Initial impressions: Final regulations under section 951A (GILTI) and certain guidance related to foreign tax credits, as well as new proposed regulations under sections 951A and 958 (rules for determining stock ownership)

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Introduction

The U.S. Treasury Department and IRS ("Treasury") on Friday, June 14, 2019, released for publication in the Federal Register final regulations (T.D. 9866) and proposed regulations (REG-101828-19) (the "final rules" and "proposed rules," respectively) relating to global intangible low-taxed income ("GILTI"), as well as certain final rules relating to the foreign tax credit ("FTC") and the section 965(n) election.

Read the **final regulations** [PDF 1,304 KB] (318 pages) and **proposed regulations** [PDF 431 KB] (74 pages) as filed with the Federal Register.

This report provides initial impressions and observations about these final and proposed rules.

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Background

The 2017 U.S. tax law (Pub. L. No. 115-97, enacted December 22, 2017)—the law that is often referred to as the "Tax Cuts and Jobs Act" (TCJA)—generally retained the existing subpart F regime that applies to passive income and related-party sales and services, and created a new type of inclusion for GILTI, which is based on a broad class of controlled foreign corporation ("CFC") income.

Similar to a subpart F inclusion, "U.S. Shareholders" of CFCs include GILTI in income on an annual basis. U.S. corporations may be entitled under section 250 to a deduction of up to 50% of their GILTI inclusion and related section 78 gross-up. Unlike a subpart F inclusion, a U.S. Shareholder calculates a single GILTI inclusion, based on all of its CFCs. In general, GILTI is the excess of a U.S. Shareholder's "net tested income" (that is, the excess of the aggregate of its CFCs' tested income over its CFCs' tested losses), over its "net deemed tangible income return" ("net DTIR"), which is a deemed return on the CFCs' tangible assets (10% of qualified business asset investment or "QBAI") reduced by the CFCs' "specified interest expense").

On September 13, 2018, Treasury released GILTI proposed regulations (the "2018 proposed regulations"), which provided guidance on both the shareholder-level computations and the CFC-level computations required for determining a U.S. Shareholder's GILTI inclusion. In particular, the 2018 proposed regulations provided guidance with respect to, among other items: (1) the pro rata share rules in Reg. §1.951-1(e), which affect both subpart F and GILTI inclusion calculations; (2) the computation of GILTI in the case of consolidated groups; (3) the determination of the tested income or tested loss of a CFC; and (4) the determination of a U.S. Shareholder's QBAI and specified interest expense. For a more detailed discussion of the 2018 proposed regulations, read ***TaxNewsFlash***.

Proposed GILTI high-tax exception

Although the 2018 proposed regulations contained needed guidance on several aspects of the GILTI regime, absent from the proposed rules was any general exception from GILTI for high-taxed income. The statute expressly excludes from a CFC's tested income the CFC's high-tax income that is excluded from subpart F "by reason of section 954(b)(4)"—namely foreign base company income ("FBCI") and insurance income that is subject to an effective tax rate greater than 90% of the U.S. corporate tax rate. Given legislative history promising that "at foreign tax rates greater than or equal to 13.125 percent, there is no residual U.S. tax owed on GILTI," taxpayers and practitioners were surprised that the statute contained no general exception from GILTI for high-taxed income. The 2018 proposed regulations, similarly, offered no generalized high-tax exception from GILTI. To the contrary, the 2018 GILTI proposed regulations clarified that the GILTI high-tax exclusion applied only to income that is excluded from FBCI and insurance income **solely** by reason of an election made to exclude the income under the high-tax exception of section 954(b)(4) and Reg. §1.954-1(d)(5). Significantly, this rule was finalized without change. See Reg. §1.951A-2(c)(1)(iii).

Numerous comments on the 2018 proposed regulations had advocated for a broad high-tax exception from GILTI. Rather than including such an exception in the final rules, Treasury included the exception in the proposed rules. Thus, these rules—when finalized—would permit taxpayers to elect to exclude additional items (beyond FBCI and insurance income) from gross tested income under a new GILTI high-tax exclusion.

Building on the statute's exception for income excluded from subpart F income by reason of section 954(b)(4), the proposed rules provide an election to exclude all items of a CFC's gross income that are subject to an effective rate of foreign income tax greater than 18.9% (i.e., 90% of the U.S. corporate tax rate, currently 21%), without regard to whether the income would otherwise be FBCI or insurance income ("GILTI high-tax exception"). In explaining the statutory authority for the new rule, the preamble notes that there is nothing in section 954(b)(4) that explicitly restricts its application to income that "first qualifies as FBCI or insurance income," and therefore "any item of gross income, including an item that would otherwise be gross tested income, could be excluded from FBCI or insurance income 'by reason of' section 954(b)(4) if the provision is one of the reasons for such exclusion, even if . . . not the sole reason."

The proposed regulations would provide a taxpayer with a single, all-or-nothing election:

- **Income tested at the qualified business unit ("QBU") level.** The proposed rules provide that the determination of whether income is eligible for the election is made on a QBU-by-QBU basis, rather than at the CFC-level or by evaluating individual items of income. More specifically, the determination is made separately with respect to all of the income that otherwise would be gross tested income (but for the application of the election) that falls within a single section 904 category and that is attributable to a single QBU. See Prop. Reg. § 1.951A-2(c)(6)(ii)(A)(1). For purposes of determining the QBU's foreign effective tax rate, the FTC rules would apply to determine the taxes allocated and apportioned to the QBU's income.

KPMG observation

A QBU is defined by reference to section 989(a) and the regulations under that section. Under that standard, a CFC, partnership or trust is a per se QBU, as well as any separate trade or business for which a separate set of books and records is maintained. Interestingly, the proposed rules do not incorporate the modifications to that standard that were included in the proposed foreign tax credit regulations' definition of a foreign branch, including the modification providing that activities that relate to disregarded transactions are taken into account in determining if a disregarded entity meets the general requirement under the section 989(a) regulations that, to constitute a trade or business, the activities must ordinarily include the collection of income and the payment of expenses. This seems significant, as it potentially allows CFCs with disregarded entities that earn only disregarded income to avoid having separate QBUs and therefore to blend some high- and low-tax income in determining whether the GILTI high-tax exception is met.

- **Attribution of income to QBUs.** Once it is established that there is a QBU, the proposed rules attribute gross income to the QBU that is properly reflected on the books and records of the QBU. Although such gross income must generally be determined under federal income tax principles, the income of the QBU is then adjusted for any disregarded payments among the CFC and QBUs owned by the same CFC-owner under the principles of Prop. Reg. § 1.904-4(f)(2)(vi), without applying the exclusion in Prop. Reg. §1.904-4(f)(2)(vi)(C)(1) for interest and interest equivalents paid by the QBU. For example, a CFC that owns a disregarded entity that qualifies as a QBU may have disregarded income that is paid by the disregarded entity to the CFC, which would have to be tested as an item of gross income attributable to the CFC itself (which is a per se QBU) rather than with respect to the disregarded entity.

- **Election applies to all commonly controlled CFCs.** An election applies to all commonly controlled CFCs that meet the effective tax rate test. CFCs are commonly controlled if the voting power in each

CFC is more than 50% owned (under section 958(a)) by the same controlling domestic shareholder or by the same controlling shareholders who own the same percentage of stock in each CFC.

KPMG observation

Despite the rigid requirement to apply the proposed GILTI high-tax exception consistently to all qualifying QBUs, the proposed rules do not appear to require consistency between the high-tax elections for GILTI and subpart F. Instead, taxpayers appear to continue to be permitted to make separate elections with respect to each category of subpart F income listed in Reg. § 1.954-1(c)(1)(iii)(A)(2), such as foreign base company sales income or foreign base company services income, such that, if the CFC's subpart F income in a particular category is taxed at greater than 21%, a taxpayer could decline to elect the high-tax exception for that income in order to cross credit the excess taxes against other general basket income.

- **No FTCs and QBAI.** The preamble clarifies that deemed paid FTCs would not be allowed for any foreign taxes allocated and apportioned to income excluded from tested income by reason of the proposed GILTI high-tax exclusion, as such taxes would not be properly attributable to tested income. Additionally, the preamble notes that property used to produce income excluded under the GILTI high-tax exception would not be taken into account for QBAI.

KPMG observation

The determination of effective tax rates on a QBU-by-QBU basis means that a low-taxed QBU would not qualify for the GILTI high-tax exception even if the CFC's overall foreign effective tax rate exceeds 18.9%. In addition, the requirement for the exclusion to apply to all qualifying income of all commonly controlled CFCs will prevent picking and choosing the extent to which the exception applies. A taxpayer with CFCs that have a mix of high-taxed and low-taxed income will need to evaluate the benefit of eliminating any tax under section 951A with respect to high-taxed tested income with the costs of forgoing the use of such taxes against other low-taxed tested income and the use of the related tangible assets in the computation of QBAI.

- **Applicability:** The new GILTI high-tax exception is proposed to apply to tax years of CFCs that **begin** on or after the date that **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.

KPMG observation

Contrary to what taxpayers were hoping, the proposed GILTI high-tax exception **cannot** be relied upon prior to finalization because the GILTI final regulations do not include the exception, and the proposed rules do not include any language permitting taxpayers to rely on them pending their finalization. Moreover, taxpayers would not seem to be able to avail themselves of the IRS administrative practice of not taking positions contrary to proposed regulations because that administrative practice only applies when there are no contrary final regulations on point. The election, therefore, remains unavailable for the 2018 tax year as well as any tax year that begins before the final regulations are published, which includes the 2019 calendar year.

In contrast to the inflexible nature of the terms of the election itself, the proposed procedures for making the election are somewhat more flexible:

- **Who makes the election:** A CFC's controlling domestic shareholder would make the election for a CFC's inclusion year by attaching a statement to an original or **amended** return in accordance with administrative pronouncements, or in accordance with rules provided in forms or instructions. The election is binding on all of the CFC's U.S. Shareholders.

- **Revocation:** Once an election is made for a CFC, all high-taxed income of the CFC is excluded from tested income for the year the election is made and all subsequent CFC inclusion years, unless the election is revoked by the controlling domestic shareholder. An initial election can be revoked for any CFC inclusion year, generally in the same manner as prescribed for making an election, which presumably would include on an amended return. Upon revocation, however, a new election cannot be made for five years after the close of the tax year for which the election was revoked, and, if a new election is later made, that subsequent election cannot be revoked for five years. The Commissioner may allow an exception from this rule if there is a change of control of the CFC.

Domestic partnerships: Final Rules for GILTI inclusions and proposed rules for subpart F and section 956 inclusions

The final rules adopt an aggregate approach to domestic partnerships for purposes of determining a partner's GILTI inclusion with respect to a CFC owned by a domestic partnership and any provision that applies by reference to the GILTI inclusion (such as the rules on previously taxed earnings and profits ("PTEP") and basis). For these purposes, a domestic partnership is not treated as owning stock of a foreign corporation within the meaning of section 958(a). Instead, a domestic partnership is treated in the same manner as a foreign partnership for purposes of determining the persons that own stock of a CFC under section 958(a).

The effect of this rule is that a domestic partnership cannot have a GILTI inclusion amount (because it does not own stock of the foreign corporation under section 958(a)) and, therefore, the partners in the partnership will not have a distributive share of any GILTI inclusion. Rather, partners in a domestic partnership are treated as owning proportionately the stock of a CFC owned by the partnership, and a partner that is a U.S. Shareholder with respect to the CFC determines its pro rata share of the tested items of the CFC (e.g., tested income, tested loss, QBAI).

The proposed regulations would extend (on a prospective basis) this aggregate treatment of domestic partnerships for purposes of determining subpart F and section 956 inclusions under section 951.

The aggregate treatment of domestic partnerships under the final and proposed rules generally is limited to determining which persons have a GILTI, subpart F, or section 956 inclusion. The final and proposed rules continue to treat domestic partnerships as entities for purposes of determining whether a foreign corporation is a CFC, whether a U.S. person is a U.S. Shareholder of a CFC, and whether a U.S. Shareholder is a controlling domestic shareholder of a CFC for purposes of making certain elections with respect to the CFC.

The final rules declined to follow the hybrid approach to domestic partnerships in the 2018 proposed regulations. The 2018 proposed regulations generally required a domestic partnership that was a U.S. Shareholder of a CFC to determine its GILTI inclusion and the U.S. partners of the domestic partnership that were not themselves U.S. Shareholders of the CFC to take into account their distributive share of the partnership's GILTI inclusion. In contrast, a U.S. partner that was a U.S. Shareholder of the CFC calculated its GILTI inclusion separately taking into account its pro rata share of certain items of the CFC.

The preamble to the final rules explains that the aggregate approach to domestic partnerships aligns better with the purposes of GILTI. In particular, the preamble repeats the concern expressed in the notice of proposed rulemaking that a pure-entity approach would open the door to planning to reduce overall GILTI inclusions by using domestic partnerships to separate CFCs with high-taxed tested income and tested interest expense from CFCs with low-taxed tested income, QBAI, and tested losses, as well as create traps for the unwary by preventing the use, for example, of tested losses to offset tested income. However, the final rules rejected the hybrid approach, which also would have addressed the foregoing concerns, noting significant concerns raised in comments regarding the procedural and computational complexity of the proposed hybrid approach. The preamble to the proposed rules further explains that it would be administratively complex to treat domestic partnerships differently for GILTI and subpart F purposes.

Applicability of final rule for GILTI inclusions. The final rules apply to tax years of foreign corporations beginning after December 31, 2017, and to tax years of U.S. Shareholders in which or with which such tax years of foreign corporations end.

KPMG observation

The retention in the final rules of the retroactive applicability date from the 2018 proposed regulations may create administrative issues for any 2018 tax returns that were filed based on the hybrid approach in the 2018 proposed regulations. The proposed regulations did not explicitly provide that taxpayers could rely on any of the proposed rules. The change in treatment is favorable to domestic partnerships that are widely held, in that the final rules remove the section 951A inclusion from the domestic partnership's taxable income and, thus, partners that are not U.S. Shareholders generally should not recognize GILTI income from a CFC held by the partnership. Partnerships that have already filed their 2018 Forms 1065 may need to consider amending. Failure to amend may further impact prospective allocations, as it creates uncertainty as to basis, capital accounts, and allocations. For partnerships that have issued draft schedules K-1 with GILTI inclusions, the final schedules K-1 should be issued following the approach of the final rules. Note that the change also could potentially affect the allocation of other partnership items when the partners' allocations vary based on levels of taxable income inclusions ("waterfall allocations") if the GILTI inclusions were of a magnitude to move the allocations between allocation tiers.

Applicability of proposed rule for subpart F and section 956 inclusions. The proposed rules generally would apply to tax years of foreign corporations beginning on or after the date final regulations are published in the Federal Register, and to tax years of U.S. persons in which or with which such tax years of foreign corporations end. Pending final regulations, domestic partnerships may rely on the proposed regulations for tax years of CFCs that begin after December 31, 2017, provided the domestic partnership, its partners that are U.S. Shareholders of any CFCs, and other domestic partnerships that are related to the partnership (and their U.S. Shareholder partners) consistently apply the proposed regulations with respect to all CFCs in which the domestic partnership owns stock under section 958(a).

KPMG observation

The aggregate approach to domestic partnerships for subpart F purposes would mark a fundamental change to the subpart F regime. The changes for subpart F purposes, coupled with the aggregate approach to domestic partnerships for GILTI purposes, may significantly impact existing private equity structures and future fund structuring.

KPMG observation

Although partners that own (within the meaning of section 958(a)) less than 10% of a CFC owned through a partnership would not be subject to subpart F under the proposed rules, they may be subject to the passive foreign investment company ("PFIC") rules if the CFC also is a PFIC. The CFC/PFIC overlap rule, which generally prevents the application of both regimes to a U.S. person that owns a foreign corporation that is both a CFC and a PFIC, would not apply to a partner that is not a U.S. Shareholder of the CFC taking into account constructive ownership of the CFC stock. In determining PFIC status, the PFIC asset test would need to be applied based on the adjusted basis of the CFC's assets, unless the CFC is publicly traded.

KPMG observation

A domestic partnership presumably would continue to be treated as a U.S. person for purposes of section 956. As a result, for example, a loan from a CFC to a related domestic partnership would be U.S. property for section 956 purposes.

GILTI final regulations

Modifications to the pro rata share rules

The final rules retained the general approach, with several modifications, of the pro rata share rules included in the 2018 proposed regulations.

- **Facts and circumstances approach.** The 2018 proposed regulations adopted a facts and circumstances approach to allocating current E&P in a hypothetical distribution between multiple classes of stock, including stock with discretionary distribution rights, rather than the fair market value method contained in the existing regulations. Although comments suggested that this facts and circumstances approach was vague and subjective, Treasury ultimately adopted the approach, noting that it believed it to be a more reliable method for determining a U.S. Shareholder's pro rata share.

- **Double benefit.** The preamble to the final rules notes that some taxpayers were taking the position that a dividend received by a person other than the U.S. Shareholder reduced both the U.S.

Shareholder's pro rata share of subpart F income **and** tested income by the full amount of the dividend. In order to prevent this inappropriate double benefit, the final rules clarify that the U.S. Shareholder's aggregate pro rata share of subpart F and tested income is reduced by the amount of any dividend received by a person other than the U.S. Shareholder, on a pro rata basis.

- **Pro rata share anti-abuse rule**. The 2018 proposed regulations would have disregarded any transaction with a principal purpose of avoiding federal income tax for purposes of determining a U.S. Shareholder's pro rata share of a CFC's subpart F income and tested items for GILTI purposes. Several comments asserted that this anti-abuse rule was overbroad, noting that it potentially could cause a U.S. Shareholder that disposed of its interest in a CFC to indefinitely include its pro rata share of tested items with respect to the CFC. In response, Treasury modified the rule to require adjustments only to the allocation of allocable earnings and profits that would be distributed with respect to outstanding shares on the hypothetical distribution date. Thus, under the final rule, adjustments will only be made to shareholders that actually own stock on the hypothetical distribution date. This should prevent indefinite income inclusions by a selling U.S. Shareholder.

  Although Treasury accepted some comments on the pro rata share anti-abuse rule, it rejected requests to limit the anti-abuse rule to transactions that lack economic substance or involve non-economic allocations, stating that these types of transactions are already policed by general tax principles and the facts and circumstance approach of the pro rata share rule. Treasury also declined to provide an exception to the rule for transactions between unrelated parties or involving small businesses.

KPMG observation

The clarification that the pro-rata share anti-abuse rule is focused on shareholders owning stock at the end of the year is a welcome refinement. It is, however, notable that taxpayers disposing of shares mid-year and receiving dividends with respect to those shares may now find themselves losing the benefit of section 245A with respect to those dividends under the temporary section 245A regulations issued on the same day as the GILTI package.

Tested income and tested loss

The 2018 proposed regulations generally determined tested income and tested loss by reference to the existing section 952 regulations, which generally treat a CFC as a domestic corporation for purposes of determining gross income and taxable income for subpart F purposes. The final rules do not contain any additional guidance on the application of the section 952 regulations to compute tested income and tested loss. Treasury intends to provide additional guidance in a future guidance project.

KPMG observation

The preamble notes that future guidance is expected to clarify that a CFC is not allowed any deduction expressly applicable only to domestic corporations, such as a section 250 deduction. The preamble also states that Treasury continues to study whether, and to what extent, a CFC should be allowed a dividends received deduction under section 245A, which by its plain language applies only to domestic corporations.

De minimis and full inclusion rules. Under the statute, gross tested income excludes any gross income "taken into account" in determining subpart F income. The final rules adopt comments suggesting that the foreign base company "de minimis" and "full inclusion" rules be taken into account for this purpose. Accordingly, the final rules clarify that income excluded from FBCI under the de minimis rule and full inclusion amounts excluded from FBCI under the high-tax exception are included in gross tested income, while income included in FBCI under the full inclusion rule is excluded from gross tested income.

Section 952 recapture amounts. The final rules maintain the proposed rule providing that the earnings and profits limitation in subpart F is not taken into account in determining the amount of subpart F income excluded from gross tested income, and that amounts included in subpart F income under the subpart F recapture rule also are included in gross tested income. Treasury rejected a comment asking for an exception for recaptured amounts that relate to income earned in pre-TCJA years.

Section 367(d). The final rules "clarify" that section 367(d) deemed payments are treated as an allowable deduction for purposes of determining tested income and tested loss. This is consistent with the rule in the section 367(d) regulations allowing a similar deduction for purposes of determining subpart F income.

Section 961(c) basis. One concern not addressed in the 2018 proposed regulations was whether section 961(c) basis (which applies only for purposes of section 951) is taken into account for purposes of determining tested income from the disposition of stock in a lower-tier CFC by an upper-tier CFC. The final rules continue to defer this issue, promising that guidance will be included in the forthcoming PTEP guidance.

KPMG observation

The preamble makes clear that Treasury is sympathetic to the issues raised by the lack of clarity on section 961(c) basis. However, the preamble notes that taking into account section 961(c) basis could inappropriately reduce the amount of stock gain subject to tax, because the sale could create E&P (since section 961(c) basis is not taken into account for E&P purposes), potentially making any gain eligible for a section 245A dividends received deduction ("DRD"). The preamble specifically requests comments on this issue.

Tested income and tested loss anti-abuse rule

The 2018 proposed regulations contained an anti-abuse rule that, for purposes of determining tested income or tested loss, generally disregarded deductions or loss attributable to "disqualified basis." Disqualified basis generally is basis created in a transfer of tangible or intangible property to a related person between January 1, 2018, and the beginning of a fiscal CFC's first tax year to which GILTI applies (the "disqualified period"), to the extent the gain was not subject to U.S. tax as a result of the transfer.

Commenters questioned Treasury's authority to issue the proposed anti-abuse rule. In response, the final rules include a revised formulation of the rule "that better reflects the source of [Treasury's] authority." Rather than disqualify the deduction or loss, the final rules generally provide that a deduction or loss attributable to disqualified basis is not "properly allocable" to gross tested income, subpart F income or effectively connected income ("ECI") of the CFC.

Helpfully, the final rules clarify that disqualified basis is not disregarded for purposes of determining income or gain on the disposition of the underlying property. The final rules include several other significant changes:

- **Expanded scope:** In contrast to the proposed rule, the final rule provides that the resulting depreciation and amortization deductions also cannot reduce a CFC's subpart F income or ECI. In the preamble, Treasury noted that this change was intended to prevent a taxpayer from circumventing the proposed rule by converting gross tested income into subpart F income in order to use the deductions.

- **Related-party sales:** A sale of property with disqualified basis generally will result in the elimination of the disqualified basis. To prevent abuse, the final rules provide that a transfer of property with disqualified basis to a related person generally will not reduce the disqualified basis in the hands of the transferee.

- **Election to eliminate disqualified basis:** A disqualified transfer could also have resulted in a covered asset acquisition under section 901(m). A comment noted that, although the deductions attributable to the disqualified basis are not taken into account for purposes of determining tested income or tested loss, those deductions could be taken into account for purposes of section 901(m), resulting in the disallowance of foreign tax credits. In response to this comment, the regulations permit taxpayers to make an election pursuant to which the adjusted basis in property is reduced by the amount of disqualified basis for all purposes of the Code. As a result, such basis would not be taken into account for purposes of the computations required under section 901(m).

QBAI

In general, a CFC's QBAI is equal to its aggregate average adjusted basis in tangible property used to produce tested income ("specified tangible property"). For this purpose, the adjusted basis of specified tangible property is determined using the alternative depreciation system ("ADS") in section 168(g). Consistent with the statute and the 2018 proposed regulations, the final rules provide that a CFC with a tested loss cannot have QBAI because a tested loss CFC's property is not used in the production of tested income.

The final rules include several modifications to the 2018 proposed regulations:

- **Exclusion from tangible property:** The 2018 proposed regulations defined "tangible property" by reference to sections 167 and 168, which technically could include certain intangible property described in section 168(k). The final rules modify the definition of "tangible property" to explicitly exclude section 168(k) intangible property, namely, computer software, qualified film productions, and qualified live theatrical productions.

- **Determination of adjusted basis – elective transition rule:** CFCs generally are required to use ADS in calculating their income for subpart F and GILTI purposes as well as E&P. Nonetheless, CFCs generally do not need to use ADS if there is no material difference between ADS and their book method. Under the final rules, CFCs that were not otherwise required to use (and did not use) ADS for income or E&P purposes can elect to use their non-ADS depreciation method to determine the adjusted basis of property that was placed in service prior to the CFC's first tax year that begins after December 22, 2017 ("pre-GILTI year") for QBAI purposes.

KPMG observation

Unfortunately, this new rule is limited to property placed in service during a pre-GILTI year. CFCs will need to compute depreciation under the ADS rules for all other specified tangible property, even if the CFC is not required to use ADS for income or E&P purposes. In addition, the preamble notes that this transition rule does not apply for purposes of determining the foreign-derived intangible income ("FDII") of a domestic corporation.

- **Accounting method considerations:** The preamble clarifies that the use of ADS for the determination of adjusted basis for QBAI purposes is not a method of accounting. As a result, a CFC does not need consent to begin using ADS to determine the adjusted basis of property for this purpose. On the other hand, a change to ADS from another depreciation method for purposes of computing tested income is a change in method of accounting subject to section 446(e). As described in the preamble, Treasury expects many CFCs not currently using ADS for income and E&P purposes to change their method of accounting to ADS, and anticipates that many changes already could be made automatically under existing procedures in Rev. Proc. 2015-13. Moreover, the preamble states that the IRS intends to publish a new revenue procedure to further expand the availability of automatic consent for depreciation changes.

- **Revised methodology for dual use property:** Property that is used in the production of both tested income and non-tested income is included in QBAI in the same proportion as gross tested income to total gross income produced with respect to the property (the "dual use ratio"). To apply the dual use ratio, the proposed rules included a "directly identifiable" standard to determine whether property produced gross tested income. The final regulations replace the "directly identifiable" standard with a rule that determines the dual use ratio based on the amount of depreciation allocated and apportioned to gross tested income under section 861 principles.

- **FDII:** The FDII proposed regulations contain a number of QBAI rules that are similar to the QBAI rules for GILTI purposes. Although the final QBAI rules apply only for GILTI purposes, the preamble notes that Treasury intends to make similar revisions for FDII purposes.

QBAI anti-abuse rules

The final rules revise, and in some cases narrow, the two QBAI anti-abuse rules in the 2018 proposed regulations.

- **Temporary ownership anti-abuse rule:** Under the 2018 proposed regulations, property held temporarily by a CFC generally was disregarded for QBAI purposes if the property was acquired with a principal purpose of reducing a GILTI inclusion. In addition, property was per se disregarded if it was held by a CFC for less than 12 months. The final rules revise and clarify the rule in a number of ways:

    - **Presumption instead of per se rule:** The 12-month per se rule was revised to be a presumption, which can be rebutted if facts and circumstance establish that the subsequent transfer of property was not contemplated when acquired by the CFC, and that a principal purpose of the acquisition was not to increase QBAI.

- **New 36-month rule:** Property held for more than 36 months is presumed to not be subject to the temporary ownership anti-abuse rule.

- **New safe harbor:** The temporary ownership anti-abuse rule does not apply to transfers of property between tested income CFCs with the same tax years, owned in the same proportion by a U.S. Shareholder.

- **No tacking of holding period:** A CFC's holding period for purposes of applying the temporary ownership anti-abuse rule does not include a tacked holding period under section 1223, because Treasury is equally concerned that taxpayers could artificially increase QBAI through the temporary transfer of specified tangible property in nonrecognition transactions.

KPMG observation

The revision of the 12-month rule from a per se rule to a rebuttable presumption is a welcomed change, although the need to establish the lack of intent to dispose of the property when acquired may unduly narrow the application of the rule. It is potentially burdensome that the final regulations do not include an "ordinary course" exception for property that is routinely transferred among CFCs.

- **Disqualified basis anti-abuse rule**: The 2018 proposed regulations included a QBAI anti-abuse rule for disqualified basis transactions, which was similar to the anti-abuse rule that applied for tested income purposes. Under this rule, the adjusted basis of QBAI was determined without regard to "disqualified basis," which generally is basis created as the result of a transfer of tangible property by a fiscal year CFC during its disqualified period, to the extent the gain was not subject to U.S. tax. The final rules retain the disqualified basis anti-abuse rule, with certain revisions, including the election discussed above to eliminate the disqualified basis for all purposes of the Code.

KPMG observation

The final rules retain the disqualified basis anti-abuse rule as a per se rule. As a result, taxpayers will need to carefully review any CFC-to-CFC transactions that were executed during the disqualified period to determine the extent to which the final rule is applicable for purposes of determining QBAI.

Tested interest expense and tested interest income

Computation of specified interest expense

Under the statute, net DTIR is reduced by interest expense that reduces tested income or increases tested loss, to the extent the related interest income is not taken into account in determining the U.S. Shareholder's net CFC tested income. The 2018 proposed regulations adopted a favorable netting approach for determining the relevant interest expense (the "specified interest expense"). Under this approach, which is retained in the final rules, specified interest expense is the excess of a U.S.

Shareholder's aggregate tested interest expense with respect to each of its CFCs over its aggregate pro rata share of tested interest income of each CFC.

KPMG observation

The methodology allows U.S. Shareholders to reduce their tested interest expense by all tested interest income, without having to "trace" the interest expense, or exclude unrelated party interest income.

The final rules made several significant changes to the scope of specified interest expense:

- **Definition of interest expense and interest income:** Consistent with the 2018 proposed regulations, the final rules provide that tested interest expense is interest expense that is allocated and apportioned to gross tested income. The final rules revise the definition of "interest expense" and "interest income" to cross-reference the corresponding definitions under section 163(j), in order to reduce administrative complexity from having separate definitions of the terms for purposes of the two provisions.

KPMG observation

The section 163(j) proposed regulations provide a broad definition of interest, which would include amounts that would be interest under general tax principles, but also items that would not otherwise be treated as interest for U.S. federal income tax purposes. Application of this broad definition may increase specified interest expense, and result in greater reductions to a U.S. Shareholder's net DTIR. To the extent the section 163(j) final regulations revise the definition of interest expense, the definition will be similarly revised for GILTI purposes as a result of the cross-reference in the final rules.

- **Interest expense of a tested loss CFC:** Consistent with the 2018 proposed regulations, tested interest expense includes interest paid or accrued by a tested loss CFC even though a tested loss CFC does not have QBAI. Although Treasury rejected comments asking for the interest expense of a tested loss CFC to be excluded from specified interest expense, the final rules do add a new rule that allows a tested loss CFC to reduce its interest expense by an amount equal to 10% of its QBAI, calculated as if the CFC were a tested income CFC.

- **Special rules for active finance and insurance CFCs:** The 2018 proposed regulations included special rules for determining the specified interest expense of CFCs that earn income that is excluded from foreign personal holding company income under the section 954(c) exception for certain dealers in securities, the section 954(h) active finance exception, or the section 954(i) insurance exception. The final rules retain these special rules, with certain changes. Although taxpayers can choose to not apply these special rules for determining tested interest expense, the rules must be applied in determining tested interest income.

Basis of tested loss CFCs

In order to prevent the double use of deductions, the 2018 proposed regulations provided for downward adjustments to the basis in stock of tested loss CFCs to the extent the tested loss is used to offset tested income of another CFC. Under this proposed rule, a suspense account is created with respect to the stock of a tested loss CFC to the extent the tested loss offsets tested income of another CFC. Special rules allow for recapture of the suspense account when the same CFC's tested income is offset by tested loss of another CFC and for the tiering (but non-duplication) of the suspense account.

The basis adjustment rule was not finalized. Instead, revised rules for basis adjustments will be considered in a separate guidance project, and any rules will apply only with respect to tested losses incurred in tax years of CFCs that end **after** the date of publication of any future guidance.

Consolidated return rules

The consolidated return rules in the 2018 proposed regulations adopted an aggregation approach to GILTI, whereby consolidated group members' GILTI items (such as tested loss and QBAI) were aggregated and then allocated to members in proportion to their share of the group's tested income. In general, this had the effect of allowing tested losses or QBAI attributable to CFCs owned by one consolidated group member to offset tested income attributable to CFCs owned by another member of the group. The 2018 proposed regulations stopped short, however, of mandating that all GILTI computations occur as if members of a consolidated group were a single U.S. Shareholder.

In spite of comments requesting different approaches for determining a consolidated group member's GILTI inclusion, the final rules generally adopt the aggregation approach from the 2018 proposed regulations without substantial changes.

As noted above, the rules related to basis adjustments for tested loss CFCs have been reserved. Similarly, special basis rules related to tested loss CFCs applicable to consolidated groups in the 2018 proposed regulations are not included in the final rules, and instead will be considered in a separate project. Any future rules will apply only to tax years of U.S. Shareholders that are members of a consolidated group after the publication of the final rules. The final rules also do not finalize certain related provisions of the 2018 proposed regulations that would have treated a member as receiving tax-exempt income immediately before another member recognizes income, gain, deduction, or loss with respect to a share of the first member's stock. The preamble to the final rules explains that Treasury has become aware of fundamental flaws in the adjustment, and that taxpayers may not rely on the adjustment from the 2018 proposed regulations.

Foreign tax credit and section 965(n) final regulations

On December 7, 2018, Treasury published proposed regulations providing guidance relating to the determination of foreign tax credits ("FTCs") (the "FTC proposed regulations"). Read ***TaxNewsFlash*** [PDF 1 MB] for KPMG's report that examines the FTC proposed regulations.

The final rules finalize several rules that were included in the FTC proposed regulations, including rules relating to the section 965(n) election.

Denial of 245A DRD for a section 78 gross-up. Prior to amendment by Pub. L. No. 155-97, section 78 provided that taxes deemed paid by a domestic corporation that elects to take FTCs were treated as a dividend received by the corporation (a "section 78 gross-up") for all purposes of the Code, except with respect to section 245. The 2017 tax law amended section 78 to extend this exclusion for purposes of the new section 245A DRD as well, albeit with an inconsistent effective date. Specifically, the amended statutory definition in section 78 is effective for tax years of foreign corporations beginning after December 31, 2017, and for tax years of U.S. Shareholders in which or with which such tax years end. The section 245A DRD, however, applies to qualifying distributions made after December 31, 2017. Thus, under the Code, a section 78 gross-up from a 10% owned foreign corporation with a fiscal year ending in 2018 may qualify for a section 245A DRD.

Nonetheless, the final rules finalize the rule in the FTC proposed regulations providing that a section 78 gross-up is not treated as a dividend for purposes of section 245A, effective for section 78 gross-ups received after December 31, 2017.

KPMG observation

Taxpayers may have taken the position on their tax returns and in their financial statements that section 78 gross-ups received after December 31, 2017, from fiscal year foreign corporations qualified for the section 245A DRD notwithstanding the FTC proposed regulations. These taxpayers must consider the immediate effects on their financial statements, and also whether the retroactive change is required to be reflected on an amended return. The section 78 gross-up dividend would have been part of most affected companies' section 965 net tax liability, and thus presents an ongoing issue if the eight-year installment election was made. Affected taxpayers can be expected to weigh the merits of challenging the validly of the final rule, and in doing so must consider Treasury's assertion of broad authority in the preamble to promulgate the regulation and set its applicability date.

Effect of section 965(n) election. The final rules also adopt, with some modification, the part of the proposed FTC regulations (Prop. Reg. § 1.965-7(e)(1)) addressing the interaction between the section 965(n) election and the section 904 limitation. Under section 965(n), a taxpayer may elect to exclude the amount of section 965(a) inclusions (reduced by section 965(c) deductions) and associated section 78 dividends in determining the amount of the net operating loss carryover or carryback that is deductible in the tax year of the inclusions. Under the finalized rule, taxpayers making a section 965(n) election are prevented from "walling off" the net section 965 inclusion from the allocation and apportionment of expenses for section 904 limitation purposes. Instead, taxpayers are required to treat the net operating loss ("NOL") that is not absorbed because of the section 965(n) election (defined as the "deferred amount") as being composed of a proportionate amount of deductions in each of the respective limitation categories (including deductions allocated to U.S. source income). As a result, any electing taxpayer with expenses allocated or apportioned to foreign source income would have to treat those expenses as partially absorbed against the net section 965 inclusion for FTC limitation purposes.

KPMG observation

Treasury presumably felt the need to accelerate the finalization of this rule before June 22, 2019, so that it could apply immediately and retroactively to taxpayers' section 965 inclusion years, given the delay in finalizing the proposed FTC regulations. Affected taxpayers will now have to consider the effect of the retroactive rule, including on whether to amend their previously filed return and on their ongoing section 965(h) installment payments, if applicable.

Importantly, the proposed regulation provided that the deferred amount was not considered to include any portion of the taxpayer's section 965(c) deduction for the year. The final rules generally retain the approach of Prop. Reg. § 1.965-7(e)(1), but in response to comments, the final rules provide that the deferred amount includes a ratable portion of all of the taxpayer's deductions for the year, including the deduction allowed under section 965(c). The inclusion of the taxpayer's section 965(c) deduction in the ratable portion of deductions included in the deferred amount will result in a larger portion of the deferred amount being treated as comprised of deductions allocated and apportioned to the same baskets as the section 965(a) inclusion (most likely foreign general) than would have been the case under the FTC proposed regulations. For electing taxpayers that had a current year NOL in the section 965 inclusion year, this change should increase the taxpayer's FTC limitation relative to the result that the FTC proposed regulations would have provided.

The final rules allow taxpayers to revoke a section 965(n) election that was filed prior to the publication date of the final rules (expected to be June 21, 2019). The revocation is made by attaching to the taxpayer's amended return for the year of the election a statement that indicates that the taxpayer revokes the section 965(n) election, which is signed under penalties of perjury and includes the taxpayer's name and taxpayer identification number. If the section 965(n) election was due prior to February 5, 2019 (the publication date of the section 965 final regulations), the taxpayer must file the amended return with the statement revoking the section 965(n) election by the due date (including extensions) for the return for the tax year following the election year. Otherwise, taxpayers have until the due date (including extensions) for the return for the election year to file the amended return and revocation statement.

KPMG observation

Taxpayers (particularly those that applied the "wall-off" approach) may have an increased section 965 net tax liability as a result of the final rule. However, these taxpayers may not have made a timely section 965(h) election to pay any section 965 net tax liability in installments because, absent the foregoing change, such taxpayers may have determined that FTCs eliminated the liability or the liability was small enough to pay as a single installment. Comments requested that taxpayers that made a section 965(n) election be treated as though they also had made a timely section 965(h) election to allow such taxpayers to pay in installments any section 965 net tax liability resulting from the application of the final regulations. This comment was not adopted, and the final rules also did not adopt a transition rule that would allow taxpayers that made a section 965(n) election additional time to make a section 965(h) election. Taxpayers in this situation must now weigh the competing considerations of the potential cash tax outlay from the changed rules against the effect on their tax attributes if they revoke the section 965(n) election.

Adjustments to tax book value of E&P deficit foreign corporations. Absent a special rule, the application of section 965 and the regulations thereunder would cause an uneconomic increase in the tax book value of the stock of a specified foreign corporation ("SFC") for purposes of expense apportionment when a deficit of one SFC was used to offset the untaxed earnings of another SFC. This is because section 965(b)(4)(B) creates a net increase in the aggregate E&P of the two corporations without any change in net asset basis or net stock basis. For example, if a taxpayer did not make a basis adjustment election under Reg. § 1.965-2(f)(2) (a "965 basis adjustment election"), the basis in the stock of a taxpayer's E&P deficit foreign corporation would not be reduced and, in any case, such corporation's E&P would be increased to the extent that the corporation's specified deficit was utilized to offset deferred foreign income. As a result, the tax book value of the corporation's stock (which generally is reduced by deficits) would be higher even though, economically, the entity's value has not changed. If a section 965 basis adjustment election was made, the tax book value of the stock of an E&P deficit foreign corporation may not be distorted because such election would cause a reduction in the basis of the corporation's stock equal to the increase in its E&P; however, the corresponding basis increase in the stock of a deferred foreign income corporation could cause that corporation's tax book value to instead be distorted.

To correct for these uneconomic effects and solely for purposes of valuing the stock of a 10% owned foreign corporation for expense apportionment purposes, the FTC proposed regulations would have treated the taxpayer as having made a section 965 basis adjustment election even if it had not done so. However, any increase in the basis of the stock that results from the election (or deemed election) would have been excluded for expense apportionment purposes. On February 5, 2019, the section 965 regulations were finalized and included a new "limited basis adjustment" election. This election was intended to minimize the gain recognized by taxpayers making the section 965 basis adjustment election. Taxpayers were, however, unsure of how to apply the special tax book value adjustment rule in the FTC proposed regulations as a result of the addition of the section 965 limited basis election.

The final rules reverse course from the proposed FTC regulations and provide a different approach to this issue. First, taxpayers determine the adjusted basis of a 10% owned corporation for expense apportionment purposes as if they did not make the basis election (limited or full). Taxpayers must then reduce the unadjusted basis of a 10% owned corporation by the amount of any reduction required as a result of the application of the full (i.e., not limited) section 965 basis adjustment election and without netting the reduction against any corresponding increases in basis required as a result of making the basis election (limited or otherwise). The amount of this reduction would equal the amount of a taxpayer's pro rata share of the section 965 specified deficit taken into account as a result of its ownership of the stock of the 10% owned corporation. This adjustment may reduce the basis of such stock below zero for purposes of determining the basis of the stock for expense apportionment purposes, but only if the value of the stock after adjustment for the "E&P bump" is not below zero. If the value of the stock would be less than zero after the addition of the "E&P bump", then the final rules provide that the value of the stock for expense allocation purposes is zero for the year.

Applicability dates and reliance

The final rules generally adopt the applicability dates of the 2018 proposed regulations, without significant modification. The provisions of the final rules related to the application of GILTI to consolidated groups, however, apply to tax years of members of a consolidated group for which the due date (without extensions) of the consolidated return is after the date on which the final regulations are published (expected to be June 21, 2019). A consolidated group may apply the provisions in their entirety to all of its members for tax years of foreign corporations beginning after December 31, 2017, and to tax years of U.S. Shareholders in which or with which such tax years of foreign corporations end.

The GILTI high-tax exception is proposed to apply to tax years that begin on or after the final regulations adopting the exception are published. As a result, the GILTI high-tax election in the proposed regulations will not be available until after the proposed rules are finalized, and may not be relied on in the interim period.

The domestic partnership rule for purposes of subpart F and section 956 is proposed to apply to tax years that begin on or after final regulations adopting the rule are published. Domestic partnerships may rely on the proposed rule for CFC tax years that begin after December 31, 2017, provided the domestic partnership, U.S. Shareholder partners, and certain related parties consistently apply the proposed rule to all CFCs in which they own stock under section 958(a).

Contact us

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

Barbara Rasch
T: +1 213 533 3382
E: brasch@kpmg.com

Jeff Farrell
T: +1 202 533 3020
E: jefffarrell@kpmg.com

Danielle Rolfes
T: +1 202 533 3378
E: drolfes@kpmg.com

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

Michael Plowgian
T: +1 202 533 5006
E: mplowgian@kpmg.com

Kristen Gamboa
T: +1 202 533 4146
E: kgamboa@kpmg.com

Josh Kaplan
T: +1 202 533 4087
E: jskaplan@kpmg.com

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

Chris Riccardi
T: +1 404 222 7187
E: criccardi@kpmg.com

Teisha Ruggiero
T: +1 212 954 2120
E: truggiero@kpmg.com

kpmg.com/socialmedia

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