New CFC Rules Too Narrow To Fix Tax Overhaul Misfire

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The U.S. Department of the Treasury and the Internal Revenue Service recently released proposed regulations and a revenue procedure relating to the repeal of Section 958(b)(4) of the Internal Revenue Code (Code)[1] by the Tax Cuts and Jobs Act.[2]

Background

For purposes of determining, among other things, whether a U.S. person was a "United States shareholder" of a foreign corporation and whether a foreign corporation was a controlled foreign corporation, or CFC, IRC Section 958(b)(4) had prohibited the downward attribution of stock held by a foreign person to a U.S. entity in which that foreign person held an ownership interest.[3]

The repeal of this prohibition resulted in a dramatic expansion in the number of foreign corporations that are treated as CFCs and had many knock-on effects throughout the Internal Revenue Code due to exceptions, limitations and other special rules applicable only to CFCs. One particularly noteworthy effect was the expansion of foreign entities and U.S. shareholders subject to the TCJA's new global intangible low-taxed income, or GILTI, rules.

Key Observations

Certain language in the legislative history of the TCJA indicated that the repeal was targeted at a very specific form of decontrol transaction undertaken by related parties and thus was intended to have a far more narrow scope than a literal reading of the code now provides. However, the proposed regulations do not seize upon that language to narrow the scope of the repeal to those transactions. Rather, the proposed regulations merely update the Section 958 regulations to reflect the repeal and revise the application of various CFC-based rules throughout the code where there are explicit grants of regulatory authority to do so.

The changes indicate that Treasury and the IRS believe they do not have sufficient regulatory authority to limit the impact of Section 958(b)(4) repeal in a more holistic way. Some of the changes in the proposed regulations are taxpayer favorable, while others are not. Notably, no relief is provided to U.S. persons from the required phantom income inclusions under the subpart F income rules and GILTI rules resulting from the repeal.

The revenue procedure provides limited relief from the difficulties taxpayers now face in gathering the necessary information to comply with the greatly (and suddenly) expanded reach of the CFC rules.

The guidance provides certain safe harbors whereby taxpayers may be considered compliant with certain CFC-related tax obligations notwithstanding their limited access to reliable information regarding foreign corporations in which they may be minority investors.

Proposed Regulations

Specific Proposed Changes to Limit Downward Attribution

The specific changes to the regulations proposed to be made are as follows:

- Section 267: Provide that certain payments to foreign related persons eligible for treaty benefits may be deductible when accrued notwithstanding that the foreign related person is a CFC, provided that it has no Section 958(a) U.S. shareholders.

- Section 332: Deny exchange treatment to a foreign corporation that receives distributions in complete liquidation of certain domestic holding companies if the foreign corporation is a CFC solely because of the repeal of Section 958(b)(4) (foreign-controlled CFC), resulting in such distributions being governed by Section 301 and thus potentially taxable as dividends in whole or in part.[4]

- Section 367: Expand events that trigger the recognition of gain under the gain recognition agreement rules by providing that Section 958(b) is to be applied without regard to the repeal of Section 958(b)(4).

- Section 672: Limit the application of certain grantor trust rules to trusts owned by foreign corporations that are CFCs without regard to downward attribution from foreign persons (U.S.-controlled CFCs).

- Section 706: In determining a partnership's tax year, disregard partners that are CFCs with no Section 958(a) U.S. shareholders.[5]

- Section 863: Limit application of the special CFC sourcing rules for space and ocean income and international communications income to U.S.-controlled CFCs.

- Section 904: Limit the application of the affiliated group rules in the Section 904 active rents and royalties exception and financial services income rules, and certain CFC look-through rules, to U.S.-controlled CFCs.

- Section 1297: Provide that the asset test for passive foreign investment company status does not need to be determined by reference to the adjusted basis

(rather than value) of assets for a non-publicly traded foreign corporation that is a foreign-controlled CFC.

- Section 6049: Reduce the scope of foreign corporations subject to IRS Form 1099 reporting requirements and backup withholding rules by narrowing the definition of "U.S. payor" to include only U.S.-controlled CFCs.

Effective Date

The final regulations are generally proposed to apply on or after Oct. 1. However, a taxpayer may generally apply the rules set forth in the final regulations to the last taxable year of a foreign corporation beginning before Jan. 1, 2018, and each subsequent taxable year of the foreign corporation, and to taxable years of U.S. shareholders in which or with which such taxable years of the foreign corporation end, provided that the taxpayer and U.S. persons that are related — within the meaning of Section 267 or 707[6] — to the taxpayer consistently apply the relevant rule with respect to all foreign corporations.

A taxpayer may rely on the proposed regulations with respect to any period before the date that they are published as final regulations.

Revenue Procedure 2019-40

Treasury and the IRS acknowledged that U.S. persons may have phantom income inclusions under the subpart F income and GILTI rules, and reporting requirements, with respect to foreign-controlled CFCs, even though the U.S. person may have limited ability to determine whether such foreign corporations are CFCs and to obtain the information necessary to accurately determine such amounts and comply with such reporting requirements.

To address these issues, Revenue Procedure 2019-40 provides certain safe harbors whereby a taxpayer may be treated as having complied with such tax obligations (and relieved of penalties) despite having incomplete information. Importantly, however, these safe harbors apply only with respect to foreign-controlled CFCs, even though some of the same issues can arise with respect to U.S.-controlled CFCs.

Safe Harbor for Determining CFC Status

The IRS will accept a U.S. person's determination that a foreign corporation does not meet the ownership requirements to be a CFC if (i) the U.S. person does not have actual knowledge, statements received and/or reliable publicly available information sufficient for the U.S. person to determine that the ownership requirements are met and (ii) if the U.S. person directly owns equity in a foreign entity (top-tier entity), the U.S. person inquires of the top-tier entity whether it meets the ownership requirements and whether, how and to what extent the top-tier entity directly or indirectly owns equity in other foreign corporations or domestic entities.

The guidance clarifies that a U.S. shareholder may rely on the safe harbor without having to affirmatively ask any unrelated foreign shareholders in the foreign corporation whether they own any interests in U.S. entities to which their stock may be attributed for purposes of determining whether the foreign corporation is a CFC.

Safe Harbor for Using Alternative Information

If information necessary to accurately calculate subpart F income and GILTI inclusions (but not Section 965 transition tax amounts) with respect to a CFC is not readily available and there is no Section 958(a) U.S. shareholder that is related to the CFC, an unrelated Section 958(a) U.S. shareholder generally may determine its inclusion amounts using alternative information.

For this purpose, "alternative information" generally means readily available separate-entity financial statements, with certain adjustments. In determining which readily available financial statements may be used, the Revenue Procedure provides a set of ordering rules that generally prefers financial statements prepared under U.S. generally accepted accounting principals, or GAAP, over those prepared under international financial reporting standards, or IFRS; those prepared under IFRS over those prepared under local-country GAAP; audited financial statements over unaudited financial statements; and only if no better information is available would it permit use of records used for other tax reporting, regulatory or internal management purposes.

Alternative information may also be used to comply with Form 5471 reporting requirements of U.S. shareholders with respect to any unrelated foreign-controlled CFCs that do not have related Section 958(a) U.S. shareholders. Alternative information may not, however, be used for purposes of claiming indirect foreign tax credits.

Safe Harbor for Section 965 Transition Tax Amounts

Similarly, if information necessary to accurately calculate Section 965 transition tax amounts with respect to a specified foreign corporation, or SFC, is not readily available and the SFC is neither a foreign-controlled CFC with respect to which there is a related Section 958(a) U.S. shareholder nor a U.S.-controlled CFC, an unrelated Section 958(a) U.S. shareholder generally may determine its transition tax amounts (but not any indirect foreign tax credits) using alternative information.

However, the safe harbor only applies to amounts reported on a return both due and filed before Oct. 1, or a return both due and filed after Oct. 1.

Accordingly, taxpayers with returns due after Oct. 1 who filed early, on or before Oct. 1 are not able to take advantage of the safe harbor. Nor are those with returns due before Oct. 1 who file late, after Oct. 1. Alternative information may also be used to comply with Form 5471 reporting requirements of U.S. shareholders with respect to any SFC that is neither a foreign-controlled CFC with respect to which there is a related Section 958(a) U.S. shareholder nor a U.S.-controlled CFC.

Other Form 5471 Filing Relief

The IRS also stated in the Revenue Procedure that it intends to narrow the Form 5471 filing obligations for "Category 5 filers" (i.e., U.S. shareholders who directly, indirectly or constructively owned stock of the CFC on the last day in the year on which it was a CFC) in certain circumstances.

Specifically, fewer of the form's schedules will need to be required by a Category 5 filer if either (i) the filer is a Section 958(a) U.S. shareholder and is not related to the foreign-controlled CFC or (ii) the filer is not a Section 958(a) U.S. shareholder but is related to the

foreign-controlled CFC.

A Category 5 filer that is not a Section 958(a) U.S. shareholder and not related to the foreign- controlled CFC will not be required to file the form.

Applicability Dates

Taxpayers generally may apply the provisions in the revenue procedure with respect to the last taxable year of a foreign corporation beginning before Jan. 1, 2018, each subsequent taxable year of such foreign corporation and the taxable years of U.S. shareholders in which or with which such taxable years of such foreign corporation end.

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[1] IRC Section 958(b)(4).

[2] 115 P.L. 97.

[3] A "Section 958(a) U.S. shareholder" is a U.S. shareholder that owns at least some stock of the CFC directly or indirectly through foreign entities (i.e., not solely constructively).

[4] IRC Section 301.

[5] IRC Section 958(a).

[6] IRC Section 267, IRC Section 707.