The international tax reform provisions of the Tax Cuts and Jobs Act significantly altered the tax treatment of losses, although in ways not always supported by policy goals.

Among the myriad changes that the 2017 U.S. tax reform legislation introduced were significant changes in the tax treatment of losses. These changes were direct, indirect, and multifaceted. The most significant changes were the reduced rates on business income, effected through a 40% reduction in the top U.S. corporate tax rate from 35% to 21%, and through the Section 199A 20% deduction for individual and flow-through business income. In addition, the Section 172 "net operating loss" (NOL) deduction was reformed, in part to address the introduction of wide-scale expensing through Section 168(k). The NOL reforms eliminated carrybacks, made carryforwards indefinite, and limited the use of NOLs in a given tax year to 80% of taxable income.

As part of U.S. international tax reform, complicated rules were introduced affecting the treatment of both operating and capital losses. Among the most significant changes were:

- The introduction of the Section 951A "global intangible low-taxed income" (GILTI) rules, which introduced broad elements of a worldwide tax system to the U.S. tax rules.
- The elimination of the Section 902 indirect foreign tax credit, which had allowed domestic
corporations credits for foreign income taxes paid by certain 10%-owned foreign subsidiaries upon the payment of dividends by those subsidiaries to their U.S. corporate shareholders. The Section 902 regime had also allowed for the pooling of income and taxes for purposes of determining the indirect foreign tax credit.

This article provides an overview of various loss provisions affecting U.S. international taxation that were introduced or changed by the TCJA. One objective of this article is to provide a technical background in the operation of these rules. A second objective is to provide context to the policy implications of these rules. As a general matter, various policies have typically driven loss provisions:

- Providing symmetry with gain or operating income treatment.
- Addressing limitations in the annual accounting period to reflect an appropriate measure of income over time.
- Providing corresponding limitations on the acquisition of loss attributes, including built-in loss assets.
- Limitations on the use of losses triggered through related-party transactions.
- Limitations on the use of losses reflecting a double tax benefit. ²

This list is not exhaustive, and the specific policy motivating a particular rule may yield to other competing policies. For example, in the international regime, losses on CFC stock are generally U.S. source, notwithstanding that under pre-TCJA law, Section 1248 would allow gains on CFC stock to be foreign source to the extent of attributable earnings from the CFC. This asymmetry benefited the use of foreign tax credits and could be viewed as facilitating the cross-crediting of foreign income taxes under the Section 904(d) foreign tax credit limitation provisions.

In reviewing the reformed international tax rules affecting losses, what stands out is the amount of "rough justice" meted out in pursuing identifiable policy goals, and the number of circumstances where no affirmative loss policy or countervailing policy is identifiable. Both of these observations, if proven true in practice, would suggest that these reforms are likely to be revisited and revised either through regulations or through new legislation.
Taxation of Operating Losses Relating to the Foreign Operations of Domestic Corporations

The TCJA changed the treatment of losses incurred by foreign branches in two fundamental ways:

1. Through the enactment of the Section 250 deduction for "foreign-derived intangible income" (FDII), which generally relates to domestic sales, licensing, and services income attributable to foreign markets.
2. Through the introduction of a separate Section 904(d) foreign tax credit "basket" for foreign branch income.

With respect to the FDII rules and the computation of taxable income, foreign branch income occupies an interesting middle ground between foreign market income earned by domestic corporations through domestic operations and foreign market income earned through CFCs. Under the FDII regime, a domestic corporation's foreign market income is subject to an effective tax rate of 13.125% through 2026. Foreign market income earned through CFCs is generally subject to the GILTI regime and incurs a minimum U.S. effective tax rate of 10.5%, subject to complicated foreign tax credit rules that can cause the global effective tax rate to be higher if the foreign market income is subject to foreign tax.

Branch income is eligible for neither FDII nor GILTI treatment and, therefore, is subject to the general corporate rate of 21%, with foreign branch income treated as a separate Section 904 limitation basket for foreign tax credit purposes. Unused taxes attributable to the foreign branch basket are eligible for one-year carryback and ten-year carryforward under Section 904(c).

Consistent with prior law, foreign branch losses may offset domestic income. Nevertheless, such losses (and, more generally, deductions attributable to branch income) are not taken into account in the calculation of FDII. Nevertheless, the Section 250 deduction applicable to FDII and GILTI is limited by the taxpayer’s total taxable income for the year. Such limitation effectively means that the Section 250 deduction can never create an NOL for the taxpayer in a given year. Therefore, foreign branch losses would go into the calculation of total taxable income and can, therefore, reduce the otherwise-available Section 250 deduction.

The Section 1503(d) "dual consolidated loss" (DCL) rules continue to apply to foreign branch losses. In general, the DCL rules target the use of a U.S. tax loss by a dual resident corporation or a domestic corporation’s separate unit to offset the income of another person under foreign law if that income is not subject to U.S. tax. The enforcement mechanism is to prevent DCLs from being shared within a U.S. consolidated group (i.e., to subject the dual consolidated loss to separate return limitation year
treatment). The DCL rules were not changed by the TCJA. Nevertheless, in the proposed regulations package under new Section 267A, relating to limitations on the deductibility of hybrid payments, the Treasury and the IRS have proposed updates to the DCL rules to reflect evolving thinking regarding hybrids, spurred in part by the OECD's "Base Erosion and Profit Shifting" project. In particular, the proposed regulations target under the DCL rules certain "double-dip" structures involving the use of domestic reverse hybrids (that is, entities that are treated as a domestic corporation for U.S. tax purposes, but are flow-through for foreign law purposes).

Domestic reverse hybrids are generally not "dual resident corporations" because they are not subject to tax in a foreign jurisdiction and they are not considered "separate units" of a domestic corporation (i.e., they do not have foreign branch or QBU operations). To address this jurisdiction issue, proposed regulations condition a "check-the-box" election under Reg. 301.7701-3(c) to create a domestic reverse hybrid on the entity agreeing to allow itself to be considered a dual resident corporation for purposes of Section 1503(d). This is an interesting evolution of the check-the-box rules, moving from simply establishing entity classification to conditioning classification on a taxpayer's affirmatively subjecting itself to an unrelated statutory regime. It is unclear whether conditioning a definition on an anti-abuse concern is a valid exercise of regulatory authority.

Having created a mechanism for jurisdiction under the DCL rules, the proposed regulations under Section 1503(d) provide that a domestic reverse hybrid will be treated as a dual resident corporation only if (1) an entity that is a tax resident of a foreign jurisdiction derives or incurs items of income, gain, deduction, or loss from the domestic reverse hybrid and (2) the tax resident is related under Section 267(b) or Section 707(b) with the domestic reverse hybrid. The domestic reverse hybrid provisions are proposed to be effective from the date the proposed regulations were filed with the Federal Register.

The Preamble to the Section 267A proposed regulations also notes that the Treasury and the IRS are studying structures whereby a domestic corporation funds a foreign disregarded entity with debt and the resulting interest is deductible for foreign law purposes but there is no corresponding income for U.S. tax purposes. Some foreign jurisdictions have addressed these structures in their implementation of BEPS Action 2, relating to hybrid arrangements.
Recapture of Foreign Branch Losses

Foreign branch losses can be recaptured in multiple ways.

Without incorporation. Because of the separate basketing of foreign branch income, foreign branch losses can contribute to a Section 904(f)(5) separate limitation loss. Such loss reduces the available limitation in other baskets and then can be recaptured in future years when income in the foreign branch basket is recharacterized as income from any basket that was originally reduced. In addition, to the extent foreign branch losses are attributable to foreign sources, which would generally be the case, such losses can contribute to a Section 904(f)(1) overall foreign loss. In such situation, to the extent such loss offsets U.S.-source income, future foreign-source income, including foreign branch basket income, would be subject to recapture and conversion to U.S.-source income. 10

Through outbound transfers. The TCJA substantially revised the rules relating to the recapture of foreign branch losses upon an outbound transfer to a foreign corporation under Section 351 or through a reorganization described in Section 368 . The TCJA repealed the active trade or business exception to Section 367(a) gain recognition on the transfer of tangible assets. 11 This necessarily repealed the "branch loss recapture" provisions of former Section 367(a)(3)(C). Accordingly, the outbound transfer of tangible property in an otherwise nonrecognition transaction is simply taxed under Section 367(a) . With regard to intangible property, the TCJA amended the definition of intangible property to provide that goodwill and going concern value and similar property is treated as intangible property under Section 367 and is therefore subject to the deemed contingent sale/royalty regime of Section 367(d) . Therefore, as a general matter all outbound transfers trigger some form of gain or income recognition, regardless of whether the property transferred is attributable to a foreign branch loss.

Section 91 , as enacted by the TCJA, carries recapture further. Section 91 provides that upon a domestic corporation's outbound transfer of substantially all the assets of a foreign branch, the "transferred loss amount" attributable to that branch is recaptured through an income inclusion as U.S.-source income. 12 The statute contemplates that "proper adjustments" be made to the stock of the transferee foreign corporation and to the assets received by the transferee. Interestingly, Section 91 is triggered by a transfer to a "specified 10-percent owned foreign corporation," as defined in Section 245A(b) , which is defined as a foreign corporation with respect to which the domestic corporation is a United States shareholder, as defined in Section 951(b) . 13 Therefore, the rule is not tied to nonrecognition treatment (before the application of Section 367 ) and could be triggered upon a taxable sale of substantially all of a foreign branch's assets to the specified 10%-owned foreign corporation.

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The simple concept embodied in Section 91 belies remarkable complexity.

*Foreign branch.* Section 91 defines a foreign branch by reference to Section 367(a)(3)(C), as in effect before the enactment of the TCJA. Foreign branch was defined for purposes of Section 367(a)(3)(C) as follows:

> [A]n integral business operation carried on by a U.S. person outside the United States. Whether the activities of a U.S. person outside the United States constitute a foreign branch operation must be determined under all the facts and circumstances. Evidence of the existence of a foreign branch includes, but is not limited to, the existence of a separate set of books and records, and the existence of an office or other fixed place of business used by employees or officers of the U.S. person in carrying out business activities outside the United States. Activities outside the United States shall be deemed to constitute a foreign branch for purposes of this section if the activities constitute a permanent establishment under the terms of a treaty between the United States and the country in which the activities are carried out. Any U.S. person may be treated as having a foreign branch for purposes of this section, whether that person is a corporation, partnership, trust, estate, or individual. 14

Interestingly, this definition of foreign branch is different from that used for purposes of defining the Section 904(d) foreign tax credit basket (which is also the definition used to define the exclusion from the FDII regime). A foreign branch for purposes of the foreign tax credit and FDII rules is defined by reference to the definition of a "qualified business unit" under Section 989(a). 15 Under the Section 989 regulations, a qualified business unit is "any separate and clearly identified unit of a trade or business of a taxpayer provided that separate books and records are maintained. 16 A QBU also includes any activity that produces effectively connected income provided that separate books and records are kept. 17

Nevertheless, the Section 904 proposed regulations, in defining foreign branch, specifically exclude any activity taking place in the U.S. from the scope of a foreign branch. 18 In addition, the Section 904(d) proposed regulations take into account otherwise disregarded payments—i.e., payments between an owner and its disregarded entity or between disregarded entities of a common owner—in determining whether a foreign branch exists and in allocating income to that foreign branch. 19 Those rules do not expressly apply for purposes of Section 91.

It appears unlikely that, absent regulations, activities and income that are entirely disregarded for U.S. federal income tax purposes would be taken into account in determining the existence of a foreign
branch or a loss attributable to a foreign branch for purposes of Section 91. Interestingly, because the Section 91 statutory definition of foreign branch is fixed to the law in place at the time of the repeal of the Section 367(a)(3) active trade or business exception, it may be that the Section 91 definition of foreign branch cannot be further conformed with the Section 904(d) and FDII definition.

Another consideration in the definition of foreign branch is the extent to which grouping is allowed. For example, are (or will) same-country branches (be) consolidated? Similarly, if same country grouping is otherwise allowed, will same country branches held by different members of a consolidated group be combined for purposes of applying Section 91? Such grouping would have implications on whether there is a foreign branch loss and on whether "substantially all" of the branch's assets are transferred.

**Substantially all.** The statute gives no indication of how "substantially all" of the foreign branch assets are determined. In the context of Section 367(a) gain recognition agreement triggering events, regulations provide that "substantially all" is determined under all facts and circumstances. This standard was promulgated to specifically reject safe harbor substantially all thresholds that applied in the context of Section 368(a)(1)(C) reorganizations. Some statutes and regulations define substantially all in varying contexts with quantitative standards that uniformly require significantly more than a majority of assets. Other authorities have added a qualitative element, giving more weight to operating assets as compared with passive assets.

**Transferred loss amount.** Section 91(b) defines a transferred loss amount as the excess of the sum of the following losses:

(1) Those incurred by the branch after 12/31/2017, and before the transfer; and

(2) With respect to which a deduction was allowed to the taxpayer

Over the sum of

(3) Any taxable income of such branch for a tax year after the tax year in which the loss was incurred and through the close of the tax year of the transfer; and

(4) Any amount which is recognized under the Section 904(f)(3) overall foreign loss disposition rules.

Section 91(c) further provides that the transferred loss amount is reduced (but not below zero) by the gain recognized by the taxpayer on account of the transfer (other than any amount recognized under the overall foreign loss disposition rules). Nevertheless, an off-Code provision modifies the application of Section 91(c) by reducing the gain recognized for purposes of Section 91(c) "by the amount of gain that
would be recognized under Section 367(a)(3)(C) (determined without regard to the amendments made by subsection (e) [which repealed the Section 367(a)(3) active trade or business exception] with respect to losses incurred before January 1, 2018." 25

A more formulaic expression of the statutory calculation is:

(1) The sum of foreign branch deducted losses recognized after 12/31/2017

(2) Minus the sum of

(i) Foreign branch taxable income recognized in a tax year after the loss in (1), above; 26 and

(ii) Gain recognized under Section 904(f)(3) on account of the transfer 27

(3) Minus the excess, if any, of

(i) Gain recognized on the transfer, other than under Section 904(f)(3), 28 over

(ii) The amount of notional Section 367(a)(3)(C) recapture on pre-1/1/2018 losses. 29

(4) Equals the transferred loss amount.

Observations and issues arise from the transferred loss amount definition.

As an initial matter, Section 91 is prospective for losses incurred after 12/31/2017. For fiscal-year taxpayers, this presumably means allocating foreign branch losses between pre-2018 and post-2017 periods. Absent guidance, any reasonable method would appear appropriate. Potential reasonable methods would include closing the books and pro-rating a loss for the entire tax year.

The deduction requirement is unclear. Read in conjunction with the focus on a domestic corporation's losses, it would appear to mean that such losses are determined based on deductions allowed and taken, and not losses otherwise suspended or deferred under Section 163(j) or 267(a) or (f), for example. The reference could also be addressing the interaction of the transferred loss amount determination with the Section 172 NOL rules. This could arise when a foreign branch loss contributes to a Section 172(c) NOL. In that case, it might be viewed as appropriate to increase the transferred loss amount only when the Section 172 carryforward gives rise to a deduction in a future year.

Nevertheless, the mechanics of associating the branch loss with an NOL and then associating NOL utilization with the transferred loss amount would be complicated. For example, presumably, to the extent the foreign branch portion of an NOL itself offsets future foreign branch income (of the same
branch or a different foreign branch), such foreign branch income could be taken into account in
determining the transferred loss amount.

The reduction for "taxable income of such branch" appears to not take into account any gains otherwise
recognized because of the transfer. Those gains are separate reductions under the Section 904(f)(3)
component or the Section 961(c) gain provisions.

The Section 91 loss computation does not start until a foreign branch loss is incurred. Therefore, post-
2017 positive branch income can offset only a prior (but still post-2017) loss, but cannot offset a future
loss. While not clear, it appears that gain is taken into account in a given year only to the extent of the
branch’s cumulative post-2017 loss going into the gain year. Under that approach, for example, if a
foreign branch’s results for 2018 through 2020 are (10), 20, and (5), respectively, it appears that only 10
of the 20 gain year is taken into account.

The off-Code limitation to the Section 91(c) gain provision is a strange mix of concepts and interactions
with other Code provisions.

Essentially, the off-Code provision keeps the Section 367 branch loss recapture provisions in operation
after 2017. Taxpayers need to compute their branch loss as of 12/31/2017, but would compute the
recapture gain at the time of the incorporation.

The amount of "off-Code" branch loss recapture applies to reduce any gain recognized on the transfer
for purposes of applying Section 91(c), but not gain recognized under the Section 904(f)(3) overall
foreign loss disposition rules.

An example in the Joint Committee on Taxation’s "Blue Book" demonstrates the application of the rule.
In the example, a domestic corporation ("U.S. Parent") incorporates its Country X branch on 12/31/2018.
The branch had incurred $150 of losses in 2018 for which U.S. Parent took a deduction. Upon the
incorporation, the branch has tangible assets with built-in gain of $100, and U.S. Parent recognizes that
$100 of gain under Section 367(a). On these facts, U.S. Parent would have a Section 91(a) income
inclusion of $50 ($150 of losses less $100 of Section 91(c) gain recognition amount). If, however, the
branch had $75 of pre-2018 branch losses, the Section 91(c) reduction amount would be reduced by
that $75 to $25, and U.S. Parent would have a Section 91(a) inclusion of $125.

Section 367(a)(3)(C) branch loss recapture applies to foreign goodwill and going-concern value.
Nevertheless, Section 91(c) gain recognition should generally be with respect to tangible property.
Further, the Section 91(c) gain and the hypothetical Section 367(a)(3)(C) gain are both determined at
the time of the outbound transfer. Accordingly, the hypothetical "recapture" of foreign goodwill should not generally affect the Section 91(a) inclusion amount.

In light of the complex computations and records that are necessary to compute the transferred loss amount, taxpayers with foreign branches and at least the potential for incorporation might consider whether tracking the relevant results starting in 2018 makes sense or whether to undertake more of a forensic exercise when the actual incorporation takes place. Consideration could be given to whether the information might be derivable on a current basis from systems being established to track the foreign branch Section 904(d) basket.

Stock basis adjustments. If there is a Section 91(a) inclusion, Section 91(e) contemplates "proper" basis adjustment in the transferee stock and in the assets received by the transferee. These rules would appear to be self-executing, notwithstanding the reference to potential regulatory or other guidance in this space. Presumably, the baseline adjustment would be equal to the Section 91(a) income inclusion and would be spread to the stock received and the assets transferred on a pro-rata basis. Guidance could potentially address the extent to which the adjustments can create built-in losses. Allowing a built-in loss in stock would appear appropriate, given that the income inclusion is effectively creating branch earnings. With regard to assets, it could be appropriate to spread basis adjustment to the extent of available gain, before allowing built-in losses to be created. 33

Operating Losses of Controlled Foreign Corporations

Under the TCJA, CFCs are now subject to three independent, yet interrelated taxing regimes relating to foreign income:

(1) The legacy subpart F rules.
(2) The Section 951A GILTI rules.
(3) The Section 245A and associated rules creating exempt income.

The subpart F rules continue to apply to certain passive income, related-party sales and service operations, and insurance operations. 34 Through its "tested income" definition, the GILTI rules apply to all other income, except income effectively connected with a U.S. trade or business; subpart F income for which the Section 954(b)(4) "high-tax exception" applies; dividends from a Section 954(d)(3) related person, and Section 907(c)(1) foreign oil and gas extraction income. Any CFC income not included in the income of a U.S. shareholder as subpart F income or GILTI is in the exempt income category. Importantly, the exemption is realized only when the Section 245A 100% deduction is applied to a
domestic corporation's inclusion in income of those earnings.

The Section 245A deduction could arise upon a dividend distribution or upon a sale of CFC stock (either by a U.S. shareholder or an upper-tier CFC's sale of lower-tier CFC stock through the application of Sections 1248 and 964(e)(4), respectively). Until those "exempt" earnings are included in a U.S. person's income, however, they are subject to the Section 959 rules and therefore coexist within the Section 959 regime with previously taxed earnings and profits (PTEP) generated by the subpart F and GILTI regimes. As discussed below, that treatment is the source of considerable complexity.

**Losses and Subpart F Income**

As relates to the treatment of losses, the subpart F and GILTI rules operate in virtual silos. Losses relating to subpart F operations cannot affect GILTI results, and vice versa. Within subpart F income, operating losses now have their biggest impact on the application of the foreign tax credit rules. As noted above, the TCJA eliminated the Section 902 indirect foreign tax credit rules and the pooling principles that governed the generation of indirect foreign tax credits under Sections 902 and 960. Indirect credits now arise solely under revised Section 960. Those provisions generally govern foreign tax credits attributable to subpart F inclusions, GILTI inclusions, and PTEP distributions.

Importantly, with the elimination of the Section 902 pooling concept, upon a subpart F inclusion, a domestic corporation is considered to have paid the foreign income taxes "properly attributable" with the CFC's item of income so included. Section 960 proposed regulations define properly attributable only by reference to the CFC's "current-year taxes." Current-year taxes are defined as foreign income taxes paid or accrued in the CFC's current tax year, which is defined as a tax year of the CFC which ends during or with the tax year of a U.S. shareholder of the CFC in which the U.S. shareholder has an income inclusion under Section 951(a)(1) or Section 951A(a), or during which the CFC receives or makes a distribution of Section 959 PTEP.

This framework creates a remarkable variety of foreign tax credit results in its interactions with the Section 952(c) overall E&P limitation, the qualified deficit rules, and the chain deficit rules. If the overall E&P limitation or chain deficit reduce but do not eliminate the CFC's subpart F income, those earnings are effectively excluded in determining the percentage of the subpart F income that is included in gross income for purposes of determining a U.S. shareholder's "proportionate share" of the CFC's foreign taxes that are allocated and apportioned to the specific category of subpart F income (i.e., the "subpart F income group"). If a qualified deficit offsets subpart F income, the reduction in subpart F
income reduces the percentage of allocable foreign taxes that are taken into account in the U.S. shareholder’s proportionate share of taxes. Any taxes that are not deemed paid cannot be credited in any future year.

In addition, while much has been made of the "use or lose" nature of GILTI taxes, insofar as there is no Section 904(c) carryover with respect to GILTI taxes deemed paid by a U.S. shareholder, there is a similar "use or lose" phenomenon at the CFC level. While suggested by the Section 960 statutory focus on taxes "properly attributable" to subpart F and GILTI inclusions, the proposed regulation’s reliance on current-year taxes inherently means that any prior-year taxes not credited (or associated with previously taxed earnings and profits) are disallowed. As related to losses, the consequences are multifold and dramatic.

A CFC (1) with subpart F generating activities that have a loss for the year, (2) whose subpart F income is entirely offset by a hovering deficit or a qualified deficit or (3) that is otherwise subject to the overall E&P limitation of Section 952(c) (adjusted to not include any tested loss of the CFC) will not be deemed to pay any foreign tax credits associated with the subpart F activity. Such foreign taxes are otherwise lost and can never be credited.

A further interaction of subpart F and losses comes in the operation of Section 952(c)(2) recapture ("Section 952(c) recapture"). While Section 951A(c)(2)(B) prevents tested losses from contributing to the Section 952(c)(1)(A) subpart F income E&P limitation, future tested income can be treated as subpart F income to effectuate the recapture under a literal reading of Section 952(c)(2)'s recapture provision. Further, and somewhat alarmingly, an example in the GILTI proposed regulations provides that the recharacterization of E&P under Section 952(c)(2) does not prevent the application of Section 951A if the E&P is otherwise attributable to tested income. Accordingly, the tested income is subject to tax under the GILTI rules, and the E&P amount attributable to tested income gives rise to Section 952(c) recapture and subpart F income. That is, the tested income earnings are double taxed in the Section 952(c) recapture year under the proposed regulations.

In the proposed regulation example, a domestic corporation wholly owns a CFC. In year 1, CFC has $100 of foreign base company sales income and a $100 loss attributable to foreign oil and gas extraction activities. Notwithstanding that foreign oil and gas extraction income is neither subpart F income nor tested income, the $100 loss affects E&P. Because CFC has no E&P in year 1, it has no subpart F income in year 1. CFC establishes a Section 952(c) recapture account of $100. In year 2, CFC has $100 of tested income and no other income or loss. The example provides that the $100 of tested income creates $100 of E&P, which creates $100 of subpart F income under Section 952(c)(2). Further,
the $100 of tested income is subject to Section 951A and potentially could give rise to a GILTI inclusion.

Under one view, the results demonstrated in the proposed regulations could be justified by considering what would happen if the CFC had earned all the income in a single year. A CFC with $100 of foreign base company sales income, a $100 loss attributable to foreign oil and gas extraction activities, and $100 of tested income would have a $100 subpart F inclusion and a $100 tested income attribution to the U.S. shareholder. The Section 961(a) basis adjustment arising upon the subpart F inclusion and any GILTI inclusion would apply to potentially provide a loss upon the ultimate taxable disposition of the CFC stock. Such loss, if ever recognized, would eliminate the double-taxation feature.

The proposed regulations achieve the $100 of subpart F income and $100 of tested income inclusion result over the two-year period by double taxing the tested income earnings in the second year. Interestingly, this result seems to be uniquely driven by the GILTI rules. The subpart F rules themselves do not contemplate double taxing subpart F earnings. For example, foreign personal holding company income offset by a foreign base company sales income loss would not be recaptured by future positive foreign base company sales income. The proposed regulation's treatment appears to be driven by the fact that the Section 951A rules do not contain an overall E&P limitation, meaning that tested income can give rise to a GILTI inclusion even if the CFC has an overall E&P deficit.

Nevertheless, there are technical and policy considerations to take into account. While E&P and income are distinct tax accounting concepts, there is a clear linkage in corporate tax accounting between the two. In the context of Section 952(c)(2), the provision converts E&P into subpart F income at the CFC level. Similarly, Section 951A itself adds-back tested losses (an income concept) to Section 952(c)(1) E&P. 51

Section 951A(c)(2)(A)(i)(II) provides that gross income taken into account in determining subpart F income is excluded from tested income. If E&P attributable to tested income triggers Section 952(c)(2) recapture, it seems entirely reasonable to conclude that the tax gross income underlying that E&P has given rise to subpart F income and should not be taken into account in determining Section 951A tested income. Further, from the policy perspective the conversion of tested income to subpart F income could be viewed as just recognizing the primacy of the "full taxation" subpart F anti-deferral rules inherent in the tested income definition. 52

More generally, the mere fact that Section 951A views tested income in a "silo" does not itself sanction the double taxation of income. The proposed regulation's narrow focus on the income results belies more systemic issues. As noted above, foreign tax attribution to a U.S. shareholder under Section 960 is
essentially a "use or lose" system. If current-year taxes are not attributed to a U.S. shareholder or associated with PTEP, they are lost. Within an international tax system that continues to rely on the foreign tax credit to eliminate international double taxation, affirmative U.S. double taxation of income is wrong. This is also in contrast to the operation of the foreign tax credit rules in the "single year" scenario. In the single year, foreign taxes attributable to the subpart F income and to any GILTI inclusion are taken into account.

These foreign tax credit considerations are in addition to the other considerations already highlighted. Section 952(c)(2) itself expressly does not allow for the double taxation of subpart F earnings. Further, expanding the creation of income inclusions and offsetting losses, and thereby creating potential character and source mismatches, is not sound tax policy.

Given the technical and policy issues raised in the coordination of Section 952(c) recapture and GILTI, the double taxation of tested income seems inappropriate. The more straightforward reading of the interaction of Section 952(c)(2) recapture and Section 951A is that the earnings giving rise to recapture are attributable to gross income giving rise to subpart F income, and such gross income is excluded from tested income. Alternatively, given that tested losses are affirmatively walled-off from subpart F income and the Section 952(c)(1) E&P determination, it would be sensible to entirely wall-off E&P otherwise attributable to tested income from Section 952(c)(2) recapture.

**Tested Losses in the GILTI Regime**

Within the GILTI regime, tested losses arise if a CFC has expenses that are properly allocable to tested income in excess of its tested income. As noted above, tested losses do not affect the consequences to the U.S. shareholder under the subpart F regime. Instead, the primary consequence of tested losses is on the U.S. shareholder's calculation of its GILTI inclusion amount, including a U.S. shareholder's determination of its qualified business asset investment (QBAI) and its "specified interest expense." A U.S. shareholder determines its GILTI inclusion amount by taking (1) the aggregate amount of its properly allocable share of the tested income and tested losses of each CFC less (2) a 10% return on its properly allocable share of each CFC's QBAI (generally, the adjusted basis in depreciable tangible property) less certain interest expense paid outside of the affiliated group-defined in the proposed GILTI regulations as "specified interest expense." The proposed GILTI regulations adopt a netting approach for determining a U.S. shareholder's specified interest expense that requires the U.S. shareholder to net the aggregate amount of its properly allocable...
share of each CFC’s interest expense against its properly allocable share of each CFC’s interest income. In the event the interest expense exceeds interest income, the resulting amount is the U.S. shareholder’s specified interest expense.

If a CFC has a tested loss, its QBAI is not allocated to the U.S. shareholder for purposes of reducing its GILTI inclusion amount. This result could be harsh, especially in cases where a CFC holds large amounts of QBAI, but has large swings in its income stream. To make matters worse, if the tested loss CFC also has large amounts of interest expense that is apportioned against gross tested income, this interest expense may increase the U.S. shareholder’s specified interest expense and ultimately reduce the U.S shareholder’s allocable share of the QBAI from other CFCs.

Tested losses also affect a U.S. shareholder’s ability to credit foreign taxes attributable to tested income. The TCJA added a separate Section 904(d) basket for foreign taxes paid with respect to a U.S. shareholder’s GILTI inclusion amount. Foreign taxes from tested loss CFCs cannot be deemed paid under Section 960(d). Further, the effective sharing of the tested loss with another CFC will reduce the foreign taxes deemed paid under Section 960(d) with respect to the tested income CFC.

Nevertheless, tested losses may be beneficial in determining a U.S. shareholder’s foreign tax credit limitation. The TCJA added Section 904(b)(4), which disregards expenses allocated to exempt income for purposes of the foreign tax credit limitation. The proposed foreign tax credit regulations apply these rules in the context of Section 864 expense allocation. Under the proposed regulations, stock value for purposes of expense allocation is allocated between the GILTI basket and exempt income. This characterization is determined based on the U.S. shareholder’s “inclusion percentage,” which is generally the U.S. shareholder’s GILTI inclusion amount divided by the U.S. shareholder’s aggregate tested income before reduction for tested losses and QBAI. Because tested losses decrease the U.S. shareholder’s inclusion percentage, tested losses reduce tested income in a manner that is more beneficial than if the economic loss were directly incurred by the tested income CFC.

Example. USP owns CFC1, a foreign corporation. CFC1 owns F1 and F2, each a foreign entity. USP has $100 of interest expense that is required to be allocated between its US and foreign assets, including the stock of CFC1. CFC1 has no operations, F1 has a $100 tested loss, and F2 has $200 of tested income. Neither CFC1, F1, nor F2 have QBAI. If F1 and F2 are disregarded entities, their income would be netted at the CFC1 level and USP would have a $100 GILTI inclusion amount and a 100% inclusion percentage ($100 GILTI inclusion amount / $100 tested income). When allocating its interest expense to the CFC1 stock, USP would characterize the stock of CFC1 as a GILTI asset based on the
100% inclusion percentage. However, if F1 and F2 were instead CFCs, USP would again have a $100 GILTI inclusion amount; however, its inclusion percentage would be reduced to 50% ($100 GILTI inclusion amount / $200 tested income).

In addition to the current-year computational issues, tested losses can also create burdens in future years. The proposed GILTI regulations address the potential double benefit that a U.S. shareholder could receive if a U.S. shareholder uses the tested loss of one CFC to reduce its allocable share of tested income from another CFC and the tested loss CFC was later sold. Because no basis reduction was made to the stock of the tested loss CFC and the tested loss ultimately benefited the U.S. shareholder by reducing its GILTI inclusion amount, allowing the U.S. shareholder to use the basis to either create a loss or reduce gain on the stock sale could be viewed as a second benefit of the loss.

To address this perceived abuse, the proposed GILTI regulations require the U.S. shareholder to reduce its basis in the stock of the tested loss CFC by its "net used tested loss amount" (NUTLA) upon a subsequent disposition of the CFC stock. If the NUTLA exceeds available basis, additional gain is recognized. The rules also apply to sales of interests in foreign entities, including foreign partnerships and trusts, that own CFCs with tested losses. Further, if a tested loss arises in a lower-tier CFC and offsets tested income of an upper-tier CFC, the basis adjustment rules apply at each level in the CFC ownership chain where the tested loss was used.

NUTLA is defined as the aggregate of a domestic corporation's used tested loss amount with respect to a CFC over the aggregate of the domestic corporation's offset tested income amount attributable to that CFC. The used tested loss amount is defined as the extent to which a CFC's tested loss offsets the domestic corporation's pro rata share of CFC tested income in a given year. If the domestic corporation does not have net CFC tested income for an inclusion year, the tested loss is deemed to be used pro rata with the domestic corporation's pro rata share of other CFC tested losses.

The offset tested income amount is the inverse of the used tested loss amount. That is, if a domestic corporation does not have net CFC tested income for an inclusion year, the offset tested income amount is the domestic corporation's pro rata share of the tested income of the CFC. If the domestic corporation has net CFC tested income for an inclusion year, the tested income is deemed to be offset by tested losses pro rata to the domestic corporation's pro rata share of the tested income of other CFCs.

The NUTLA rules raise technical and policy issues. As an initial matter, there is no express regulatory authority to make the contemplated adjustments. The proposed regulations merely cite Section 7805.
general authority and, in the Preamble, justify the rule based on Supreme Court precedents preventing double deductions with respect to the same economic loss. Nevertheless, the NUTLA rules address not merely deductions from stock losses but the computation of gain as well. Interestingly, when Congress addressed similar issues potentially arising under Section 961(d) (discussed in detail below), the limitation applied only to losses generated on the disposition of CFC stock. Further, and similar to the issues raised under Section 961(d), the NUTLA rules appear overly broad insofar as they are not predicated on a domestic corporation actually realizing a double benefit.

As discussed below in relation to losses and exempt income, the exempt income benefit depends on a dividend inclusion or equivalent that benefits from the Section 245A deduction. There are limitations on the availability of the 245A deduction and, because the payment of a dividend or an equivalent is predicated on E&P, losses can prevent the benefit from ever being realized.

**Losses and Exempt Income**

As discussed above, exempt income held by CFCs is subject to the Section 959 rules and relies on net positive E&P to become "officially" exempt upon an inclusion by a U.S. shareholder. In the context of dividends, exempt income is stacked behind PTEP. In the absence of PTEP, the nimble dividend rule of Section 316(a)(2) still applies, such that current-year exempt income could be distributed even if there is an overall loss in the Section 959(c)(3) E&P bucket. Interestingly, there are significant consequences to continuing to rely on E&P and the Sections 301, 316, and 959 mechanics for managing exempt income.

As an initial matter, E&P computations differ from income computations. Deductions that are disallowed for U.S. tax purposes, and therefore are disallowed in determining subpart F and tested income, often are still deductions for E&P purposes and therefore are effectively allocated against exempt income. Therefore, disallowed meals and entertainment, stock-based compensation, potentially losses from the distribution of property, and other E&P losses are effectively allocated against exempt income. In addition, it appears that subpart F losses and tested losses are effectively allocated to exempt income because of the loss of dividend-paying capacity. The consequence of the reduction in dividend-paying capacity is an increased risk of distributions to a U.S. shareholder triggering capital gain.

The concept of the TCJA’s international tax reforms was to create a system whereby a CFC’s earnings were subject to tax or deemed exempt on an annual basis. Nevertheless, the retention of the E&P concept and the need for dividends to “perfect” the exemption appears to be a significant flaw in the
system. The avenues for regulatory relief in this area seem limited. A straightforward legislative solution would be to delink CFC distributions from Section 316 and amend Section 959(c)(3) to make the non-PTEP bucket just apply to "exempt income." Exempt income would be defined by reference to deductions properly allocable to otherwise exempt gross income, such that disallowed deductions and losses unrelated to exempt income would effectively drop out of the Section 959(c)(3) bucket. Basis recovery under Section 301(c)(2) would begin only after the income in each of the Section 959(c) buckets had been distributed.

**Controlled Foreign Corporation Stock Losses-First-Tier CFCs**

Prior to the TCJA, a U.S. shareholder’s sale of CFC stock at a loss would generally create a capital loss. The benefit of a capital loss from a U.S. shareholder’s sale of CFC stock is dependent on there being capital gain. Under the Section 865 regulations, the loss would generally be sourced the same as gain, and so would generally be U.S.-source. Nevertheless, the regulations contain various exceptions to the general rule:

1. If the stock sale is attributable to a foreign office, the loss will be allocated to foreign-source income if, had the sale produced a gain, the foreign country would have imposed at least a 10% tax thereon.
2. If the loss is with respect to stock that had paid certain dividends and deemed equivalents within the prior 24 months (the "dividend recapture amount"), then all or part of the loss is allocated to the class of income to which the dividend income related. The dividend recapture amount includes all dividends paid on the stock (excluding any gross-up in a dividend for foreign taxes under Section 78), subpart F inclusions (and inclusions from a qualified election fund) attributable to dividends received by a foreign corporation that are not allocable to passive income for foreign tax credit purposes, and Section 956 inclusions. If the dividend recapture amount is less than 10% of the realized loss, then the dividend recapture rules do not apply.
3. A series of anti-abuse rules addressing: (a) nonrecognition transfers of built-in loss property and changes of taxpayer residence; (b) taxpayers holding offsetting positions with respect to the loss stock; and (c) taxpayers engaging in transactions that create foreign-source income and a corresponding U.S.-source stock loss.

Such loss could affect the taxpayer’s foreign tax credit limitation through the application of. The TCJA affects this general treatment in a number of ways. Perhaps most directly, new Section 961(d) affects the basis in the stock held by domestic corporations in 10%-owned foreign
subsidiaries (therefore including CFCs with respect to their corporate U.S. shareholders) for purposes of determining loss on any disposition of such stock. In particular, upon such disposition, the stock basis is reduced (but not below zero) by the amount of any deduction allowable under Section 245A with respect to such stock. The provision is coordinated with the Section 1059 "extraordinary dividend" rules by giving priority to Section 1059. Notwithstanding the statute's vague language ("deduction allowable"), the legislative history makes clear that the provision is triggered by dividend distributions that give rise to the Section 245A deduction and not merely by a foreign subsidiary's pool of untaxed earnings. 83

The policy underlying Section 961(d) appears to be that the Section 245A 100% deduction would be duplicated by losses attributable to the deduction. 84 Nevertheless, this general notion of Section 245A creating a loss is not clear in many contexts.

For example, assume USP, a domestic corporation, forms CFC, a foreign corporation, with 100x on January 1, Year 1. CFC buys an asset for 100x and earns 10x in Year 1. On December 30, Year 1, CFC distributes 10x to USP, which claims a Section 245A deduction with respect to the dividend. On December 31, Year 2, USP sells CFC for 90x, which is the fair market value of CFC's asset. CFC having earned and distributed 10x does not affect the value of or gain in USP's stock. The loss on the stock is economically attributable to the decrease in value in CFC's asset. It is hard to understand the policy justification for denying this loss. As applied in this situation and recognizing the linkage between the stock loss and the CFC's asset loss, Section 961(d) could be viewed as carrying through a policy that one cannot have a stock loss to the extent assets have given rise to exempt income. Nevertheless, if CFC's asset had appreciated to 110x and that was the sale price of the CFC stock, the 10x of gain would be recognized for U.S. tax purposes.

Where the underlying policy of Section 961(d) is more easy to see is upon the acquisition of a foreign corporation if no Section 338 election is made and the foreign corporation has preexisting E&P or built-in gain assets and the gain results in Section 959(c)(3) earnings post-acquisition. Using the same "characters" as above, USP buys CFC for 100x on January 1, Year 1. No Section 338 election is made. At the time of the acquisition, CFC has E&P of 10x held in cash and an asset with a basis of 80x and value of 90x. These assets remain unchanged until December 29, Year 3, when CFC sells its asset for 90x. The gain generates 10x of exempt income. On December 30, Year 3, CFC distributes 20x to USP, which claims a 20x Section 245A deduction with respect to the dividend. On December 31, Year 3, USP sells CFC for 80x, which is equal to the cash held by CFC. Upon the distribution of the 20x, CFC's value was reduced but USP's 100x basis remained unchanged. 85 Accordingly, but for the application of Section 961(d), USP would recognize a 20x loss on the sale. Section 961(d), however, would appear to
apply to eliminate the loss. In this situation, the loss on the CFC stock is much more clearly attributable to the decrease in value in CFC's assets caused by the distribution that qualified for the Section 245A deduction.

It appears that Section 961(d) is overbroad. Remediation from its effects would be through Section 338 elections upon foreign target acquisitions (which may have other consequences). Otherwise, relying on the substantial amounts of PTEP created under the Section 965 rules and under the GILTI regime, and noting the impacts of E&P losses and stranded E&P deductions discussed above, it may be that Section 245A dividends are relatively rare for domestic corporations, thereby preventing or at least limiting the application of Section 961(d).

Implications of Section 338(g) elections. Sales of first-tier CFC stock to unrelated persons allow the buyer to make a Section 338(g) election, resulting in the CFC's deemed sale of its assets to "New CFC." The resulting consequences of the deemed sale, including presumably under the GILTI regime, are attributed to the seller. Accordingly, upon the deemed sale, subpart F income, tested income (or loss), and exempt income is generated. A U.S. shareholder's subpart F inclusion under Section 951(a) and GILTI inclusion under Section 951A(a) both give rise to a Section 961(a) basis adjustment in the CFC stock, and thereby can create or increase a loss in the CFC stock.

Interestingly, the GILTI inclusion can give rise to the Section 250 deduction and allows the utilization of foreign tax credits, both resulting in a reduced U.S. effective tax rate on the inclusion. As noted, the loss generated is generally a U.S.-source, capital loss. While the loss, generally subject to a three-year carryback and a five-year carryforward under Section 1212, is allowed only to the extent of offsetting capital gains, any benefit has a 21% value as a deduction against income subject to the full corporate income tax rate. The creation of tax benetted income and a corresponding potential loss that is fully usable is odd, although not out of keeping with the general design of the reformed international tax rules, which apply quasi-consolidation or flow-through principles to CFC income, but continue to recognize CFC stock as a separate income-producing asset of the U.S. shareholder and maintain to a significant extent the classical U.S. tax rules with respect to that stock.

The Section 338(g) election would invoke Section 338(h)(16). That provision provides that for purposes of applying the foreign tax credit rules, Section 338 does "not apply for purposes of determining the source or character of any item." The apparent purpose of the rule is to limit the extent to which the Section 338 election and the accompanying deemed sale can create a Section 904(d) foreign tax credit limitation to absorb excess foreign tax credits. The rule expressly does not apply to the conversion of gain to dividend income under Section 1248 (although the Section 1248 consequences themselves are

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determined without regard to the Section 338 deemed sale). There is regulatory authority to otherwise limit the application of Section 338(h)(16), but no such regulations have been issued. 88

The scope of Section 338(h)(16) is unclear in large part because the provision does not appear to change the amount of any item generated in the Section 338 deemed sale for purposes of applying the foreign tax credit rules. In its simplest application, Section 338(h)(16) clearly applies to determine the treatment of stock gain under Section 1248, and provides that deemed sale earnings cannot apply to convert gain to a Section 1248 dividend.

But its application in other contexts is unclear. For example, upon the sale of stock with no gain or loss (i.e., with basis equal to fair market value), a Section 338 election may generate subpart F or GILTI inclusions, which may carry foreign tax credits. The amount of subpart F and GILTI income and any associated foreign tax credits deemed paid under Sections 960(a) and (d) are apparently taken into account for purposes of determining the U.S. shareholders foreign tax credit consequences. Nevertheless, what does it mean to not apply Section 338 to determine the source and character of any item?

Under one potential approach, Section 338(h)(16) operates under a matching principal. Whatever source and character of income would have been generated absent the Section 338 election is preserved. Whatever incremental income is generated in the Section 338 election has its source and character determined under the regular rules without application of Section 338(h)(16). This approach aligns with the general treatment for Section 1248 income directly contemplated in the statute. 89

Alternatively, whatever source and character exist without the Section 338 election could be viewed as "tainting" any item of income generated in any amount upon the Section 338 election. For example, if CFC stock has a built-in loss (absent the Section 338 election), under the “tainting” approach, the source and character of that loss would determine the source and character of any subpart F or GILTI inclusion resulting from the Section 338 election. As noted above, the source would generally be U.S. source. The character would generally be capital and passive. As so applied, it seems odd that Section 338(h)(16) could apply to convert subpart F or GILTI inclusions into capital gain for Section 904 purposes. This could seemingly have implications for Section 904(b)(2), as discussed above.

Sourcing. Losses on first-tier CFC stock seem likely to remain U.S. source. Nevertheless, arguments could be made that with respect to the Section 865 regulations, the "dividend recapture amount" concept should be amended. The dividend recapture amount exception appears intended to prevent taxpayers from using foreign-source dividends close in time to a sale of stock to create or increase a U.S.-source
loss on the stock. The dividend capture amount is defined by reference to dividends, subpart F income attributable to dividends, and Section 956 inclusions. Actual dividends and Section 956 inclusions for corporate U.S. shareholders are largely eliminated by the Section 245A regime.  

Dividends are generally excluded from GILTI income if they are from related persons or because they are treated as subpart F income. Therefore, there is limited ability to use dividends or equivalents to generate losses that are not otherwise being addressed by Section 961(d).

Upon Section 338 elections on a domestic shareholder's sale of CFC stock, if Section 338(h)(16) applies narrowly under a "matching" principal discussed above, consideration could be given to the application of the Section 865 regulations. As noted above, the Section 865 regulations contain an anti-abuse rule providing for source matching if a taxpayer or related party engages in a "transaction or series of transactions with a principal purpose of recognizing foreign-source income that results in the creation of a corresponding loss with respect to stock." Certainly, the sale of CFC stock to a third party seems a strained circumstance to invoke a principal purpose anti-abuse rule. A Section 338(g) election is at the whole discretion of the buyer, who is not obtaining a sourcing benefit. Nevertheless, Section 338 elections have been and, in the reformed tax environment, will continue to be highly negotiated aspects of a stock purchase agreement. In circumstances when the buyer is U.S. tax indifferent (e.g., a foreign, non-CFC buyer) or the seller otherwise can be shown to have compelled a Section 338(g) election by the buyer, application of the 865 regulations matching rule might be considered.

Lower-Tier CFCs

While many of the issues discussed above for losses in the stock of first-tier CFCs have the same application for lower-tier CFC stock held by another CFC, stock losses in lower-tier CFC stock raise other unique issues.

Section 961(d). Section 964(e)(4)(B) provides that rules similar to Section 961(d) apply to a CFC's sale of the stock of another foreign corporation. Accordingly, Section 245A distributions from a CFC's 10%-owned subsidiary could create issues with respect to subsequent sales of the lower-tier foreign corporation that generate a loss. For lower-tier subsidiaries that are not CFCs ("10/50 companies"), the application of Section 961(d) "rules" in this situation would appear largely to mirror that of first-tier CFCs with respect to domestic corporate shareholders.

The application of Section 964(e)(4)(B) and Section 961(d) to sales of lower-tier CFCs is less clear and raises a more fundamental issue. The application of Section 961(d) to sales of lower-tier CFC stock is
predicated on the application of Section 245A to dividends from lower-tier to upper tier CFCs. Accordingly, there needs to be an instance when the upper-tier CFC is actually entitled to claim the deduction. Such instance is hard to identify.

As noted above, there are broadly three income tax bases operating for CFCs-subpart F, GILTI, and E&P rules governing exempt income. CFC-to-CFC dividends are hardly ever subpart F income because of the exception in Section 954(c)(6) 94

Tested income for GILTI purposes does not include related-party dividends. 95 As a matter of common sense, if the dividends are not in the gross income base, it would be absurd to allow a deduction that could seemingly be used only against other, non-dividend subpart F or tested income. With regard to exempt income and E&P, the dividend-received deduction does not reduce E&P. It would seem similarly absurd to argue that the exempt income is separate and apart from the E&P and that the Section 245A deduction is applying against a separate, irrelevant exempt income base.

As a design matter, exempt income is not separately defined and is only accounted for in the revised international tax system through E&P and the Section 301 , 316, and 959 distribution rules. 96 Accordingly, it appears that credible arguments exist that, for as long as Section 954(c)(6) remains applicable, Section 245A generally does not apply to CFC-to-CFC dividends. Nevertheless, the issue is far from clear. 97

Character of stock losses. Stock losses recognized by CFCs are subject to complex treatment within the subpart F income tax base. In determining foreign personal holding company income, Section 954(c)(1)(B) provides a netting regime for the excess of gains over losses from the sale or exchange of three classes of property:

(1) Certain property that gives rise to dividends, interest, rents, royalties, and annuities.
(2) Interests in trusts, partnerships, or REMICs.
(3) Property that does not give rise to income.

This net amount, if positive, functions as an item of gross subpart F income. 98 To the extent losses from such property exceed gains, such losses (and any allocable deductions) affect subpart F income only through the Section 952(c)(1) earnings and profits limitation. 99 Importantly, the stock losses are accounted for entirely within the subpart F regime and do not appear to give rise to deductions that are properly allocable to tested income under the GILTI rules. Because such losses affect only E&P, in the reformed international tax system they serve to prevent only otherwise exempt income from being paid up to a corporate U.S. shareholder in a dividend eligible for Section 245A. This treatment dramatically
differs from the treatment of losses on first-tier CFC stock. It further demonstrates the discontinuities that are created by dissociating the treatment of income and gain attributable to related CFC stock from the treatment of the CFC's underlying operating income.

1 Pub. L. 115-97 (12/22/2017), commonly referred to as the Tax Cuts and Jobs Act (TCJA).

2 See Section 1211 (generally limiting the deduction for capital losses to the corresponding amount of capital gain); Section 469 (limiting a taxpayer's loss deduction for certain passive activities to the corresponding taxable income); Section 382 (setting a limit for the amount of losses that can be deducted by a corporation after certain changes in ownership); Section 267(a)(1) (limiting a taxpayer's ability to deduct losses arising from certain related-party transactions); Reg. 1.1502-36 (preventing the duplication of losses within U.S. consolidated groups).

3 Section 250(a)(2) . As enacted, the Section 250 taxable income limitation does not take into account the deduction attributable to the Section 78 income inclusion attributable to taxes associated with GILTI income under Section 960(d) . This appears to have been an oversight that may be rectified through a technical correction. Joint Committee on Taxation, General Explanation of Public Law No. 115-97 (JCS-1-18) at 395 n.1751, December 2018.

4 Interestingly, onshore losses can similarly affect FDII either by reducing the "foreign derived deduction eligible income" (FDDEI) that is attributable to the benefited sales, licensing, or services income under the FDII regime or by reducing non-FDDEI income so as to eliminate either (1) "deduction eligible income" (DEI), the general category of domestic income generally eligible for the deduction, or (2) non-DEI and thereby implicate the taxable income limitation.

5 Reg. 1.1503(d)-2 , -4(b).

6 72 Fed. Reg. 12,901 (2007) (Preamble to 2007 DCL final regulations, concluding that Section 1503(d) should not apply to domestic reverse hybrids, but noting continued study of the issue).

7 Prop. Reg. 301.7701-3(c)(3) .

8 Prop. Reg. 1.1503(d)-1(c)(1) .

9 See Prop. Reg. 1.1503(d)-8(b)(6) ; Prop. Reg. 301.7701-3(c)(3)(iii) .

10 The lack of symmetry between the FDII regime and the foreign tax credit rules creates interesting
interactions. As discussed above, foreign branch losses would never reduce DEI or FDDEI, although they could affect the Section 250 taxable income limitation. There is no apparent "recapture" mechanism to increase DEI or FDDEI when a foreign branch loss reduces the Section 250 deduction through the taxable income limitation. Nevertheless, there are foreign tax credit limitation consequences resulting from recapture under the Section 904(f) rules.

11 Pub. L. 115-97, section 14102(e).

12 Sections 91(a) and (d).

13 Sections 91(a) and 245A(b)(1).

14 Reg. 1.367(a)-6T(g)(1).

15 Section 904(d)(2)(J)(i) ; see Prop. Reg. 1.904-4(f)(3)(iii) (defining foreign branch by reference to the definition of qualified business unit under Regs. 1.989-1(b)(2)(i) and (b)(3)).

16 Regs. 1.989-1(b)(1) and (2)(ii).

17 Reg. 1.989-1(b)(3).


19 Prop. Regs. 1.904-4(f)(2)(vi) and (3)(iii)(B).

20 See, e.g., Reg. 1.1503(d)-1(b)(4)(ii) (combining all separate units on a country-by-country basis).

21 Reg. 1.367(a)-8(b)(1)(xii).

22 TD 9311 (2/05/2007). See Rev. Proc. 77-37, 1977-2 CB 568 (requiring that 90% of net assets or 70% of gross assets be transferred to constitute "substantially all" for IRS ruling purposes).

23 See, e.g., Sections 45D(b)(1)(B) and (b)(3) (creating an 85% safe-harbor threshold).

24 See, e.g., Rev. Rul. 57-518, 1957-2 CB 253 (providing that substantially all in the context of Section 368(a)(1)(C) was determined based on "the nature of the properties retained by the transferor, the purpose of the retention, and the amount thereof.").


26 Section 91(b)(1).
27 Section 91(b)(2).

28 Section 91(c).


30 Compare Reg. 1.1503(d)-5(c)(4)(iii) (attributing income recognized under various statutory and regulatory provisions to a separate unit or interest in a transparent entity).

31 Joint Committee on Taxation, General Explanation of Public Law No. 115-97 (JCS-1-18) at 354, December 2018.

32 Arguments could be made that Section 367(d) income recognized in the year of the incorporation is "gain recognized on account of the transfer" for purposes of Section 91(c), taking into account the "contingent sale" construct in the statute. Such gain, or a portion thereof, could in concept be subject to the off-Code provision. Nevertheless, such interpretation is far from clear and would create a new set of complex interactions between Section 91 and the Section 367(d) calculation.

33 See, e.g., Section 732(c)(2).

34 The TCJA’s only substantive modification to the scope of subpart F was the repeal of the foreign base company oil-related income rules. Pub. L. 115-97, section 14211. The TCJA left Section 956 in the Code as an application of the subpart F regime. Nevertheless, as related to domestic corporation U.S. shareholders, the Treasury and the IRS issued proposed regulations limiting applicable earnings for purposes of Section 956 to untaxed E&P that would not qualify for Section 245A if distributed to the U.S. shareholder. Prop. Reg. 1.956-1(a)(2). For this purpose, Section 958(a) is applied to determine the U.S. shareholder's percentage ownership and holding period in the stock and Section 245A(e) (relating to hybrid dividends) applies as though the distribution were paid up through the chain of ownership. These rules would virtually eliminate the application of Section 956 to domestic corporation U.S. shareholders and thereby minimize the opportunities for otherwise exempt income to become subject to U.S. taxation.

35 Section 964(e) generally applies Section 1248 rules to an upper-tier CFC's sale of lower-tier CFC stock to convert gain into dividend income. As implemented by the TCJA, Section 964(e)(4) treats that dividend income as subpart F income, but allows the U.S. shareholder to take a Section 245A deduction with respect to such subpart F income as though it were a dividend paid by the selling CFC directly to the U.S. shareholder.
See Section 951A(c)(2)(B)(ii) (increasing the subpart F E&P limitation under Section 952(c)(1)(A) by the amount of any Section 951A tested loss); Prop. Reg. 1.951A-2(b)(4) (determination of gross tested income and deductions properly allocable thereto are determined without regard to Section 952(c)); see also Prop. Reg. 1.951A-2(b)(3) (a CFC’s otherwise allowable deductions are allocated and apportioned to gross tested income under the principles of Section 954(b)(5) and Reg. 1.954-1(c), as modified).

See Sections 960(a), (d), and (b), respectively.

Section 960(a).


Prop.Regs. 1.960-1(b)(3), (4), and (10).

Section 952(c)(1)(A) (providing that the subpart F income of a CFC cannot exceed its current-year E&P).

Section 952(c)(1)(B) (allowing certain "qualified deficits" from prior years that relate to a specified category of subpart F income to reduce positive income in such category in future years).

Section 952(c)(1)(C) (allowing current-year deficits of "qualified chain members" relating to specified categories of subpart F income to offset income in the specified category of a CFC in the chain).

Prop. Regs. 1.960-2(b)(3)(i) and (iii).


See Prop. Reg. 1.960-2(b)(2) (providing that "No other foreign income taxes are considered properly attributable to an item of income of a controlled foreign corporation" and thereby precluding subpart F inclusions from carrying anything other than current-year taxes).

In addition, because the proposed foreign tax credit regulations associate foreign income taxes with discrete items of subpart F income, losses within the discrete subpart F income categories would also appear to lead to stranded foreign tax credits, even if there is overall positive foreign-source income. See Prop. Reg. 1.960-1(d)(2)(ii)(B) (defining subpart F income groups), -2(b)(2) (providing rules defining "properly attributable" for purposes of associating foreign income taxes with income). To add insult to injury, the foreign taxes themselves are deductible at the CFC level, and may therefore contribute to the loss that prevents their crediting.


50 See Section 952(c)(2); Reg. 1.952-1(f)(2)(ii) (providing for recapture only to the extent current-year earnings and profits in a given year exceed subpart F income in a tax year).

51 Section 951A(c)(2)(B)(ii).

52 Section 951A(c)(2)(A)(i).

53 Section 951A(c)(2)(B)(i).

54 Section 951A(b); Prop. Reg. 1.951A-1(c)(3)(iii).


57 Prop. Reg. 1.960-2(c)(1).

58 Prop. Reg. 1.960-2(c)(1), (2) (determining deemed paid credits based on the CFC’s “inclusion percentage” which is the U.S. shareholder’s aggregate GILTI inclusion divided by the aggregate amount of tested income taken into account by the U.S. shareholder).


60 Prop. Reg. 1.861-13(a)(2).


62 See discussion in the REG-104390-18, Preamble, section I.G.3.


64 Prop. Reg. 1.951A-6(e)(1)(i). Prior to the disposition, the basis exists for all federal income tax purposes, including for purposes of attracting expense allocation under the Section 864(e) regulations.


72 83 Fed. Reg. 51,072 (2018) ("The Treasury Department and the IRS have determined that in certain cases the lack of adjustments to stock basis of a tested loss CFC can lead to inappropriate results.... See Charles Ilfeld Co. v. Hernandez, 292 U.S. 62 (1934) (denying the loss on stock of subsidiaries upon liquidation when operating losses were previously claimed from the subsidiaries' operations because "[i]f allowed, this would be the practical equivalent of double deduction"); Skelly Oil Co., 394 U.S. 678 (1969) ("the Code should not be interpreted to allow respondent 'the practical equivalent of a double deduction'" (citing Charles Ilfeld Co.)); section 1.161-1.)" Reg. 1.161-1 notes in part that "[d]ouble deductions are not permitted."

73 It could be argued that the initial elimination of GILTI is at least a deferral benefit. Nevertheless, potential exchanges of timing benefits for permanent loss of an economic loss is at best a debatable policy choice. In any event, the Preamble to the proposed regulations does not raise this as a justification.

74 Notice 2019-1, 2019-2 IRB 275 , provides that distributions of PTEP are done on a "first-in, first-out" basis, apparently meaning that in the context of 316(a)(2) dividends out of the 959(c)(1) and (c)(2) E&P buckets, such dividends are not spread to current-year distributions but rather are simply paid out in the order of the current-year distributions. That is, it appears that the ordering rules of Reg. 1.316-2(b) do not apply to PTEP distributions, but continue to apply to distributions out of the Section 959(c)(3) bucket.

75 Section 1211(a) .

76 Reg. 1.865-2(a)(1) .

77 Reg. 1.865-2(a)(2) .

78 Reg. 1.865-2(b)(1)(i) .

79 Regs. 1.865-2(b)(1)(iii) , (d)(2), and (d)(3).

80 Reg. 1.865-2(b)(1)(ii) .
81 Reg. 1.865-2(b)(4).

82 See Section 904(b)(2) (limiting the contribution of foreign-source capital gains to the foreign tax credit limitation to the amount of “foreign source capital gain net income”).

83 See H.R. Conf. Rep't No. 115-466 at 475-76 (explaining the provision as reducing the adjusted basis in loss stock by an amount “equal to the portion of any dividend received with respect to such stock”); see also Joint Committee on Taxation, General Explanation of Public Law No. 115-97 (JCS-1-18) at 353, December 2018 (same).

84 See Joint Committee on Taxation, General Explanation of Public Law No. 115-97 (JCS-1-18) at 353, December 2018 (“A distribution from a foreign corporation eligible for a DRD could reduce the value of the foreign corporation, reducing built-in gain or increasing built-in loss in the stock of the foreign corporation.”).

85 Section 1059 did not apply because USP satisfied the two-year holding period of Section 1059(a).

86 Reg. 1.338-9(b)(1).

87 Section 338 proposed regulations issued in 1992 requested comments on Section 338(h)(16) and described the purpose of the provision as follows: “The primary abuse that Section 338(h)(16) prevents is the increase of general limitation foreign source income for purposes of sourcing and the foreign tax credit rules through the deemed sale of foreign assets, when the only actual sale is of the stock of a domestic or foreign corporation, which ordinarily generates passive foreign or U.S. sourced income. Because no foreign taxes are paid on the deemed sale of the foreign assets, the general limitation deemed sale earnings and profits can be used to ‘soak up’ excess foreign taxes in the same basket.” 57 Fed. Reg. 1409 (1992).

88 See Reg. 1.338-9(e) (reserving on regulations addressing the "Operation of section 338(h)(16)"). The 1992 Section 338 proposed regulations requested comments on the "proper application of section 338(h)(16), including its application where the deemed sale of assets results in subpart F income under section 952." 57 Fed. Reg. 1409 (1992).

89 The legislative history to Section 338(h)(16) also focuses solely on the application of the rule to stock gain, although the general description of the provision, like the statutory language, is not so limited. S. Rep't No. 100-445 (1988) ("Under the bill, a deemed asset sale under section 338 shall generally be disregarded for source and foreign tax credit limitation purposes in determining the seller's foreign tax credit limitation, except as provided in regulations. Instead, for these purposes, the
gain is generally treated as a gain from the sale of stock. An exception to this rule is provided for gain
derived from the deemed sale by a U.S. corporation of stock in a controlled foreign corporation, to the
extent that the gain is treated as dividend income under section 1248 (before any deemed sale by the
controlled foreign corporation of its assets). To that extent, income derived from the sale of stock of
the U.S. corporation is treated, for foreign tax credit purposes, as income from the sale of the U.S.
corporation's assets.

Proposed regulations under Section 956 would reduce Section 956(b)(1) applicable earnings by the
amount of the Section 245A deduction that would be available if the CFC distributed all its earnings to

Sections 951A(c)(2)(A)(i)(II) and (IV).

Reg. 1.865-2(b)(4)(iii).

This is also an area where the Section 865 regulations might be modified to affirmatively apply a
matching rule to stock loss attributable to Section 961(a) adjustments arising because of GILTI
inclusions generated by a Section 338 deemed sale.

See Notice 2007-9, 2007-1 CB 401 (“Because of the way the subpart F rules operate, distributions
of earnings from a CFC to a related CFC typically will not be attributable to subpart F income for
purposes of the section 954(c)(6) exception.”). Note that Section 954(c)(6) will expire for tax years
beginning on or after 1/1/2020.

Section 951A(c)(2)(A)(i)(IV).

The application, or lack thereof, of Section 245A to CFC-to-CFC dividends is an issue in other
contexts. For example, whether Section 1059’s basis reduction rules for extraordinary dividends,
including dividends arising under Section 304 and Section 356(a), apply to CFC-to-CFC dividends is
implicated by this issue.

See Section 245A(e) (applying in relevant part the Section 245A(e) hybrid dividend rules to CFC-to-
CFC dividends and defining a hybrid dividend, in part, as a dividend to which Section 245A would
apply but for the application of Section 245A(e)).

Reg. 1.954-1(a)(2)(i).

Reg. 1.954-1(c)(1)(ii).