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UNINTENDED CONSEQUENCES OF THE REPEAL OF § 958(b)(4) AND PROPOSED SOLUTIONS

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The Tax Cuts and Jobs Act of 2017 repealed § 958(b)(4) (the Repeal), which prevented a U.S. person from constructively owning stock owned by a non-U.S. person in determining if a corporation is a controlled foreign corporation (CFC). After the Repeal, a U.S. corporation owned by a foreign corporation is considered to own stock in a foreign affiliate owned by the foreign parent. Thus, the foreign affiliate can be considered a CFC of the U.S. subsidiary even if the U.S. subsidiary does not own directly or indirectly any shares in the foreign affiliate. These changes caused unintended negative consequences for foreign multinational corporations with U.S. subsidiaries. Even though some measures have been taken to mitigate these consequences, issues remain. This article discusses problems caused by the Repeal that affect foreign corporations with U.S. subsidiaries and proposes solutions.

INTRODUCTION

The repeal of § 958(b)(4) (the Repeal) causes several issues for U.S. subsidiaries of foreign corporations that also own foreign subsidiaries, particularly where U.S. subsidiaries directly or indirectly own minority shares in the foreign subsidiaries. For example, assume a Japanese parent corporation (JPCo) wholly owns a U.S. subsidiary (USCo) and also owns 99 percent of the shares in a Mexican subsidiary (MexCo). The remaining 1 percent of the shares in MexCo are directly owned by USCo (the Example). This article analyzes why and how such a structure is affected by the Repeal. Part I explains how the definition of a controlled foreign corporation (CFC) was changed by the Repeal and the U.S. tax consequences of a

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U.S. shareholder owning stock in a CFC. Part II discusses the purposes and the unintended consequences of the Repeal. Part III describes measures taken to reduce the negative consequences of the Repeal, and Part IV discusses remaining issues. Part V proposes solutions to mitigate the concerns. This article concludes by recommending Congress take action to eliminate the unintended consequences of the Repeal and properly reflect its original intent.

I. CONTROLLED FOREIGN CORPORATIONS

A CFC is a foreign corporation of which more than 50 percent of the total voting power or the total value of the stock is directly, indirectly, or constructively owned by U.S. shareholders.[1] A "U.S. shareholder" is a U.S. person[2] that directly or indirectly owns, or is considered as constructively owning, 10 percent or more of the total combined voting power or the total value of shares of a foreign corporation.[3] The constructive ownership rules under § 318(a) generally apply to treat a U.S. person as a U.S. shareholder and a foreign corporation as a CFC.[4] If 50 percent or more in value of the stock in a corporation is directly or indirectly owned by any person, such corporation is considered as owning the stock directly or indirectly owned by such person.[5] Thus, in the absence of any authority to the contrary, a U.S. subsidiary that is directly or indirectly owned at least 50 percent by a foreign corporation is considered to constructively own shares in any foreign affiliate owned by the foreign parent. Prior to the Tax Cuts and Jobs Act (TCJA) of 2017,[6] § 958(b)(4) prevented such "downward attribution" from a foreign person, by providing that § 318(a)(3) did not apply to consider a U.S. person as owning stock owned by a non-U.S. person.[7]

In the Example, USCo was not considered to own stock in MexCo owned by JPCo before the Repeal. Due to the Repeal, a U.S. subsidiary is now treated as constructively owning stock in a foreign affiliate that is owned by the foreign parent through downward attribution, provided the foreign parent corporation owns directly or indirectly 50 percent or more in value of the stock in the U.S. subsidiary.[8] Accordingly, if the U.S. subsidiary constructively owns more than 50 percent of the total voting power or the total value of the stock of the foreign affiliate, the foreign affiliate is considered a CFC of the U.S. subsidiary. In the Example, MexCo is now a CFC of USCo due to constructive ownership via JPCo, even though USCo directly owns only 1 percent of the shares in MexCo.

A CFC's income may be subject to U.S. taxation under the subpart F provisions or the Global Intangible Low-Taxed Income (GILTI) rules. The subpart

[1] I.R.C. §§ 957(a), 958(a), 958(b).
[2] A "U.S. person" is a citizen or resident of the United States, a domestic partnership, a domestic corporation, and certain estates and trusts. I.R.C. §§ 957(c), 7701(a)(30).
[3] I.R.C. § 951(b).
[4] I.R.C. § 958(b).
[5] I.R.C. § 318(a)(3)(C).
[6] Pub. L. No. 115-97, 131 Stat. 2054 (2017).
[7] I.R.C. § 958(b)(4) (before repeal by Pub. L. No. 115-97, 131 Stat. 2054 (2017)).
[8] I.R.C. § 318(a)(3)(C).

F provisions were enacted by the Revenue Act of 1962[9] to prevent deferral of U.S. taxation on a CFC's income. Under subpart F, certain types of income of a CFC, including income arising from certain transactions with related parties and passive income such as dividends, interest, royalties, and rents, are included in the gross income of the CFC's U.S. shareholders in proportion to their direct or indirect (but not constructive) ownership in the CFC when earned by the CFC.[10] Prior to the TCJA, dividends paid by a foreign corporation to its U.S. shareholders were subject to U.S. tax,[11] unless previously taxed under subpart F. One generally could avoid U.S. tax on non-subpart F earnings of the foreign corporation by not repatriating the income to the United States.

The TCJA changed the rules for dividends received from foreign corporations, such that dividends received by a U.S. shareholder that is a corporation from a foreign corporation are included in the shareholder's gross income but are fully deductible.[12] Concurrently, the TCJA introduced GILTI, under which a U.S. shareholder of a CFC is required to include GILTI in its gross income.[13] GILTI subjects a U.S. shareholder's share of a CFC's overall income to U.S. taxation that corresponds to the U.S. shareholder's direct and indirect ownership in the CFC (but not constructive ownership).[14] Without GILTI, non-subpart F income earned by a foreign corporation generally would never be taxed in the United States to a U.S. shareholder that is a corporation, even if the foreign corporation makes a shareholder distribution.

Notwithstanding the above, if a CFC's income is subject to foreign tax at an effective tax rate greater than 90 percent of the U.S. tax rate (i.e., 90 percent of 21 percent for corporations, or 18.9 percent), the CFC's income can be excluded from U.S. taxation under subpart F and GILTI ("high-tax exceptions").[15]

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[9] Pub. L. No. 87-834, 76 Stat. 960 (1962).
[10] I.R.C. §§ 951(a), 952(a), 954(a), 954(c), 954(d), 954(e).
[11] I.R.C. § 61(a)(7).
[12] I.R.C. § 245A(a).
[13] I.R.C. § 951A(a). GILTI is a U.S. shareholder's net CFC tested income in excess of the shareholder's net deemed tangible income return. I.R.C. § 951A(b)(1). Net CFC tested income is the excess of the aggregate of a U.S. shareholder's pro rata share of the tested income of each CFC with respect to which the shareholder is a U.S. shareholder over the aggregate of the shareholder's pro rata share of the tested loss of each such CFC. I.R.C. § 951A(c)(1). Tested income is the gross income of a CFC determined without regard to any gross income taken into account in determining subpart F income and certain other income, minus the deductions properly allocable to such gross income, to the extent it results in a positive balance. If it results in a negative balance, it is a tested loss. I.R.C. § 951A(c)(2). Net deemed tangible income return is the excess of 10 percent of the aggregate of a U.S. shareholder's pro rata share of the qualified business asset investment (QBAI) of each CFC, over the amount of interest expense taken into account in determining the shareholder's net CFC tested income. I.R.C. § 951A(b)(2). QBAI is the average of a CFC's aggregate adjusted bases of any tangible depreciable property used in the production of tested income and in a trade or business of the CFC as of the close of each quarter. I.R.C. § 951A(d).
[14] I.R.C. §§ 951A(a), 951A(e)(2).
[15] I.R.C. §§ 954(b)(4), 951A(c)(2)(A)(i)(III); Treas. Reg. § 1.951A-2(c)(7).

II. REPEAL OF § 958(b)(4)

A. Purpose of the Repeal

The purpose of the Repeal was to "render ineffective certain transactions that are used to [sic] as a means of avoiding the subpart F provisions."[16] Section 958(b)(4)'s prohibition on downward attribution from a foreign person had been used to convert former CFCs to non-CFCs despite continuous ownership by U.S. shareholders.[17] According to legislative history, "the provision is not intended to cause a foreign corporation to be treated as a controlled foreign corporation with respect to a U.S. shareholder as a result of attribution of ownership under section 318(a)(3) to a U.S. person that is not a related person (within the meaning of section 954(d)(3)) to such U.S. shareholder as a result of the repeal of section 958(b)(4)."[18] Rather, Congress intended to make ineffective certain transactions among related persons entered into with the intention of avoiding subpart F, including "de-control" transactions.[19] A common example of a de-control transaction is a U.S. corporation that converts a CFC to a non-CFC by having a new foreign parent corporation or another non-CFC foreign affiliate transfer property to a CFC for stock representing at least 50 percent of the voting power and value of the CFC, while the U.S. corporation effectively maintains influence over the former CFC through related parties.[20] The purpose of the Repeal was to prevent U.S. corporations from abusing § 958(b)(4) by converting CFCs to non-CFCs to avoid subpart F while retaining the ownership in CFCs as a group through related parties. Any additional tax consequences were not intended, and a technical correction to the legislation may be necessary to reflect the purpose of the Repeal expressed by Congress. [21]

B. *Unintended Consequences of the Repeal*

Notwithstanding Congress's purpose, the Repeal not only prevented abuses of de-control transactions, but it affected other tax aspects of foreign corporations with U.S. subsidiaries. Prior to the Repeal, because there was no downward attribution for stock owned by a non-U.S. person, USCo in the Example was not considered to constructively own the stock in MexCo owned by JPCo. Thus, MexCo was not a CFC of USCo, and there was no income inclusion by USCo of MexCo's subpart F income. Post-TCJA, MexCo is a CFC, because it is directly and constructively owned more than 50 percent by USCo. USCo directly owns 1 percent of the shares in MexCo and must therefore include 1 percent of MexCo's subpart F income in its gross income. Subpart F income attributable to USCo's constructive ownership of MexCo's stock is not, however, included in USCo's income. Subpart F income is reported on Schedule I of Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations. Post-TCJA,

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[16] H.R. Rep. No. 115-466, at 633 (2017) (Conf. Rep.).
[17] *Id.*
[18] *Id.*
[19] STAFF OF JOINT COMM. ON TAX'N, GENERAL EXPLANATION OF PUBLIC LAW 115-97, 115th Cong., 2d. Sess. at 384 (Dec. 2018).
[20] *Id*.
[21] *Id.* at 385, n. 1761.

USCo is also subject to taxation on GILTI from MexCo with respect to the shares it owns directly in MexCo and is required to file Form 8992, U.S. Shareholder Calculation of Global Intangible Low-Taxed Income.[22]

If the country where the ultimate parent corporation is taxed has CFC rules similar to the subpart F and GILTI provisions, such as the Japanese anti-tax haven rules,[23] foreign subsidiaries could be subject to triple taxation—in the country where the CFC is taxed, in the United States, and in the country where the ultimate parent corporation is taxed. In the Example, MexCo's income might be taxed in Mexico, the United States, and Japan. Although the risk of triple taxation might be mitigated by foreign tax credit (FTC) systems in the relevant countries, the FTC may not fully eliminate the risk, which depends on how the FTC is calculated in each country. This risk existed prior to the TCJA due to subpart F but increased significantly due to GILTI and the Repeal. The reach of GILTI taxation is much broader than the subpart F provisions, and, due to downward attribution, more foreign corporations will be treated as CFCs.

Another negative impact of MexCo being a CFC of USCo is that USCo is required to file Form 5471.[24] Persons described in any of five categories must file Form 5471, and USCo would be in Category 1 and Category 5.[25] Category 1 includes "a U.S. shareholder of a foreign corporation that is a section 965 specified foreign corporation (SFC) … at any time during any tax year of the foreign corporation, and who owned the stock on the last day in that year on which it was an SFC."[26] A SFC is any CFC, or any foreign corporation in which one or more U.S. corporations are U.S. shareholders.[27] Category 5 applies to "a U.S. shareholder who owns stock in a foreign corporation that is a CFC at any time during any tax year of the foreign corporation, and who owned that stock on the last day in that year on which it was a CFC."[28] The administrative burden of preparing Form 5471 is significant even if there is only minimal tax increase from subpart F or GILTI. Form 5471 typically extends to more than 20 pages, with increased information required post-TCJA,[29] and includes detailed financial information of the CFC in addition to reporting subpart F income and GILTI.

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[22] I.R.C. §§ 951A(a), 951A(e)(2); Treas. Reg. §§ 1.6038-5(a), 1.6038-5(d).

[23] THE ACT ON SPECIAL MEASURES CONCERNING TAXATION (*SOZEI-TOKUBETSU-SOCHI-HO*) OF JAPAN, Art. 66-6. *See* Sebastian Dueñas & Daniel Bunn, *How Controlled Foreign Corporation Rules Look Around the World: Japan*, https://taxfoundation.org/japanese-cfc-rules-japan-tax/ (July 3, 2019) (last visited Oct. 24, 2021).

[24] I.R.C. § 6038(a)(4); Treas. Reg. § 1.6038-2(a)(2).

[25] *See* Instructions for Form 5471 at 3–6 (rev. Jan. 2021).

[26] *Id.* at 3.

[27] I.R.C. § 965(e).

[28] Instructions for Form 5471 at 4 (rev. Jan. 2021).

[29] Changes to Form 5471 due to the TCJA include the additions of Schedule I-1, Information for Global Intangible Low-Taxed Income, and Schedule P, Previously Taxed Earnings and Profits of U.S. Shareholder of Certain Foreign Corporations, and an expansion of Schedule J, Accumulated Earnings & Profits (E&P) of Controlled Foreign Corporation. *See* Instructions for Form 5471 at 1 (rev. Dec. 2018).

The Repeal also affects withholding tax imposed on interest paid by a U.S. subsidiary of a foreign corporation to a foreign affiliate. In general, interest paid by a U.S. corporation to a foreign corporation is subject to withholding tax of 30 percent unless an applicable tax treaty provides a full or partial exemption.[30] The Code exempts U.S.-source portfolio interest paid to a foreign corporation from U.S. withholding tax.[31] Portfolio interest, however, does not include any interest paid to a CFC by a related person.[32] In the Example, the portfolio interest exemption would not apply to interest paid by USCo to MexCo, because MexCo is now a CFC of USCo.

The timing of the deduction of amounts owed by a U.S. subsidiary of a foreign corporation to a foreign affiliate is also changed by the Repeal. The matching rule in § 267(a)(3) generally provides that an amount owed to a foreign related party is deductible to the payor only when paid.[33] Exceptions to this rule apply that allow deduction in the year of accrual for an amount accrued to a related foreign person that is effectively connected income or is exempt from tax by treaty (other than interest).[34] These exceptions do not, however, allow a deduction for an amount payable to a CFC in a year prior to the year of payment, unless the amount is includible in the gross income of a U.S. direct or indirect shareholder ("CFC payee rule").[35] In the Example, because MexCo is now a CFC of USCo, USCo cannot deduct an amount owed by USCo to MexCo until it is either paid or included in USCo's income.

III. Measures to Reduce the Negative Consequences of the Repeal

After its enactment, Congress and the Internal Revenue Service (IRS) recognized the unintended consequences of the Repeal and implemented several measures to limit its negative effects.

A. *Notice 2018-13*

The IRS announced its intention in Notice 2018-13[36] to revise the instructions to Form 5471 to provide a reporting exception. This exception is for a U.S. shareholder of a CFC, provided that the CFC is (1) not directly or indirectly owned by any U.S. shareholder and (2) a CFC solely because a U.S. person is considered to constructively own the stock of the CFC owned by a foreign person through downward attribution.[37] Prior to the TCJA, a U.S. corporation did not have to file Form 5471 with regard to a foreign affiliate in which it owned no shares directly or indirectly because it was not a CFC. Post-TCJA, a U.S. corporation owned by a foreign corporation would have to file Form 5471 with regard to a

[30] I.R.C. § 881(a)(1).
[31] I.R.C. § 881(c)(1).
[32] I.R.C. § 881(c)(3)(C).
[33] I.R.C. §§ 267(a)(2), 267(a)(3)(A); Treas. Reg. § 1.267(a)-3(b)(1).
[34] Treas. Reg. § 1.267(a)-3(c).
[35] I.R.C. §§ 267(a)(3)(B)(i), 958(a).
[36] Notice 2018-13, 2018-6 I.R.B. 341.
[37] *Id.* § 5.02.

foreign affiliate that is owned by the foreign corporation, even if the U.S. corporation owns no shares in the foreign affiliate directly or indirectly, because the U.S. corporation constructively owns the foreign affiliate via the parent corporation.

B. *Revenue Procedure 2019-40*

Revenue Procedure 2019-40[38] addresses the situation where taxpayers required to include amounts attributable to foreign corporations in income under subpart F and GILTI rules may have limited ability to determine whether such foreign corporations are CFCs due to the Repeal.[39] Taxpayers may also have difficulty in obtaining the information necessary to accurately determine the amount of income inclusions from such CFCs.[40] The revenue procedure provides three safe harbors and penalty relief[41] to taxpayers that cannot obtain sufficient information to make these determinations.

First, the IRS will accept a U.S. person's determination that a foreign corporation is not a CFC with respect to the U.S. person if the U.S. person does not have "actual knowledge, statements received, and/or reliable publicly available information" sufficient to make this determination.[42] If the U.S. person directly owns stock of, or an interest in, a foreign entity ("top-tier entity"), this safe harbor applies only if the U.S. person inquires of the top-tier entity whether it is a CFC and whether, how, and to what extent it directly or indirectly owns stock of foreign corporations and domestic entities.[43] The safe harbor applies only to a CFC that would not be a CFC without applying downward attribution under § 318(a)(3) so as to consider a U.S. person as owning stock owned by a foreign person ("foreign-controlled CFC").[44]

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[38] Rev. Proc. 2019-40, 2019-43 I.R.B. 982.
[39] *Id.* § 2.
[40] *Id.*
[41] Penalties under §§ 6038 and 6662 do not apply in the case of the three safe harbors. *Id.* § 7. Section 6038(b) imposes a $10,000 penalty for failure to file Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations, and Form 8992, U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI). *See* Treas. Reg. §§ 1.6038-2(k)(1), 1.6038-5(c)(1). If a taxpayer fails to furnish required information, the FTC is reduced by generally 10 percent under § 6038(c). An accuracy-related penalty on underpayments of generally 20 percent is imposed under § 6662 in certain cases, including negligence or disregard of rules or regulations, and substantial understatement of income tax.
[42] Rev. Proc. 2019-40, 2019-43 I.R.B. 982, § 4.02(b)(i).
[43] *Id.* § 4.02(b)(ii).
[44] *Id.* §§ 3.03, 3.13, 4.02(a).

The second safe harbor applies to a foreign-controlled CFC with no "related section 958(a) U.S. shareholder"[45] if required information[46] is not readily available[47] to an "unrelated section 958(a) U.S. shareholder."[48] In such a case, the U.S. shareholder generally can rely on "alternative information" in determining a subpart F or GILTI inclusion amount, including audited or unaudited financial statements of the CFC that are prepared in accordance with U.S. generally accepted accounting principles (GAAP), the international financial reporting standards (IFRS), or the local GAAP of the CFC's country of incorporation.[49] In addition, the Treasury and the IRS committed to revising the Form 5471 instructions to provide that if required information is not readily available to an unrelated direct, indirect, or constructive U.S. shareholder of a foreign-controlled CFC with no related direct or indirect U.S. shareholder, an amount reported on a Form 5471 may be determined by the unrelated shareholder on the basis of alternative information.[50]

A safe harbor is also provided for certain SFCs to determine amounts under the § 965 transition rule.[51] The safe harbor applies to SFCs other than foreign-controlled CFCs that have related direct or indirect U.S. shareholders and U.S.-controlled CFCs.[52] If required information is not readily available, the SFC can rely on alternative information.[53]

The revenue procedure acknowledges that, "even as modified [by Notice 2018-13], the Form 5471 filing requirements may result in a significant undertaking for certain U.S. shareholders with limited access to information with respect to a foreign-controlled CFC."[54] The IRS expressed its intention to limit the information required to be reported on Form 5471 by a Category 5 filer that is either an unrelated

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[45] A "related section 958(a) U.S. shareholder" means a direct or indirect U.S. shareholder of a foreign corporation if such U.S. shareholder (1) directly, indirectly, or constructively owns more than 50 percent of the foreign corporation, (2) is more than 50 percent owned by the foreign corporation, or (3) is more than 50 percent owned by the same person(s) that owns more than 50 percent of the foreign corporation. An "unrelated section 958(a) shareholder" means a direct or indirect U.S. shareholder of a foreign corporation that is not a related section 958(a) U.S. shareholder with respect to the foreign corporation. I.R.C. § 954(d)(3); Rev. Proc. 2019-40, 2019-43 I.R.B. 982, §§ 3.07, 3.06, 3.09, 3.12.

[46] Required information is the information necessary to determine gross income, taxable income and earnings and profits of a foreign corporation. I.R.C. § 964; Treas. Reg. §§ 1.952-2(a), 1.952-2(b); Rev. Proc. 2019-40, 2019-43 I.R.B. 982, § 5.02.

[47] Rev. Proc. 2019-40, 2019-43 I.R.B.982, § 3.04.

[48] *Id.* § 5.02.

[49] *Id.* § 3.01.

[50] *Id.* § 5.02. The Form 5471 instructions were accordingly revised. *See* Instructions for Form 5471 at 8-9 (rev. Jan. 2021).

[51] In general, the U.S. corporate income tax system changed from a worldwide to a territorial tax system under the TCJA, which enacted a deduction for dividend income received by a corporation from a 10 percent owned foreign corporation. As part of the transition to the new system, § 965 imposed a one-time tax on a U.S. shareholder's portion of an SFC's accumulated earnings and profits so that the earnings would not escape taxation.

[52] U.S.-controlled CFC means a foreign corporation that is a CFC other than a foreign-controlled CFC. Rev. Proc. 2019-40, 2019-43 I.R.B. 982, § 3.13.

[53] *Id.* §§ 3.01, 6.02.

[54] *Id.* § 8.01.

section 958(a) U.S. shareholder (Category 5b filer), or a related constructive U.S. shareholder (Category 5c filer),[55] of the foreign-controlled CFC.[56] The IRS also revealed its intention to revise the instructions to exempt a Category 5 filer from the filing requirement if it is an unrelated constructive U.S. shareholder of a foreign-controlled CFC.[57]

The IRS revised the instructions for Form 5471 to implement Notice 2018-13 and Revenue Procedure 2019-40. Specifically, a Category 5 filer[58] does not have to file Form 5471 if no U.S. shareholder directly or indirectly owned stock in the foreign corporation on the last day in the year in which it was a CFC, and the foreign corporation is a CFC solely because one or more U.S. persons are considered to constructively own the stock of the foreign corporation through downward attribution.[59] An additional exception applies if (1) the filer is a U.S. shareholder that owns stock only constructively in the foreign corporation; (2) the filer is not related to the foreign corporation; and (3) the foreign corporation is a foreign-controlled CFC.[60] A Category 5 filer[61] also does not have to file Form 5471 if the U.S. shareholder does not own a direct or indirect interest in the foreign corporation and is required to file Form 5471 solely because of constructive ownership from a nonresident alien.[62] Information required to be reported by Category 5b and Category 5c filers is limited.[63]

C. *Regulations*

Proposed regulations were issued in October 2019 to "ensure that the operation of certain rules is consistent with their application before the [Repeal]."[64] The proposed regulations were finalized in September 2020[65] and include a provision that the CFC payee rule does not apply if a CFC payee does not have any direct or indirect U.S. shareholder.[66]

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[55] A "related constructive U.S. shareholder" is a U.S. shareholder that does not own stock directly or indirectly in a foreign corporation if such U.S. shareholder (1) directly, indirectly, or constructively owns more than 50 percent of the foreign corporation, (2) is more than 50 percent owned by the foreign corporation, or (3) is more than 50 percent owned by the same person(s) that own more than 50 percent of the foreign corporation. An "unrelated constructive U.S. shareholder" is a U.S. shareholder that does not own stock directly or indirectly in a foreign corporation and is not a related constructive U.S. shareholder with respect to the foreign corporation. *Id.* §§ 3.02, 3.05, 3.06, 3.09, 3.11.

[56] I.R.C. § 958(a); Rev. Proc. 2019-40, 2019-43 I.R.B. 982, §§ 8.02, 8.03.

[57] Rev. Proc. 2019-40, 2019-43 I.R.B. 982, § 8.04.

[58] The exception also applies to a Category 1 filer. Instructions for Form 5471 at 1-3 (rev. Jan. 2021).

[59] *Id.* at 6.

[60] *Id.*

[61] The exception also applies to Category 1 and Category 4 filers. A Category 4 filer is a U.S. person who had control of a foreign corporation during the annual accounting period of the foreign corporation. *Id.* at 4.

[62] *Id.* at 6.

[63] *Id.* at 4-5.

[64] REG-104223-18, 84 Fed. Reg. 52,398, 52,399 (Oct. 2, 2019).

[65] T.D. 9908, 85 Fed. Reg. 59,428 (Sept. 22, 2020).

[66] Treas. Reg. § 1.267(a)-3(c)(4).

New proposed regulations were concurrently published with the final regulations to further eliminate unexpected consequences of the Repeal.[67] Specifically, the proposed regulations "are intended to ensure that certain rules under §§ 367(a) and 954(c)(6) apply in the same manner in which they applied before the Repeal."[68] In general, an outbound transfer of stock in a U.S. corporation by a U.S. person to a foreign corporation in certain transactions that otherwise would be nontaxable, such as a § 351 transfer or a tax-deferred reorganization, is taxable under § 367(a)(1). However, Regulation § 1.367(a)-3(c)(1) provides an exception to this rule if certain conditions involving stock ownership in the transferee foreign corporation and the target U.S. corporation are met, including a U.S. person cannot own 5 percent or more of the transferee foreign corporation immediately after the transfer. For purposes of determining ownership under § 367, the attribution rules under § 318 as modified by § 958 generally apply.[69] Under the proposed regulations, the stock attribution rules under § 318(a)(3) would not apply for purposes of determining ownership under § 367, other than to determine whether a U.S. person owns at least 5 percent of the transferee foreign corporation.[70] These attribution rules also would not be applied in determining whether a foreign corporation is a CFC for purposes of § 954(c)(6), which excludes from subpart F income certain payments received or accrued from related CFCs.[71]

IV. Remaining Issues

Although the IRS and the Treasury took steps to mitigate some unintended consequences of the Repeal, issues remain for foreign corporations with U.S. subsidiaries. First, the subpart F provisions still apply if a U.S. subsidiary directly or indirectly owns even one share in a foreign corporation if the U.S. subsidiary's total ownership, including constructive ownership through its foreign parent, is more than 50 percent of the foreign corporation, such as USCo in the Example. Because the U.S. subsidiary's pro rata share of subpart F income from the foreign corporation is only the portion that corresponds to the shares directly or indirectly owned,[72] the inclusion amount may be minimal. Depending on the percentage of direct or indirect ownership in the CFC and the level of the CFC's income, however, the subpart F income inclusion could result in a significant tax increase, as well as the administrative burden required to calculate the subpart F income inclusion.

USCo also would be subject to GILTI inclusion, based only on its direct and indirect ownership.[73] Just as for subpart F income, GILTI can result in a significant tax increase and an administrative burden for USCo. Currently, the effective tax rate on GILTI is 10.5 percent, which is half the regular corporate tax rate of 21 percent, because a 50 percent deduction is allowed.[74] In addition,

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[67] REG-110059-20, 85 Fed. Reg. 59,481 (Sept. 22, 2020).
[68] *Id.* at 59,481.
[69] Treas. Reg. § 1.367(a)-3(c)(4)(iv).
[70] Prop. Treas. Reg. § 1.367(a)-3(c)(4)(iv).
[71] Prop. Treas. Reg. § 1.954(c)(6)-2(a).
[72] I.R.C. §§ 951(a)(2), 958(a).
[73] I.R.C. §§ 951A(a), 951A(e)(1), 958(a).
[74] I.R.C. § 250(a)(1)(B).

currently 10 percent of a U.S. shareholder's pro rata share of a CFC's aggregate adjusted bases of tangible depreciable properties is deducted in calculating GILTI.[75] President Biden plans to raise the tax rate on foreign earnings of U.S. companies located overseas to 21 percent[76] and to eliminate the 10 percent deduction, further increasing the tax burden from GILTI.[77]

As discussed in Part I, the high-tax exceptions[78] can reduce or eliminate subpart F income and GILTI. President Biden intends to repeal the high-tax exceptions.[79] Even if they are not repealed and the requirements for the exceptions are met, substantial work may be required to calculate the effective foreign tax rate to determine if the exceptions apply. President Biden also would like to increase the corporate tax rate from 21 percent to 28 percent,[80] which would raise the threshold for the high-tax exception from18.9 percent to 25.2 percent,[81] making it more difficult to come within the exceptions.[82]

In addition, there is a risk of a $10,000 penalty for failure to file Form 8992 and report GILTI inclusions if a U.S. corporation, such as USCo, fails to recognize that it directly or indirectly owns shares in a foreign affiliate that is a CFC due to downward attribution.[83] Furthermore, USCo would have to obtain detailed financial information from MexCo to determine GILTI, such as a trial balance, a general ledger, and a list of MexCo's fixed assets, to determine MexCo's income under U.S. tax principles. For example, depreciation of MexCo's fixed assets would have to be computed using the alternative depreciation system (ADS), which could require substantial work if MexCo has many fixed assets.[84] The safe harbor allowing the use of alternative information would not apply, because USCo is a related person to MexCo.[85]

The filing requirement of Form 5471 also remains for MexCo, where USCo directly owns 1 percent of the shares in MexCo and constructively owns more than 50 percent of MexCo.[86] The exemptions for filing Form 5471 would not apply, because they are limited to a U.S. shareholder that does not own a direct or indirect

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[75] I.R.C. §§ 951A(b)(1), 951A(b)(2)(A), 951A(d). *See supra* note 13.

[76] In the Build Back Better reconciliation bill passed by the House of Representatives on November 19, 2021 (BBB Bill), the tax rate on foreign earnings of U.S. companies is increased to 15 percent by reducing the 50 percent deduction to 28.5 percent. H.R. 5376, 117th Cong. § 138121(a) (2021).

[77] DEP'T OF THE TREASURY, GENERAL EXPLANATION OF THE ADMINISTRATION'S FISCAL YEAR 2022 REVENUE PROPOSALS at 7 (2021). In the BBB Bill, the 10 percent deduction is not eliminated but is reduced to 5 percent. H.R. 5376, 117th Cong. § 138126(d)(1) (2021).

[78] I.R.C. §§ 954(b)(4), 951A(c)(2)(A)(i)(III); Treas. Reg. § 1.951A-2(c)(7).

[79] DEP'T OF THE TREASURY, GENERAL EXPLANATION OF THE ADMINISTRATION'S FISCAL YEAR 2022 REVENUE PROPOSALS at 7 (2021).

[80] *Id.* at 3.

[81] Treas. Reg. § 1.951A-2(c)(7)(i)(B).

[82] Although the Biden administration originally expressed an intention to increase the corporate tax rate from 21 percent to 28 percent, it was not included in the BBB Bill. H.R. 5376, 117th Cong. (2021).

[83] I.R.C. §§ 958(a), 6038(b)(1); Treas. Reg. §§ 1.6038-5(a), 1.6038-5(c)(1), 1.6038-5(d).

[84] I.R.C. § 168(g).

[85] *See supra* text accompanying note 49.

[86] I.R.C. § 6038(a)(4); Treas. Reg. § 1.6038-2(a)(2).

interest in the foreign corporation.[87] The relief under Revenue Procedure 2019-40 that limits the information required to be reported on Form 5471 also would not apply, because it applies only to a U.S. shareholder that is unrelated to the foreign corporation or that is not a direct or indirect shareholder of the foreign corporation.[88] If a U.S. subsidiary directly or indirectly owns any shares in a foreign affiliate that is a CFC due to downward attribution from a foreign corporation and does not file Form 5471, it may incur a $10,000 penalty.

Even if a U.S. subsidiary does not own any shares directly or indirectly in a CFC that is constructively more than 50 percent owned via a foreign parent, to the extent the CFC has any U.S. shareholders including those unrelated to the U.S. subsidiary, the U.S. subsidiary would have to file Form 5471. It would not be exempt from filing under Notice 2018-13, which only applies to CFCs that are not directly or indirectly owned by any U.S. shareholder.[89] The U.S. subsidiary also would not be able to rely on Revenue Procedure 2019-40 to determine that a foreign corporation is not a CFC. The U.S. subsidiary would know that it is a CFC via the foreign parent, and the revenue procedure requires a taxpayer to have no actual knowledge that the foreign corporation is a CFC.[90] The U.S. subsidiary would have an additional burden to determine whether foreign corporations in which it does not own any shares directly or indirectly have any unrelated U.S. shareholders. If the U.S. subsidiary fails to file Form 5471 for CFCs that have direct or indirect unrelated U.S. shareholders, the U.S. subsidiary could be subject to a $10,000 penalty per CFC for which it fails to file Form 5471.

Similar to other relief measures, the CFC payee rule applies only if the CFC payee does not have any direct or indirect U.S. shareholders.[91] In fact, the Treasury's and the IRS's position is that the CFC payee rule should not be applied without regard to the Repeal.[92] If the Repeal is disregarded, the CFC payee rule could be avoided in foreign-parent structures such as in the Example, where a direct or indirect U.S. shareholder (USCo) is required to include amounts in income with respect to a recipient foreign corporation (MexCo) that is a CFC due solely to the Repeal.[93] The preamble to the final regulations clarifies that the CFC payee rule continues to apply to a CFC that has a direct or indirect shareholder, even if the foreign corporation would not be a CFC without constructive ownership.[94]

There has been no relief measure enacted regarding withholding tax on portfolio interest received by a CFC from a related person. Thus, any portfolio interest paid from a U.S. subsidiary of a foreign corporation to its foreign affiliate

[87] *See supra* notes 60–63 and accompanying text.
[88] *See supra* notes 56–57 and accompanying text.
[89] Notice 2018-13, 2018-6 I.R.B. 341.
[90] Rev. Proc. 2019-40, 2019-43 I.R.B. 982.
[91] Treas. Reg. § 1.267(a)-3(c)(4).
[92] T.D. 9908, 85 Fed. Reg. 59,428, 59,429 (Sept. 22, 2020).
[93] *Id.*
[94] *Id.*

that is a CFC due to downward attribution from a foreign parent may be subject to U.S. withholding tax.

V. PROPOSED SOLUTIONS

Despite the measures taken to mitigate the unintended consequences of the Repeal, negative consequences remain for foreign corporations with U.S. subsidiaries, especially in the case where a U.S. subsidiary has direct or indirect ownership in a foreign affiliate that is controlled by the foreign parent. Transferring the stock of the CFC owned by the U.S. subsidiary to a foreign affiliate could potentially eliminate the issues. However, such transfer would likely entail tax costs.

Stock in the CFC could be transferred to a foreign affiliate by a sale, or a distribution of the stock to the parent followed by a contribution of the stock to the affiliate. If the U.S. subsidiary sells its CFC stock, a gain from the sale is treated as a dividend to the extent of the earnings and profits of the CFC attributable to such stock, provided the U.S person directly, indirectly, or constructively owns 10 percent or more of the CFC at any time within the five years preceding the sale.[95] If the U.S. subsidiary has held the stock in the CFC for at least a year, the portion of the gain treated as a dividend received is deductible.[96] However, if the fair market value of the stock in the CFC exceeds the amount of the CFC's earnings and profits, the amount in excess of the stock basis is taxable gain. If the U.S. subsidiary instead distributes its CFC stock to the foreign parent, a gain would be recognized by the U.S. subsidiary as if the stock were sold for its fair market value,[97] and the foreign parent would have dividend income subject to U.S. withholding tax. Contributing the stock in the CFC to a foreign affiliate also would not solve the problem, because the U.S. subsidiary would receive stock in the transferee foreign affiliate, which would be a CFC of the U.S. subsidiary.

If the stock in the CFC owned by the U.S. subsidiary is minimal, the tax costs on the gain from the sale or distribution of the stock may not be significant, while the transfer could relieve the U.S. subsidiary from the subpart F and GILTI inclusions and related filing requirements. If the stock owned by the U.S. subsidiary is not minimal, the costs of maintaining the current structure, continuing to pay tax on subpart F income and GILTI, and filing Forms 8992 and 5471 should be compared to the costs, including taxes, of transferring the U.S. subsidiary's CFC stock to a foreign affiliate to determine whether it is beneficial to transfer the stock.

Another option to mitigate the consequences of the Repeal is to change the entity classification of the CFC for U.S. tax purposes from a corporation to a passthrough entity[98] so that the foreign affiliate would not be considered a CFC.[99] This would avoid subpart F and GILTI inclusions to the U.S. shareholder, but the U.S. subsidiary would include its share of the foreign entity's income in its taxable

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[95] I.R.C. § 1248(a).
[96] I.R.C. §§ 245A(a), 245A(b), 1248(j).
[97] I.R.C. § 311(b).
[98] Treas. Reg. § 301.7701-3(a).
[99] A foreign entity can elect its classification for federal tax purposes unless it is a business entity classified as a corporation under Regulation § 301.7701-2(b)(8). Treas. Reg. § 301.7701-3(a).

income. This option could be beneficial to the extent that the foreign affiliate is subject to a relatively high tax in its country and the U.S. subsidiary could claim a FTC to offset the U.S. tax imposed on the foreign affiliate's income.[100] If, on the other hand, the foreign affiliate is taxed in a country with a tax rate lower than the U.S. corporate tax rate, in general, a FTC will not fully offset the U.S. tax on the foreign affiliate's income, resulting in an additional tax to be paid in the U.S. on the foreign affiliate's income. Once the foreign affiliate becomes a passthrough entity, it would solve other issues caused by the Repeal, such as the filing requirement of Forms 5471 and 8892 and the associated potential penalties. While the U.S. subsidiary would instead be required to file Form 8858, Information Return of U.S. Persons With Respect to Foreign Disregarded Entities (FDEs) and Foreign Branches (FBs), or Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships, the amount of information required on these forms is less than that required for Form 5471. There is likely a tax cost to changing the classification of the foreign affiliate from a corporation to a passthrough entity, as this change is considered a liquidation.[101]

Foreign corporations could also work with the U.S. government, as well as the governments of the countries in which their ultimate parent corporations are subject to income tax, to mitigate the triple taxation risk set out in Part II. For example, similar to the BEPS Project of the Organisation for Economic Co-operation and Development,[102] countries could establish a framework in which priority to tax lower-tier entities is given to the country where an ultimate parent corporation is taxed if such a country and the country where its subsidiary is taxed both have CFC rules. Each participating country would need to incorporate the framework in their respective domestic tax laws.

As part of its tax reform, Congress could limit the scope of constructive ownership to match Congress's intention for the Repeal, which was to prevent U.S. corporations from taking advantage of § 958(b)(4) by converting CFCs to non-CFCs. Punishing foreign corporations with U.S. subsidiaries owning minority shares in foreign affiliates was not the intention. Congress could restore the downward attribution prohibition of § 958(b)(4) except to determine U.S. shareholders and CFCs for §§ 951 and 951A.

In September 2021, the House Ways and Means Committee included a proposal to restore § 958(b)(4), while adding a new § 951B (the Bill).[103] Under proposed § 951B, the subpart F provisions would apply to foreign-controlled U.S. shareholders of foreign-controlled foreign corporations.[104] A foreign-controlled U.S. shareholder is a U.S. person that directly, indirectly, or constructively owns more than 50 percent of a foreign corporation without applying § 958(b)(4) (i.e., by

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[100] I.R.C. §§ 901(a), 901(b)(1).
[101] I.R.C. § 332(b); Treas. Reg. § 301.7701-3(g).
[102] *See* OECD, *What is BEPS?*, https://www.oecd.org/tax/beps/about/ (last visited Oct. 24, 2021).
[103] STAFF OF H. COMM. ON WAYS AND MEANS, 117TH CONG., AMENDMENT IN THE NATURE OF A SUBSTITUTE TO THE COMMITTEE PRINT OFFERED BY MR. NEAL OF MASSACHUSETTS at 576 (Comm. Print 2021).
[104] *Id.* at 577.

taking downward attribution into account.[105] A foreign-controlled foreign corporation is a foreign corporation other than a CFC that is more than 50 percent owned by foreign-controlled U.S. shareholders without applying § 958(b)(4) (i.e., by taking downward attribution into account).[106] Section 951B would further provide that for purposes of the GILTI provisions, a U.S. shareholder would include a foreign-controlled U.S. shareholder and a CFC would include a foreign-controlled foreign corporation.[107]

This proposal, however, would not be sufficient to relieve foreign corporations like JPCo in the Example even though MexCo would not be a CFC of USCo due to the restoration of § 958(b)(4). Under proposed § 951B, USCo would be a foreign-controlled U.S. shareholder of MexCo, constructively owning more than 50 percent of MexCo via JPCo, and MexCo would be a foreign-controlled foreign corporation, owned constructively more than 50 percent by USCo. USCo thus would still be subject to the subpart F and GILTI provisions.

Another solution would be to restore § 958(b)(4) but stipulate that it does not apply if a foreign corporation has ever been a CFC through direct and indirect ownership only. If a foreign corporation was a CFC in the past but currently is not a CFC without considering constructive ownership, there was likely an abusive intention to convert a CFC to a non-CFC. Otherwise, no abusive intention likely existed. If such changes are made, MexCo would not be a CFC, because it had never been a CFC of USCo without the constructive ownership via JPCo. Thus, the unintended negative consequences on foreign multinational corporations could be prevented.

CONCLUSION

The Treasury and the IRS have taken measures to mitigate the unintended consequences of the Repeal. While such actions limit negative results, there are still issues for foreign corporations with U.S. subsidiaries that own minority shares in foreign affiliates. Negatively affecting such foreign corporations was not the purpose of the Repeal. To resolve this situation, Congress should take actions to amend the Internal Revenue Code to eliminate the unintended consequences while preserving the purpose of the Repeal: to prevent the abuse of § 958(b)(4) by U.S. corporations converting CFCs to non-CFCs to avoid the application of the subpart F provisions. Corporations that are negatively affected by the Repeal should work together and pressure the U.S. government to cooperate with the international community to take action to limit the negative consequences of the Repeal and resulting double or triple taxation due to the CFC rules of multiple countries.

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[105] *Id.* at 577.
[106] *Id.* at 578.
[107] *Id.* at 577.