D. may potentially be claimed in some cases where the Code §245 D.R.D. would be inapplicable.

[10] These regulations, issued as final in T.D. 9896 under both Code §245A(e) and §267A, are explored further in another article in this edition of Insights. The hybrid rules apply to situations in which a foreign hybrid mismatch rule does not apply. The final regulations under T.D. 9896 also provide rules on dual consolidated losses and entity classifications to prevent a deduction being claimed under the laws of both the U.S. and a foreign country.

[11] Code §245(a)(10).

> *"This downward adjustment to basis applies to reduce basis available for a distribution out of P.T.I. form the same C.F.C., as well as for purposes of determining loss on any disposition of stock. . ."*

BASIS ADJUSTMENTS

Under Code §961 as in effect prior to the T.C.J.A., a U.S. Shareholder is required to make upward adjustments to the basis for shares of stock in a C.F.C. to reflect amounts included in gross income under Subpart F, and downward adjustments to reflect distributions of P.T.I. Since distributions of P.T.I. are not treated as taxable dividends, they do not qualify for a D.R.D. When distributions are out of not previously-taxed E&P — known as Code §959(c)(3) E&P — the distribution is treated as a dividend that gives rise to a D.R.D. For those dividends, Code §961(d) requires the U.S. shareholder to make a downward adjustment to the basis in the S.F.C. stock to reflect the benefit of the D.R.D. — and thus apparently expanding Code §961's reach to S.F.C.'s that are not C.F.C.'s. This downward adjustment to basis applies to reduce basis available for a distribution out of P.T.I. form the same C.F.C., as well as for purposes of determining loss on any disposition of stock of such foreign corporation in such taxable year or any subsequent taxable year. This provision closes the door on any plan that includes (i) the purchase a cash rich foreign corporation, (ii) the receipt of a tax-free dividend once the 12-month holding period passes, and (iii) the generation of a capital loss when the corporate shell is sold that reduces an unrelated taxable capital gain.

CODE §91 — NEW BRANCH LOSS RECAPTURE RULES

An additional component of the new participation exemption architecture is Code §91, which is a loss recapture provision. It requires a domestic corporation that transfers substantially all the assets of a foreign branch -— as defined in Code §367(a)(3)(C) in effect prior to the T.C.J.A.[12] — to an S.F.C. to include in gross income an amount equal to the transferred loss amount. The "transferred loss amount" means the sum of losses incurred by the foreign branch after December 31, 2017 and before the transfer, with respect to which a deduction was allowed to the domestic taxpayer, reduced by (i) gain recognized after the year in which the loss was incurred and through the close of the table year in which the transfer is effected and (ii) certain amounts recognized under Code §904(f)(3). To avoid double taxation of the same gain, if gain is otherwise recognized on the transfer, the amount of the loss that is recaptured will be reduced. The net amount is treated as U.S source income. This departs from the treatment under the loss recapture rules previously in effect under prior law, which treated branch loss as foreign source.

In addition to the loss recapture, inherent gain in assets transferred to a foreign corporation will be recognized and taxed. Should the U.S. person instead seek to remove the assets to the U.S., foreign exit taxes may apply. Whether the tax is creditable against U.S. tax is an open question post-T.C.J.A.[13]

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[12] The T.C.J.A. repealed the active trade or business ("A.T.B.") exception to gain recognition for purposes of certain nonrecognition transactions under Code §367(a) but retained the A.T.B. definition for purposes of this branch loss recapture provision.

[13] See Kimberly S. Blanchard, "Out on a Limb: The New Significance of the Foreign Branch," Tax Notes (Jan. 6, 2020).

DEEMED DIVIDENDS UNDER CODE §§1248(A) AND 964(E)

The D.R.D. does not generally eliminate Subpart F income, nor does it apply to Code §78 "gross-up" dividends when an indirect foreign tax credit is claimed under Code §960 in connection with an amount included in income under Subpart F or G.I.L.T.I.[14] As a result, the taxable amount of the inclusion is increased by the taxes of the C.F.C. that become creditable at the level of a corporation that is a 10% shareholders.

In comparison, Code §245A applies to deemed dividends under Code §§1248(a) and 964(e). As background, whenever a U.S. person sells or exchanges stock in a foreign corporation and owns — or is deemed to own — 10% or more of the combined voting power of all classes of stock entitled to vote during the five-year period ending on the date of the sale or exchange. The amount that is converted into dividend income is equal to the earnings and profits that have been accumulated while the corporation was a C.F.C. and the U.S. person was a 10% shareholder. Code §1248 provides that:

> the gain recognized . . . shall be included in the gross income of such person as a dividend, to the extent of the earnings and profits of the foreign corporation attributable . . . to such stock which were accumulated in taxable years of such foreign corporation beginning after December 31, 1962, and during the period or periods the stock sold or exchanged was held by such person while such foreign corporation was a controlled foreign corporation. . . .

"The T.C.J.A. tweaked Code §1248 and Code §964(e) to indicate that a dividend deemed under those provisions generally would be eligible for a D.R.D."

Historically many taxpayers used this provision to "pull up" Code §902 indirect foreign tax credits from the lower-tier target, effectively allowing the U.S. 10% shareholder to use the tax to offset more of the residual U.S. tax on the subpart F Income. Without the rule, foreign income taxes paid by the lower-tier target C.F.C. would be trapped at that level. It could not be used to offset U.S. tax imposed under Subpart F on the U.S. 10% shareholder. The only way for the shareholder to access those taxes would be to force the actual payment of a dividend to the upper-tier C.F.C. Lower-tier C.F.C.'s that were cash rich could more easily pay a dividend prior to a sale than lower-tier subsidiaries that were cash poor but asset rich.

To provide parity of treatment both between sales of cash poor and cash rich lower-tier C.F.C.'s, Congress added Code §964(e), providing that gain realized by an upper-tier C.F.C. on the sale or exchange of a lower-tier C.F.C.'s stock should allow some or all of the gain to be converted into a deemed dividend, similar to Code §1248(a). The taxpayer benefit from Code §964 is that the Subpart F income of the upper-tier C.F.C. will be grossed up to include foreign income taxes actually paid by the lower-tier C.F.C. without the need for an actual dividend being declared.

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[14] REG-105600-18, 83 Fed. Reg. 63,200 (Dec. 7, 2018) (proposed regulations); T.D. 9866, 84 Fed. Reg. 29,288 (June 21, 2019) (final regulations). New Treas. Reg. §1.78-1(a) provides that a Code §78 dividend is "treated as a dividend for all purposes of the Code, except that it is not treated as a dividend for purposes of section 245 or 245A, and does not increase the earnings and profits of the domestic corporation or decrease the earnings and profits of the foreign corporation."

Consequently, when the deemed dividends and the accompanying foreign taxes of the lower-tier C.F.C. are included by the upper-tier C.F.C., the foreign taxes can be claimed as a foreign tax credit by the U.S. corporation that is taxed under Subpart F.

The T.C.J.A. tweaked Code §1248 and Code §964(e) to indicate that a dividend deemed under those provisions generally would be eligible for a D.R.D. The Temporary Regulations may cut back on that benefit in select fact patterns. Also, under a peculiar interaction between Code §§245A, 951A, and 1248, the sale by one U.S. Shareholder to another of C.F.C. stock could transmute what is otherwise G.I.L.T.I. tested income into permanently untaxed income by operation of the D.R.D.[15] After the Temporary Regulations, this loophole may have closed.

THE TEMPORARY REGULATIONS

The following passage from the N.Y.S.B.A. Report on the D.R.D. encapsulates how the U.S. participation exemption is envisaged to function as part of a "territorial" system:[16]

> In many cases, a CFC's net income that is subject to current tax [under G.I.L.T.I.] in the hands of its United States shareholder(s) will constitute a very large percentage of the CFC's total net income. Section 245A thus implements the territorial tax portion of the modified territorial tax system by effectively exempting from U.S. tax that portion of a CFC's earnings that are not subject to tax under the subpart F and GILTI rules, and thus are subject only to foreign tax.

Code §245A(g) provides broad language authorizing the I.R.S. to issue whatever rules are deemed "necessary or appropriate" to carry out the provisions of Code §245A. In the Preamble to the Temporary Regulations, the I.R.S. reaches even further, to the legislative history of the D.R.D., to justify its approach of crafting wide-ranging anti-abuse rules, suggesting that "without appropriate limits, domestic corporations might be incentivized to shift income to low-taxed foreign affiliates ''where the income could potentially be distributed back to the [domestic] corporation with no U.S. tax imposed.[17]

Before jumping into the "nitty-gritty," a word on the regulations' guiding philosophy will help us to complete our labor worthy of Herakles.

<u>The Regulations' Philosophy</u>

Code §245A may have been seeking something of a grounding philosophy to help find its home in this complicated tax system. Enter the Temporary Regulations, in which the I.R.S. sought to address situations where taxpayers might base erode the

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[15] Subpart F and G.I.L.T.I. tested income can also be transmuted into permanently untaxed income in the case of regular dividends — for example, dividends paid by one C.F.C. to another may qualify for an exception to Subpart F under Code §954(c)(3) or (c)(6), and an exception to tested income under Code §951A(c)(2)(A)(i)(IV).

[16] New York State Bar Association, Report on Code §245A, October 25, 2018 ("N.Y.S.B.A. Report"), at 7.

[17] Citing to Senate Committee on the Budget, 115th Cong., Reconciliation Recommendations Pursuant to H. Con. Res. 71, at 365 (Comm. Print 2017).

U.S. by transferring valuable income-producing assets offshore and then claiming a D.R.D. with respect to distributions of associated earnings back to the U.S., effectively removing them from the U.S. tax net. Explaining this concern further, the Preamble states:

> The transition tax, the subpart F and GILTI regimes, and the participation exemption . . . together form a comprehensive and closely integrated set of tax rules with respect to the earnings of foreign corporations with requisite levels of U.S. ownership. Those related provisions must be read and interpreted together in order to ensure that each provision functions as part of a coherent whole, as intended

The Preamble adds that the Temporary Regulations are intended to apply where "the literal effect of Section §245A would reverse the intended effect of the subpart F and [G.I.L.T.I.] regimes," and in particular to limit the D.R.D.'s effect where income that would otherwise give rise to tax under Subpart F or G.I.L.T.I. would escape taxation under those rules. It is a testament to the ingenuity of the drafters of the Temporary Regulations that two disparate sets of rules are elegantly dealt with in a single conceptual framework.[18]

With this challenging mission in mind, in select base erosion circumstances, the Temporary Regulations (i) remove a D.R.D. for distributions received by a U.S. owner from a C.F.C., and (ii) turn off Code §954(c)(6)'s "look-thru" exception for distributions received by an upper-tier C.F.C. from a lower-tier C.F.C.

Ineligible Amount — What is it?

The ineligible amount is introduced by the Temporary Regulations and corresponds to the portion of any dividend received for which a Code §245A D.R.D. (or look-thru exception under Code §954(c)(6)) may not be claimed, and includes extraordinary dispositions and extraordinary reductions.

Extraordinary Dispositions

As a matter of background, after the T.C.J.A. was enacted, the I.R.S. realized that a disjuncture existed between effective date of the D.R.D. under Code §245A — December 31, 2017 —and the effective date of the G.I.L.T.I. tax for a fiscal year taxpayer. The G.I.L.T.I. provisions are first effective as of the first day of the first year beginning after December 31, 2017. For a fiscal year taxpayer having a year end of November 30, the gap was 11 months long. During this period, a C.F.C. could sell operating assets to an affiliate in a transaction not subject to G.I.L.T.I. for the seller. For the buyer, a step-up in basis of operating assets could reduce G.I.L.T.I. tax in future years by reason of rules applicable to ordinary returns on qualified business assets. The sales proceeds could be repatriated tax-free under the D.R.D. as Code §245A to distributions made after December 31, 2017. Hence the gap.

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18 For Code §954(c)(6), see Notice 2007-9, 2007-5 I.R.B. 401, discussing future guidance for income eligible for "look-thru" treatment under Code §954(c)(6), shortly after that rule was introduced by the Tax Increase Prevention and Reconciliation Act ("T.I.P.R.A.") of 2005, P.L. 109-222. Code §954(c)(6)'s look-thru exception has never been made permanent and thus far has been renewed by Congress each year.

The Temporary Regulations attempt to close the planning opportunity. Using the language of the Temporary Regulations, the extraordinary disposition rule refers to dispositions of "specified property" (property that gives rise to G.I.L.T.I. tested income) in transactions with related parties occurring during the "gap" period, meaning the time between effective date of the D.R.D. the effective date of the G.I.L.T.I. provisions, or the first tax year beginning after December 31, 2017. Dispositions are examined in light of all facts and circumstances, except where they are *per se* "extraordinary." This occurs in two circumstances. The first is where the transaction is undertaken with a principal purpose of generating earnings during the gap period. The second is where the transferred asset is an item of intangible property, as defined in Code §367(d).

The extraordinary disposition rule applies to select fiscal-year taxpayers who experienced a disqualified gap period and is not relevant for transactions after this period closes.

The ineligible amount is 50% of the dividend attributable to E&P from extraordinary dispositions.

Extraordinary Reductions

This provision is designed to prevent a taxpayer reducing tax under Subpart F of a C.F.C. by means of a purchase of shares in a C.F.C. followed by the seller's distribution of a dividend to a common 10% shareholder in the U.S. The archetypal transaction is explained in the preamble to the Temporary Regulations. It appears to be based on a structured product that was being marketed by investment banks and major accounting firms.

Subpart F contains a provision that was originally intended to prevent the double taxation of Subpart F income of a C.F.C. when the shares of the C.F.C. are sold in early in a tax year. The provision is Code §951(a)(2)(B). It prevents double taxation of the same earnings by reducing a U.S. Shareholder's *pro rata* share of Subpart F income of a C.F.C. when dividends are paid by the C.F.C. to another person with respect to the same share of stock. When enacted, the expectation would be that the dividends would be fully taxable in the U.S. at rates similar to Subpart F Income. However, the math is changed under the D.R.D. provided in Code §245A.

Once the D.R.D. applies to the dividend, a U.S. taxpayer acquiring the C.F.C. stock from a related U.S. person could reduce the amount included in its income by the tax-free dividend paid to the selling U.S. Shareholder prior to the acquisition. The same benefit would apply to tested income that is subject to G.I.L.T.I. tax in the hands of a U.S. Shareholder. The Preamble cautions that this result was not contemplated by the T.C.J.A. as it results in double non-taxation, borrowing a term from B.E.P.S.

The extraordinary reduction applies in the following fact pattern:

- The transaction occurs in a tax year ending after December 31, 2017.
- A "controlling Code §245A shareholder" owns 50% or more, by vote or value, of the outstanding shares of stock in a C.F.C.
- In determining whether the 50% ownership threshold is met, any stock owned by related parties is counted.

- The “controlling Code §245A shareholder” transfers, directly or indirectly, shares representing more than 10% of value of all shares issued by the C.F.C. The transferred shares of stock constitute at least 5% by value of the total outstanding stock of the C.F.C.

Alternatively, the extraordinary reduction rule may apply where, as a result of one or more transactions carried on during the year, the controlling Code §245A shareholder’s stock that is owned directly or indirectly on the last day of the taxable year is less than 90% of the stock owned on either of two measuring dates: (i) the date on which the shareholder’s ownership percentage is highest measured by the total value of all shares outstanding in the year; or (ii) the day immediately before the first day on which any stock is transferred, directly or indirectly, in one or a series of transactions pursuant to a plan intended to reduce the percentage of stock ownership.

If the extraordinary reduction rule is triggered, a portion of the dividend received by the shareholder is ineligible for the D.R.D. under Code § 245A. The ineligible amount is the lesser of (i) the dividend received or (ii) the relevant Code §245A shareholder’s pre-reduction *pro rata* share of Subpart F income and tested income.

An exception applies where the opportunity of a double tax benefit is not available. The occurs in any of the following three circumstances:

- Another U.S. Shareholder takes additional Subpart F income or tested income into account as a result of the changes in ownership.
- The C.F.C.’s taxable year ends.
- The controlling Code §245A shareholder elects to close the taxable year of the C.F.C. the dividend, which means that Subpart F or tested income will be taken into account by the seller at a favorable rate under the effect of Code §250.

Where an election is made to close the year of the C.F.C., the election statement must contain the following information:

- It must identify the extraordinary reduction transactions and E&P attributable to the shares of stock within the meaning of Code §1248.
- It must state that each controlling Code §245A shareholder and each U.S. tax resident have entered into a written binding agreement to close the tax year.
- It must provide certain other details identified in the Temporary Regulations.

Comments at a D.C. Bar conference earlier this year suggested the I.R.S. may remove the election because it gives taxpayers too good of an answer.[19] As this rule is implicated by almost every M&A transaction, U.S. Shareholders who sell shares in a C.F.C. prior to the date the Temporary Regulations are finalized may wish to close their transactions on an expedited basis in order to take advantage of the election.

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[19] See Emily L. Foster, “Changes Coming to Dividends Received Deduction Regs Election,” Tax Notes (Jan. 24, 2020). The charge is that the election results in taxing tested income or Subpart F at a 10.5% rate instead of the 21% rate that would otherwise apply under Code §1248 (assuming the D.R.D. is not applicable to reduce it to 0%).

Based on news reports, the Temporary Regulations clearly have affected some taxpayers. One public company, Qualcomm, announced a $2.5 billion charge to income tax expense in its Q3 2019 financials.[20]

FOREIGN-TO-FOREIGN DISTRIBUTIONS

The Temporary Regulations reflect the view that the D.R.D. is not applicable to "foreign-to-foreign" distributions, *i.e.*, distributions by a lower-tier 10%-owned foreign corporation to an upper-tier C.F.C. not involving any domestic U.S. recipient. Remember, but for two exceptions in Code §954(c), such dividends generate Subpart F Income inclusions for the U.S. Shareholders of the recipient C.F.C. Without any recognition of Conference Committee Report language suggesting a foreign corporation might claim the D.R.D.[21] or the N.Y.S.B.A. Report's suggestion of permitting a D.R.D. in foreign-to-foreign distributions,[22] the Temporary Regulations take the approach that Code §§954(c)(3)(A)(i) (related party dividends from a related corporation formed in the same jurisdiction and having a substantial part of its assets located in that jurisdiction) and 954(c)(6) (look-through rule for dividends paid from active E&P)) are good enough protection for C.F.C.'s and their U.S. Shareholders. However, the Preamble to T.D. 9866,[23] relating to G.I.L.T.I and foreign tax credits, suggests that the Code §245A D.R.D. for foreign-to-foreign dividends remained open.

"The Temporary Regulations reflect the view that the D.R.D. is not applicable to 'foreign-to-foreign' distributions. . ."

CODE §956 — INVESTMENTS IN U.S. PROPERTY

Under special rules introduced last year, U.S. corporations that are U.S. Shareholders are no longer subject to inclusions under Code §956. This provision backstops the general anti-deferral rule of Subpart F by treating an "investment in U.S. property" as a dividend. The special rules are intended to achieve symmetry with the Code §245A D.R.D. provisions. Under these rules, Code §956 is inapplicable whenever a Code §245A shareholder would be entitled to a D.R.D. had a dividend been paid rather than the controlled foreign corporation engaged in a transaction that constitutes an investment in U.S. property.

CONCLUSION

Cerberus is a dog with at least 3 heads. Similarly, the Temporary Regulations have at least three heads, which respectively focus on the following tasks:

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[20] See Emily Foster, "ABA Section of Taxation Meeting: Dividends Received Deduction Rules Could Come in Discrete Pieces," Tax Notes (Feb. 10, 2020).

[21] This despite a "domestic corporation" being described as the relevant claimant in Code §245A(a). See Conference Committee Report at 599, n. 1486.

[22] See N.Y.S.B.A. Report, at 20. N.Y.S.B.A. suggests Code §245A(g) provided ample authority to extend the D.R.D. to foreign-to-foreign distributions, and also requests that guidance be issued on this — which the Temporary Regulations did, albeit indirectly, by not providing anything in this regard.

[23] I.R.B. 2019-29 (July 15, 2019), Guidance Related to Section 951A (Global Intangible Low-Taxed Income) and Certain Guidance Related to Foreign Tax Credits.

- Ensure that in legitimate cases, taxpayers benefit from the D.R.D. to repatriate cash free of further U.S. tax.
- Prevent erosion of U.S. taxing jurisdiction through transactions that remove income from U.S. tax in ways not contemplated by Congress and deemed to be abusive under a double nontaxation concept.
- Provide anti-abuse rules for Code §954(c)(6)'s "look-thru" exception, including by refusing to extend the Code §245A D.R.D. to a fact pattern involving a foreign-to-foreign dividend payment.

As the I.R.S. may soon remove the closing of the year election, taxpayers who wish to take advantage of that feature of the Temporary Regulations should do so. Based on the I.R.S. 2019-2020 Priority Guidance Plan and recent comments at D.C. Bar conference, finalized regulations may be just around the corner. Updates might address certain issues that practitioners have requested more clarity on, such as

- whether foreign-to-foreign distributions would be eligible for a D.R.D.;
- whether an S.F.C. can be owned through a partnership (it would appear so), and whether the holding period is tested at the partner or partnership level; and
- whether the D.R.D. can apply to nimble dividends, which would make sense.[24]

While the Temporary Regulations are in some ways a blunt instrument to protect the anti-deferral regimes of Subpart F and G.I.L.T.I., their Cerberus-like effect cannot be denied. They shut down some important loopholes that likely were flogged by investment banks and large accounting firms. In addition, they emphasize the rather limited scope of the D.R.D. under Code § 245A. The D.R.D. can be claimed in only two limited circumstances. The first is a 10% U.S. shareholder of an operating company that is not a C.F.C. and not a P.F.I.C. In these fact patterns the anti-abuse rules provided by the Temporary Regulations generally will not be relevant. The second is the ordinary return realized by a C.F.C. on its Q.B.A.I., which is not taxed on a current basis under the G.I.L.T.I. rules.

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[24] Other practitioners have noted interaction with consolidated return provisions can lead to harvesting of non-economic losses. See Emily Foster, "ABA Section of Taxation Meeting: Dividends Received Deduction Rules Could Come in Discrete Pieces," Tax Notes (Feb. 10, 2020).

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