



US Tax Alert

Treasury, IRS release final regs on dividends received deduction and proposed regs coordinating extraordinary disposition and disqualified basis rules

On August 21, 2020, Treasury and the IRS released final regulations under sections 245A and 954 (“the final regulations”) that limit the deduction for certain dividends received by United States persons from foreign corporations under section 245A and the exception to subpart F income under section 954(c)(6) for certain dividends received by controlled foreign corporations. These regulations finalize a package of temporary and proposed regulations issued on June 18, 2019 (“the temporary regulations”) that limit the section 245A deduction and the section 954(c)(6) exception with respect to distributions supported by certain earnings and profits (E&P) that were not subject to tax under section 965 (transition tax), section 951 (subpart F) or section 951A (GILTI). In addition, new proposed regulations were also issued to coordinate the extraordinary disposition rule under section 245A with the disqualified basis rule under section 951A in order to prevent excess taxation due to the application of both limitations. This alert provides a summary of the final and proposed regulations.

Effective dates

Final regulations: In general, the final regulations apply to tax periods ending on or after June 14, 2019. The temporary regulations remain applicable to distributions occurring after December 31, 2017. To coordinate the overlap

between these periods, the final regulations provide that when both the temporary regulations and the final regulations would apply, only the final regulations apply. Finally, a taxpayer may choose to apply the final regulations retroactively provided that the taxpayer and all related parties consistently apply the final regulations in their entirety.

Proposed regulations: The proposed regulations are proposed to apply to taxable years of foreign corporations beginning on or after the date of publication of the Treasury decision adopting the rules as final regulations in the Federal Register (the “finalization date”), and to taxable years of a US person in which or with which such taxable years of foreign corporations end. See proposed § 1.245A-11(a). For taxable years beginning before the finalization date, a taxpayer may apply the rules in the proposed regulations, provided that the taxpayer and all related parties consistently apply the rules to those taxable years. See proposed § 1.245A-11(b); see also section 7805(b)(7).

Final regulations

Authority to issue regulations and effective dates: The preamble to the final regulations discusses the arguments regarding the IRS and Treasury’s authority to issue regulations and the effective date of those regulations, concluding that the effective dates were appropriate and that the temporary and final regulations are necessary and appropriate to ensure the proper application of section 245A and section 954(c)(6) in relation to income inclusions under sections 965, 951 and 951A.

The preamble states Treasury and the IRS plan to take into account comments received regarding the availability of the section 245A dividends received deduction (DRD) at the controlled foreign corporation (CFC) level when issuing future guidance.

Requests for comments for exceptions to extraordinary dispositions: Other than with respect to certain intangible property, the final regulations did not include any exceptions to the definition of an extraordinary disposition.

- Exception to *per se* rule for certain intangible property: In response to comments, the final regulations provide that a disposition of certain types of intangible property defined in section 367(d)(4) is not *per se* treated as an extraordinary disposition if the intangible property is transferred to a related party during the disqualified period with a reasonable expectation that such property would be sold to an unrelated customer within one year of the transfer.
 - However, transfers of intangible property described in section 367(d)(4) (C) or (F), such as trademarks and goodwill, are not eligible.

- In addition, transfers of copyright rights within the meaning of Treas. Reg. § 1.861-18 or intangible property described in section 367(d)(4)(A) that qualify for the exception to the *per se* rule are still subject to a presumption that they occur outside the ordinary course of the transferor specified foreign corporation's (SFC) activities, which can only be rebutted upon a showing that the disposition took place in the ordinary course of the SFC's activities.
- Finally, the preamble makes clear that platform contribution transactions (PCT) between related CFCs are subject to the *per se* rule and thus would be considered an extraordinary disposition (unless they qualified for the limited exception for intangible property described above).
- Tiered extraordinary disposition amounts: The final regulations continue to limit the application of the section 954(c)(6) exception with respect to certain dividends attributable to extraordinary disposition E&P from a lower tier CFC to an upper-tier CFC.
 - In addition, although the **final regulations do not contain any specific rules limiting same-country dividends under section 954(c)(3)**, *the preamble to the final regulations provides that transactions structured to use section 954(c)(3) to avoid the purposes of the final regulations are subject to adjustments under the anti-abuse rule in § 1.245A-5(h) and note that an example in the final regulations illustrates the application of the anti-abuse rule with respect to a transaction involving section 954(c)(3).*

Anti-abuse rule: In response to comments, the final regulations include examples illustrating the anti-abuse rule and also provide that the anti-abuse rule is "self-executing," rather than applicable at the discretion of the Commissioner. The examples illustrate the application of the rule for the prepayment of a royalty, a restructuring transaction, and a related-party loan.

- Extraordinary disposition accounts:
 - Section 245A shareholder's share of the E&P of an SFC: The final regulations revise the rule to measure the section 245A shareholder's share of E&P described in section 959(c)(3) based on the percentage of stock of the SFC that the section 245A shareholder owns immediately before the distribution, *as opposed to immediately after the distribution*. The preamble contains an explanation of the reason for this change.
 - Impact of post-transaction losses on extraordinary disposition accounts: The final regulations, like the temporary regulations, provide that losses do not reduce an extraordinary disposition account if the losses are incurred after the disqualified period.

- Nimble dividends: The preamble notes that the final regulations do not address the impact of a nimble dividend (i.e., current E&P and accumulated E&P deficit) on extraordinary disposition accounts, noting that Treasury and the IRS are studying the extent to which nimble dividends should qualify for the section 245A deduction generally and may address this issue in future guidance under section 245A.
- Coordination with section 956 and other distributions: The final regulations modify the definition of a prior extraordinary disposition amount to take into account certain income inclusions under section 956.
 - In addition, the final regulations add a new type of prior extraordinary disposition amount for prior dividends that would have been subject to Treas. Reg. § 1.245A-5(c) but failed to qualify for the section 245A deduction because they did not satisfy the requirement that the recipient domestic corporation be a United States shareholder with respect to the distributing SFC.
- Successor rules
 - Stand-alone 355s: The final regulations extend the application of the successor rules and provide that a section 245A shareholder's extraordinary disposition account with respect to a distributing SFC is allocated between the distributing SFC and the controlled SFC in any section 355 distribution (that is not preceded by a section 368(a)(1)(D) reorganization) in which the E&P of the distributing SFC are decreased and the E&P of the controlled SFC are increased by reason of Treas. Reg. § 1.312-10.
 - Transactions subject to Treas. Reg. § 1.1248-8: The final regulations provide that in a transaction described in Treas. Reg. § 1.1248-8(a)(1) in which stock of an SFC is transferred to a foreign acquiring corporation in exchange for stock of a foreign corporation, any extraordinary disposition account with respect to the SFC remains with the pre-transaction section 245A shareholder.
 - Triangular reorganizations with domestic parent: The final regulations provide that the domestic corporation whose stock was issued in the triangular reorganization succeeds to the extraordinary disposition account of the section 245A shareholder with respect to the target SFC.

- Rule for related domestic corporations: In order to address a perceived abuse with respect to distributions to related parties, the final regulations provide a rule that treats domestic corporations related under section 267(b) or section 707(b) as a single domestic corporation for purposes of determining the extent to which a dividend is an extraordinary disposition amount or a tiered extraordinary disposition amount.
- Section 338(g) elections: The final regulations clarify that, in connection with an election under section 338(g), a section 245A shareholder of the new target generally does not succeed to an extraordinary disposition account with respect to the old target. However, the final regulations also contain special rules for transactions in which a section 338(g) election is made and not all the stock of the SFC target is subject to the qualified stock purchase.
- No section 245A shareholder: In general, the final regulations provide that an extraordinary reduction account is eliminated if the stock of the SFC is transferred to an unrelated party and, following the transfer, no person is a section 245A shareholder with respect to the SFC. The final regulations also provide that transactions undertaken with a principal purpose to avoid the foregoing limitations on the elimination rule will be disregarded.
- Extraordinary reductions
 - Bilateral election to close the year:
 - Election procedure:
 - The final regulations clarify that each controlling section 245A shareholder participating in the extraordinary reduction with an extraordinary reduction amount greater than zero, and each US tax resident that is a United States shareholder of the CFC at the end of the day of the extraordinary reduction (thus including a person that becomes a United States shareholder of the CFC by reason of the extraordinary reduction), must enter into a binding agreement to close the taxable year of the CFC.
 - The final regulations allow a US tax resident that owns its interest in the CFC through a partnership to delegate the authority to enter into the binding agreement on its behalf provided that the delegation is pursuant to a written partnership agreement.

- Nonrecognition transactions: The final regulations do not contain special rules for extraordinary reductions occurring as a result of section 368 reorganizations or transfers qualifying under section 351 or section 721. The Treasury Department and the IRS continue to study these transactions and their potential to avoid the purposes of the extraordinary reduction rules and request comments.

Proposed regulations

Background: The GILTI regulations provide that qualified business asset investment (QBAI) does not include disqualified basis in property. Furthermore, deductions and losses attributable to disqualified basis are not allocated and apportioned to reduce tested income (or create a tested loss) or subpart F income (or create a qualified deficit). For this purpose, disqualified basis generally means the adjusted basis of property immediately after a disqualified transfer less the basis immediately before said transfer. A disqualified transfer is a transfer of property during a CFC transferor's disqualified period. A CFC transferor's disqualified period is the period beginning on January 1, 2018 and ending as of the close of the CFC's last taxable year beginning before January 1, 2018. Thus, many transfers of property by a CFC during its disqualified period resulted in both disqualified basis and an extraordinary disposition account. The proposed regulations generally are intended to coordinate the two sets of rules.

General explanation: In general, the proposed regulations adopt an approach which requires an adjustment to either:

1. The disqualified basis in certain cases (the "DQB reduction rule"), or
2. An extraordinary disposition account in certain cases (the "EDA reduction rule").

Further, and similar to the section 1248 regulations, the proposed regulations provide two approaches for applying these rules, one for simple cases (Prop. Treas. Reg. § 1.245A-7) and one for complex cases (Prop. Treas. Reg. § 1.245A-8).

- The simple case approach may be applied when two conditions are satisfied, because those conditions eliminate the need for certain additional rules under the version for complex cases. The first condition provides requirements related to the seller SFC with respect to which there is an extraordinary disposition account. The second condition provides requirements related to an item of specified property for which an extraordinary disposition occurred, and the buyer CFC holds the item.

- However, the version of the rules for simple cases is not available if the section 245A shareholder's extraordinary disposition account with respect to an SFC has been adjusted pursuant to the successor rules. In addition, the rules for simple cases are not available for any taxable year for which the conditions to apply the rules for simple cases are not satisfied and for all taxable years thereafter.

Simple case approach:

- **Disqualified basis reduction rule (DQB reduction rule):** The DQB reduction rule provides that when an extraordinary disposition account of a section 245A shareholder gives rise to an extraordinary disposition amount or tiered extraordinary disposition amount, the disqualified bases of certain items of specified property are reduced by the same amount.
 - The amount of the reduction under the DQB reduction rule is allocated pro rata across the disqualified basis of each item of specified property that corresponds to the section 245A shareholder's extraordinary disposition account, based on the item's disqualified basis relative to the aggregate disqualified bases of the items.
 - For purposes of applying the DQB reduction rule for a taxable year of a section 245A shareholder, disqualified basis of an item of specified property is generally determined as of the beginning of the taxable year of the CFC holding the item that includes the date on which the section 245A shareholder's taxable year ends.
- **Extraordinary disposition account rule (EDA reduction rule):** The EDA reduction rule provides that when items of deduction or loss attributable to disqualified basis of an item of specified property are allocated and apportioned to residual CFC gross income of a CFC and have the effect of reducing certain E&P of the CFC that could otherwise potentially qualify for the section 245A deduction when distributed, the extraordinary disposition account to which the specified property corresponds is reduced by up to the same amount.
 - Specifically, the extraordinary disposition account is generally reduced by the lesser of two amounts: (i) the amount by which the E&P for which a section 245A DRD would be available has been reduced and (ii) the balance of the section 245A shareholder's residual gross income account ("RGI account").
 - Computation of the reduction of the amount by which the E&P for which a section 245A DRD would be available: (i) the CFC's E&P at the end of the taxable year are determined, taking into account distributions during the taxable year; (ii) those E&P are adjusted, including by generally increasing the E&P by items of

deduction or loss that are or have been allocated to residual CFC gross income of the CFC solely by reason of the disqualified basis rule (“adjusted earnings”); and (iii) the adjusted earnings are reduced by the sum of the previously taxed earnings and profits accounts with respect to the CFC under section 959 (taking into account any adjustments to the accounts for the taxable year) in order to reflect that an amount equal to such sum would not have been eligible for the section 245A deduction were it distributed by the CFC to the section 245A shareholder and any domestic affiliates.

- **Computation of RGI account:** The balance of the RGI account generally reflects items of deduction or loss allocated and apportioned to residual CFC gross income of the CFC solely by reason of the disqualified basis rule, to the extent that the allocation and apportionment is likely to increase income of the CFC that is subject to US taxation at the level of the section 245A shareholder and any domestic affiliates pursuant to section 951 or 951A.

Complex case approach:

- **DQB reduction rule:** The version of the DQB reduction rule for complex cases uses the same architecture as the version of the rule for simple cases but provides additional rules to address scenarios in which the conditions for application of the rule for simple cases have not been met. The modifications are:
 - **Ownership requirement:** This version of the DQB reduction rule for complex cases provides that an ownership requirement must be satisfied for disqualified basis of an item of specified property to be eligible for relief under the DQB reduction rule. Specifically, this condition to the DQB reduction rule requires that on at least one day that falls within the taxable year of the section 245A shareholder, the item of specified property is held by: (i) a section 245A shareholder, (ii) a person that is for at least one day during such year related to the section 245A shareholder (a qualified related party), or (iii) a specified entity at least 10% of which is owned directly or indirectly by the section 245A shareholder. A specified entity includes a foreign corporation and a partnership.
 - **Basis benefit provisions:** To address concerns about dispositions of disqualified property, the proposed regulations provide that the amount of the reduction to disqualified bases under the DQB reduction rule is equal to the sum of the extraordinary disposition amounts or tiered extraordinary

disposition amounts for the taxable year, less the balance of the section 245A shareholder's "basis benefit account" with respect to the extraordinary disposition account.

- A "basis benefit account" with respect to an extraordinary disposition account generally reflects the extent to which the disqualified basis of one or more items of specified property that correspond to the extraordinary disposition account has been used to offset or reduce income subject to US tax (the use of disqualified basis to such an extent, a "basis benefit amount").
 - **Reduction of ECI:** For this purpose, the use of disqualified basis by a US tax resident to offset or reduce taxable income, or the use of disqualified basis by a foreign person (including a CFC) to offset or reduce income effectively connected with a trade or business in the United States, is always considered to offset or reduce income subject to US tax.
 - **Reduction in subpart F or GILTI:** The use of disqualified basis by a CFC to reduce its categories of positive subpart F income or tested income, or to prevent or decrease an offset to the amount of a CFC's tested loss or qualified deficit.
 - **Adjustments to basis benefit account:** The basis benefit account is adjusted at the end of each taxable year of a section 245A shareholder.
- **Timing rules:** To address the possibility that an item of specified property may be held by a person other than a CFC, the timing rules for purposes of the version of the DQB reduction rule for complex cases provide that disqualified basis of an item of specified property is generally determined and reduced as of the beginning of the taxable year of the "specified property owner" of the item.
- Additional rules apply to address situations in which disqualified basis of an item of specified property gives rise to a deduction or loss that is deferred or disallowed, disqualified basis gives rise to duplicative basis benefit amounts, a person succeeds to a basis benefit account or there is duplicative disqualified basis due to an exchange of property (discussed in greater detail below).
- **EDA reduction rule:** Similar to the DQB reduction rule, the version of the EDA reduction rule for complex cases uses the same architecture

as the version of the rule for simple cases but provides additional rules to address scenarios in which the conditions for application of the rule for simple cases has not been met.

- **Shift in ownership:** The EDA reduction rule for complex cases provides several additional rules for purposes of measuring this reduction to the CFC's capacity to pay dividends eligible for the section 245A deduction, to address the possibility that the section 245A shareholder and any domestic affiliates may not own all of the stock of the CFC (including because the section 245A shareholder or a domestic affiliate disposed of stock of the CFC during the CFC's taxable year), and other issues. In particular:
 - The complex case EDA reduction rule provides an ownership requirement pursuant to which, for the section 245A shareholder's extraordinary disposition account to be reduced by reason of the application of the EDA reduction rule with respect to a taxable year of the CFC, the section 245A shareholder (or a domestic affiliate) must, on the last day of the CFC's taxable year, be a United States shareholder with respect to the CFC.
 - The complex case EDA reduction rule provides special rules for hovering deficits.
 - The complex case EDA reduction rule provides a rule that allocates the CFC's adjusted earnings to the section 245A shareholder, based on the percentage of stock of the CFC that the section 245A shareholder and any domestic affiliates own.
- **Computation of RGI account:** The EDA reduction rule for complex cases provides several additional rules for purposes of computing an increase to a section 245A shareholder's RGI account with respect to a CFC.
 - The rule for complex cases provides that the section 245A shareholder's RGI account can be increased only by items of deduction or loss (to which the disqualified basis rule applies) that are attributable to disqualified basis of an item of specified property that corresponds to the section 245A shareholder's extraordinary disposition account.
 - In cases in which the section 245A shareholder owned less than all of the stock of the SFC when the SFC undertook an extraordinary disposition (such that the extraordinary disposition ownership percentage as to the section 245A shareholder's extraordinary disposition account with respect to the SFC is less than 100%), the section 245A shareholder's RGI account

can be increased by only the same ratable portion of the items of deduction or loss.

- To address the possibility that the section 245A shareholder and any domestic affiliates may not own all of the stock of the CFC holding items of specified property that correspond to an extraordinary disposition account of the section 245A shareholder, a limit applies regarding the extent to which an item of deduction or loss (or portion thereof) may increase the section 245A shareholder's RGI account.
- The proposed regulations provide a rule that limits the aggregate reductions to extraordinary disposition accounts by reason of the application of the EDA reduction rule with respect to a taxable year of a CFC to certain adjusted earnings of the CFC and to prevent an extraordinary disposition account from being reduced below the balance of the basis benefit account that relates to the extraordinary disposition account.
- Additional rules apply to allocate a reduction among multiple extraordinary disposition accounts.
- **Treatment of certain items as attributable to specified property:** In certain complex cases, an item of property may have disqualified basis even though the item itself was not transferred as part of an extraordinary disposition. For example, a share of stock may have disqualified basis if the share was received in exchange for an item of specified property with disqualified basis in a transaction to which section 351 applies.
 - Accordingly, the proposed regulations provide special rules that provide that certain items of property that have disqualified basis by reason of Treas. Reg. § 1.951A-3(h)(2)(ii)(B)(2)(i) increase corresponding to adjustments in other property. In addition, the proposed regulations include an anti-duplication rule.
- **Successor rules:** The proposed regulations provide two sets of rules to address situations in which either: (i) section 245A shareholder succeeds to a portion of the extraordinary disposition account or (ii) a portion of the extraordinary disposition account is attributed to another extraordinary disposition account.

Other items:

- **Coordination with prepayment rule:** The coordination mechanism of the proposed regulations also applies to cases in which a prepayment

during the disqualified period gives rise to extraordinary disposition E&P of an SFC under the anti-avoidance rule and items of deduction or loss of a CFC are allocated and apportioned to residual CFC gross income under the disqualified payment rule.

- **Currency translation rules:** Accounts created under the proposed regulations are maintained in the functional currency of the items to which they relate. In addition, the proposed regulations provide rules addressing the computation and timing of determining the functional currency adjustment to the items required to be maintained under the proposed regulations.
- **Anti-abuse rule:** The proposed regulations contain an anti-avoidance rule providing that appropriate adjustments are made if a transaction or arrangement is engaged in with a principal purpose of avoiding the purposes of the proposed regulations.
- **Revocation of basis elimination election:** The proposed regulations permit taxpayers to revoke a basis elimination election made pursuant to Treas. Reg. § 1.951A-3(h)(2)(ii)(B)(3) within 90 days after the proposed regulations are finalized.

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