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KPMG report: Initial impressions of temporary regulations under section 245A; denial of dividends received deduction for certain dividends from current or former CFCs

The U.S. Treasury Department and IRS (collectively, “Treasury”) on Friday, June 14, 2019, released long-promised temporary regulations that claw back into the U.S. tax net certain earnings of controlled foreign corporations (“CFC”) that otherwise would have escaped U.S. taxation under a literal application of the 2017 tax law (Pub. L. No. 115-97)—the law that is often referred to as the “Tax Cuts and Jobs Act” (TCJA).

In particular, the temporary regulations limit the application of the new section 245A dividends received deduction in the case of dividend income recognized by corporate U.S. shareholders as a result of certain transactions with respect to CFCs and, somewhat unexpectedly, limit the application of the section 954(c)(6) “look-thru” exception to subpart F income in the case of dividends received by a CFC that are attributable to earnings resulting from certain lower-tier transactions. The temporary regulations are limited in scope to these issues and do not provide general guidance under section 245A. The preamble to the temporary regulations (“Preamble”) notes that additional regulations will be issued at a later date to address other issues raised by section 245A, including specifically the treatment of partnerships under section 245A and whether and to what extent section 245A applies to foreign corporations.

Read the text of the [temporary regulations](#) [PDF 335 KB] (27 pages) as published in the Federal Register on June 18, 2019.

This report provides initial impressions and observations about these temporary regulations.

Read a [printable version](#) [PDF 1.3 MB] of this report: *Initial impressions of temporary regulations under section 245A; denial of dividends received deduction for certain dividends from current or former CFCs*

Effective dates

The temporary regulations apply retroactively to distributions occurring after December 31, 2017.

KPMG observation: The Preamble discusses at length the perceived necessity of issuing the regulations in temporary form and with immediate retroactive effect. Treasury's primary concern in this regard was to limit the opportunity for taxpayers to engage in the transactions perceived by the Treasury as abusive while proposed regulations were outstanding for notice and comment.

Background

New section 245A allows a corporate U.S. shareholder a 100% dividends received deduction (the "section 245A DRD") with respect to the foreign source portion of a dividend received from a specified 10% owned foreign corporation ("SFC") provided certain requirements are met (e.g., the holding period in section 246(c) and that the dividend is not a "hybrid dividend" as defined in section 245A(e)). Section 954(c)(6) was enacted prior to the TCJA and generally excludes from a CFC's subpart F income, dividends, interest, rents, and royalties received from a related CFC. Interestingly, section 954(c)(6) is slated to expire for CFC tax years beginning after December 31, 2019.

The temporary regulations were issued to limit the application of sections 245A and 954(c)(6) in the case of transactions resulting in U.S. tax consequences that Treasury viewed as inconsistent with the statutory framework of the international tax provisions following the enactment of the TCJA.

KPMG observation: One surprising item in the Preamble was Treasury's discussion of the treatment of dividends received by a CFC that were not otherwise eligible for the exclusion in section 954(c)(6) and were included in the gross income of the CFC as subpart F income. Based on a footnote in the legislative history, which the Preamble cites, many taxpayers believed that such dividends could be eligible for the section 245A DRD. In addition, the IRS issued a private letter ruling a decade ago (PLR 200952031) that allowed a dividends received deduction under section 243 for purposes of computing a CFC's subpart F income. The Preamble, however, states that this issue is under consideration and also indicates that future guidance will "clarify" that the rules in Reg. section 1.952-2, which treat a CFC as a domestic corporation for purposes of determining its taxable income, do not apply with respect to any Code provision that is expressly limited in its application to domestic corporations. This future guidance may address provisions, such as section 1059, whose application to CFCs in post-TCJA years is currently unclear.

Non-application of section 245A to CFC-to-U.S. dividends

Overview

The temporary regulations disallow the section 245A DRD to the extent of the "ineligible amount" of a dividend paid by an SFC to its U.S. shareholder (referred to in the temporary regulations as a section 245A shareholder). The ineligible amount of a dividend is generally the amount of the dividend that is equal to the sum of: (1) 50% of the "extraordinary disposition amount," and (2) the "extraordinary reduction amount."

KPMG observation: The Preamble indicates that the 50% reduction of the extraordinary disposition amount approximates the deduction the section 245A shareholder would have been allowed had the earnings and profits ("E&P") generated in the extraordinary disposition been subject to either the section 965 or global intangible low-taxed income ("GILTI") regimes. This was a helpful acknowledgement by Treasury that the E&P generated in the extraordinary dispositions would not have been subject to full U.S. taxation had the E&P been recognized either before December 31, 2017, (and subject to section 965) or in a tax year to which the GILTI regime applies.

The Preamble requests comments on whether the buyer-side consequence of disallowed amortization and depreciation deductions for the property transferred in extraordinary dispositions continues to be necessary. [See Reg. section 1.951A-2(c)(5), as finalized by T.D. 9866 and released on the same day as the temporary regulations.] At present, between the two consequences, some taxpayers that engaged in extraordinary dispositions are worse off than if they had implemented the same transaction before or after the “gap period” beginning after December 31, 2017 (the last section 965 transition tax measurement date) and ending before the start of the fiscal-year SFC’s first tax year in which its income was subject to the GILTI regime.

The ineligible amount generally is attributable to the E&P created in two types of transactions that Treasury views as improperly converting subpart F income or tested income into E&P that is eligible for the section 245A DRD.

The first type of transaction involves taxable transfers by fiscal-year SFCs to related parties of built-in gain property during the gap period. These “extraordinary dispositions” created E&P that was not currently subject to U.S. tax under the CFC rules (that is, as subpart F income or GILTI-tested income), but may be repatriated tax-free pursuant to section 245A.

The second type of transaction involves a section 245A shareholder’s mid-year transfer of its SFC stock or a dilution of the section 245A shareholder’s interest in the SFC. This type of transaction could have been effectuated in many forms and could occur in non-tax motivated third-party dispositions, but could also have been undertaken internally for the purpose of obtaining the section 245A benefit. In general, the conversion of current year income from includible subpart F income or GILTI to E&P eligible for the section 245A DRD would have occurred by operation of section 951(a)(2)(B) or section 958(b)(4) repeal. The temporary regulations identify this type of transaction as giving rise to an “extraordinary reduction.”

KPMG observation: Extraordinary reductions often arise from the interaction of section 951(a)(2)(B) and the section 245A DRD. Furthermore, the repeal of section 958(b)(4) means that, in practice, it is far more likely for a CFC to remain a CFC after being transferred to a foreign acquirer. Because section 951(a)(2)(B) is contingent on CFC status continuing after the transfer, the repeal of section 958(b)(4) expands the universe of transactions to which section 951(a)(2)(B) is relevant. The Preamble notes that the historic function of section 951(a)(2)(B) was to prevent double taxation and that this role is significantly less necessary in the post-TCJA landscape, which largely eliminates U.S. tax on dividends from CFCs.

In a similar vein, and consistent with the current rumors that Treasury has struggled to identify the authority and means by which it could pare back the consequences of section 958(b)(4) repeal, the Preamble is silent as to any future section 958(b)(4)-related guidance.

Extraordinary dispositions

The temporary regulations define the “extraordinary disposition amount,” of which half is made ineligible for the section 245A DRD, through a series of defined terms.

An “extraordinary disposition amount” is the portion of a dividend from an SFC to its section 245A shareholder that is paid out of the SFC’s “extraordinary disposition account.” Notably, because the subpart F income inclusion arising from a first-tier CFC’s sale of a lower-tier CFC stock under new section 964(e)(4) is treated as a dividend for section 245A purposes, the temporary regulations may also apply to treat a portion of this amount as an extraordinary disposition amount.

A section 245A shareholder must track its “extraordinary disposition accounts” with respect to each of its SFCs. The balance of this account is generally (1) increased by the section 245A shareholder’s ownership percentage (by value) of the stock of the SFC multiplied by the E&P of the SFC attributable to the net gain recognized by the SFC with respect to the extraordinary disposition (referred to as the

“extraordinary disposition E&P”), and (2) decreased by prior dividends paid from the extraordinary disposition account (referred to as a “prior extraordinary disposition amount”).

KPMG observation: The concept of the extraordinary disposition account adds yet another layer of complexity to an already labyrinthine set of rules for determining the treatment of distributions from foreign corporations.

In determining whether the dividend is paid out of an extraordinary disposition account, the temporary regulations provide a helpful ordering rule—dividends are treated as paid out of non-extraordinary disposition E&P before being sourced from the section 245A shareholder’s extraordinary disposition account. For this purpose, non-extraordinary disposition E&P are generally the section 245A shareholder’s share of the section 959(c)(3) E&P (i.e., non-taxed E&P) with respect to the SFC in excess of the amount of the section 245A shareholder’s extraordinary disposition account with respect to the SFC.

KPMG observation: Interestingly, this appears to be one of the few (possibly only) taxpayer-favorable provisions in the temporary regulations. Treasury noted in the Preamble that the purpose of the ordering rule is to prevent the lock-out of foreign earnings from the United States. The result here should be contrasted with the proposed section 245A(e) regulations’ “hybrid deduction account” rules, which treat distributions as coming first from the hybrid deduction account until the account is exhausted.

An “extraordinary disposition” is a transaction pursuant to which an SFC (1) transfers “specified property” (which includes all property other than property the gain with respect to which would not be treated as tested income), (2) to a related person, (3) outside of the ordinary course of its business, and (4) during the “disqualified period” (i.e., the gap period, noted above).

The determination of whether a transaction is outside the ordinary course of an SFC’s business generally is determined based on the facts and circumstances specific to the SFC. The temporary regulations also include a per se rule that treats a transaction as occurring outside of the SFC’s ordinary course of business if (1) the transaction was undertaken with a principal purpose of increasing the SFC’s E&P during the gap period or (2) the transaction involves a transfer of intangible property, as defined in section 367(d)(4).

KPMG observation: The Preamble notes that the reason for the per se rule with respect to intangible property is that the disposition of intangible property is not an ordinary course transaction (that is, in comparison to a related-party sale involving raw materials used in manufacturing) and that taxpayers had a strong incentive to dispose of intangible property taking into account the low basis that a taxpayer generally has in its intangible property. Given this articulation of what the government views as ordinary course, it is unclear what transactions other than routine sales of inventory were intended to be treated as in the ordinary course.

The temporary regulations include a de minimis exception to the extraordinary disposition rules if the net gain recognized by the SFC from all transactions that would otherwise be extraordinary dispositions does not exceed the lesser of \$50 million or 5% of the value of the SFC’s assets immediately prior to the beginning of the disqualified period.

KPMG observation: Given that transactions of immaterial value would not typically be outside the ordinary course of business, this de minimis rule seems likely to have the most relevance to smaller transfers of intellectual property rights between CFCs during the disqualified period.

The E&P generated in an extraordinary disposition are defined as “extraordinary disposition E&P.” A section 245A shareholder’s extraordinary disposition account with respect to its first-tier SFCs is increased by the section 245A shareholder’s share of the extraordinary disposition E&P of the SFC and reduced by the sum of (1) prior dividends that were treated as extraordinary disposition amounts, and

(2) dividends that would have otherwise been associated with extraordinary dispositions but are subject to U.S. tax under section 245A(e) because they are “hybrid dividends” under that provision. In addition, a section 245A shareholder’s extraordinary disposition account with respect to its lower-tier CFCs is reduced by (1) 200% of amounts attributable to subpart F inclusions related to lower-tier CFC distributions that are not eligible for section 954(c)(6) under the temporary regulations (defined as “tiered extraordinary dispositions” and discussed below), and (2) dividends that would have otherwise been associated with tiered extraordinary dispositions but are subject to U.S. tax under section 245A(e) because they are “hybrid dividends” under that provision.

Finally, the temporary regulations provide “successor” rules to help ensure that a section 245A shareholder’s extraordinary disposition account is not reduced or eliminated through the following transactions: (1) a section 245A shareholder’s transfer of SFC stock, (2) a section 381 transaction in which the assets of an SFC are transferred to an acquiring foreign corporation, (3) a section 355 distribution involving the SFC, and (4) a CFC’s sale of the stock of a lower-tier SFC with respect to which the section 245A shareholder has an extraordinary disposition account.

Extraordinary reduction

The temporary regulations also disallow a controlling section 245A shareholder the section 245A DRD with respect to a distribution from a CFC to the extent it constitutes an “extraordinary reduction amount.” A “controlling section 245A shareholder” is a section 245A shareholder that owns more than 50% of the CFC (by vote or value), taking into account CFC ownership of related persons. Like the rules regarding extraordinary dispositions, the temporary regulations define “extraordinary reduction amount” through a series of defined terms.

An “extraordinary reduction amount” generally is, with respect to a dividend paid by a CFC in a post-2017 tax year in which an extraordinary reduction occurs, the lesser of: (1) the amount of the dividend, or (2) the pro rata share of subpart F income and tested income the controlling section 245A shareholder would have otherwise included in its gross income if there had been no extraordinary reduction and determined without the application of section 951(a)(2)(B) (defined in the temporary regulations as the “pre-reduction pro rata share”). A controlling section 245A shareholder’s pre-reduction pro rata share is reduced by an amount equal to the sum of the amounts by which other U.S. shareholders’ pro rata share of the subpart F income or tested income of the CFC is increased as a result of the extraordinary reduction. The temporary regulations include a de minimis rule that provides that no amount is considered an extraordinary reduction amount if the controlling section 245A shareholder’s subpart F income and tested income for the tax year does not exceed the lesser of \$50 million or 5% of the CFC’s total income for the year.

An “extraordinary reduction” occurs in two circumstances, which respectively key off of whether the shareholder’s ownership is decreased through a disposition or dilution.

- The disposition rule is triggered if a controlling section 245A shareholder transfers an amount of its CFC stock that is greater than 10% (by value) of such stock as of the beginning of the tax year of the CFC as long as such amount is at least 5% of the total value of the CFC as of the beginning of the tax year of the CFC.
- The dilution rule is triggered if a controlling section 245A shareholder’s ownership (by value) after the relevant transaction is reduced, pursuant to a plan, to less than 90% of the ownership percentage on either (1) the day of the controlling section 245A shareholder’s highest percentage owned (directly or indirectly) in the CFC during the tax year, or (2) the day immediately before the first day on which stock was transferred in the preceding tax year in a transaction occurring pursuant to a plan to reduce the percentage of stock (by value) of the CFC that the controlling section 245A shareholder owns (directly or indirectly).

In both cases the “initial percentage” and the percentage at the end of the year must be at least five (5) percentage points apart.

Notably, the temporary regulations do not apply to a transfer that would otherwise be an extraordinary reduction if the CFC's tax year closes as a result of the transfer while such CFC is held by the controlling section 245A shareholder (e.g., a tax-free liquidation governed by section 332). In such cases, the controlling section 245A shareholder would be required to include in its gross income its subpart F income and tested income with respect to the CFC, with the result that there is no avoidance of subpart F income or GILTI.

For similar reasons, the temporary regulations include an election that may be made by all of a CFC's controlling section 245A shareholders pursuant to which each controlling section 245A shareholder avoids the application of the extraordinary reduction rules by having the CFC close its tax year on the date of the extraordinary reduction. This "year closing election" causes the controlling section 245A shareholder to include in its income its pro rata share of the CFC's subpart F income and tested income as of the date of the extraordinary reduction. In the case of tested income, this election may allow corporate U.S. shareholders to take advantage of the section 250 deduction.

A controlling section 245A shareholder makes this election by filing a statement with its U.S. federal income tax return for the year in which the transfer occurs. If the transfer for which the controlling section 245A shareholder desires to make the election occurs prior to the date the temporary regulations are published in the Federal Register, the controlling section 245A shareholder can attach the election statement to its original or amended U.S. federal income tax return in the year of the transfer. If multiple extraordinary reductions occur during a tax year, the election must be made consistently for all such extraordinary reductions to the extent they occur pursuant to a plan or series of related transactions.

If the year closing election is made, foreign tax credits are allocated between the two U.S. tax years under the same rules that apply upon section 338(g) elections.

Non-application of section 954(c)(6) to CFC-to-CFC dividends

In addition to the rules limiting the application of the section 245A DRD, the temporary regulations include rules that limit the applicability of the section 954(c)(6) look-thru exception to subpart F income with respect to certain CFC-to-CFC dividends that constitute a "tiered extraordinary disposition amount" or "tiered extraordinary reduction amount."

KPMG observation: Treasury indicated in the Preamble that the reason for including these rules is to prevent the inappropriate deferral of income that otherwise would be subpart F income or tested income. Perhaps curiously, the temporary regulations do not appear to limit the application of the same country exception in section 954(c)(3) to CFC-to-CFC dividends attributable to income that would otherwise be subpart F income or tested income.

The temporary regulations' rules regarding section 954(c)(6) build on the general rules relating to extraordinary dispositions and extraordinary reductions and apply similar principles to taint the E&P arising from similar transactions that occur with respect to lower-tier CFCs.

Operating rules and anti-abuse rule

The temporary regulations provide a number of operating rules, including the following:

- **Sourcing rule:** The temporary regulations provide that for purposes of determining the source of a dividend received by a section 245A shareholder, such amount is considered received directly from the foreign corporation whose E&P give rise to the dividend.
- **Coordination rule:** The temporary regulations coordinate the interaction between the extraordinary disposition rules, extraordinary reduction rules, and hybrid dividend rules under

section 245A(e) by prioritizing section 245A(e) over the extraordinary disposition and extraordinary reduction rules, and prioritizing the extraordinary reduction rules (including tiered extraordinary reductions) over the extraordinary disposition rules (including tiered extraordinary dispositions).

- **Ordering rule:** The temporary regulations provide that in the case of multiple dividends received by a section 245A shareholder from an SFC or CFC, the rules in the temporary regulations are applied to such dividends on a first-in-time basis.

The temporary regulations also provide a broad anti-abuse rule that permits the IRS to make “appropriate adjustments to any amounts determined under [the temporary regulations] if a transaction is engaged in with a principal purpose of avoiding the purposes of [the temporary regulations].”

KPMG observation: The broad language of the anti-abuse rule seems contrary to the overall intent to draft narrow and specific rules with respect to a limited class of dividends.

Reporting requirements

The temporary regulations expand the reporting requirements under section 6038(a)(1)(A) through (a)(1)(E) to account for extraordinary dispositions, extraordinary reductions, tiered extraordinary dispositions, and tiered extraordinary reductions. In particular, taxpayers will be required to report the ineligible amounts, tiered extraordinary disposition amounts, and tiered extraordinary reduction amounts.

Because the temporary regulations are retroactive and may apply to transactions relating to a tax year for which a U.S. federal income tax return was already filed, the temporary regulations include a transition rule. When applicable, the transition rule requires section 245A shareholders to report the information required by the temporary regulations on the first return filed following the issuance of the revised forms, instructions, or other guidance with respect to reporting such information.

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