By **Carl A. Merino, Dina Kapur Sanna** & **Seth J. Mersky**

Attribution After the TCJA

A downward spiral of unintended consequences

As many readers are aware, the Tax Cuts and Jobs Act of 2017 (TCJA) dramatically changed the rules governing controlled foreign corporations (CFCs), including the introduction of a one-time transition tax on deferred foreign income, a new tax on global intangible low taxed income (GILTI) and other changes that expanded the scope of the CFC regime. However, one provision many advisors are still grappling with is the repeal of the limitation on downward attribution in former Internal Revenue Code Section 958(b)(4).

The blanket repeal of IRC Section 958(b)(4) had a much broader impact than the more surgical changes proposed with respect to that provision in the TCJA legislative history. Although recently issued proposed Treasury regulations[1] and Revenue Procedure 2019-40 provide limited safe harbors for certain taxpayers who aren't related to other shareholders and who can satisfy certain minimum diligence requirements, those rules and guidance provide little relief to U.S. taxpayers who own interests in closely held businesses and investment structures in which the beneficial owners are related. While the House has proposed legislation to remedy this apparent legislative oversight, it appears that, until Congress passes a fix, full downward attribution will remain the law.

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Overview of CFC Rules

A foreign corporation is a CFC if it's more than 50% owned by "United States shareholders"[2] (U.S. shareholders). A U.S. person[3] is a U.S. shareholder with respect to a CFC if such U.S. person owns at least 10% of the CFC's stock.[4] In both cases, ownership is determined by vote or value.[5]

If a foreign corporation is a CFC, U.S. shareholders of the CFC who own shares directly or indirectly through foreign entities on the last day of the CFC's taxable year are taxed currently on certain of the CFC's earnings, regardless of whether such earnings are distributed. These taxes result from either the longstanding Subpart F regime dating back to 1962 or the new GILTI regime that went into effect last year.[6]

Repeal of Section 958(b)(4)

The CFC regime includes indirect and constructive ownership rules (which are a modified version of general attribution rules in the IRC) that can treat U.S. persons as owning stock of a foreign corporation held by certain family members and entities. Generally, one must have an actual economic interest (either directly or indirectly) in a CFC to be subject to Subpart F income or GILTI inclusions.[7] However, a U.S. person may be considered to own more than such person's direct or indirect economic interest in a foreign corporation under the constructive ownership rules for purposes of determining whether such person is a U.S. shareholder and for purposes of determining whether a foreign corporation is a CFC.[8]

Family attribution. A U.S. person may be treated as owning shares of a foreign corporation held by a U.S. spouse, parent, grandparent or child. However, there's no attribution among siblings[9] or from family members who are nonresident aliens.[10]

Upward attribution from entities. Foreign

corporate stock owned by a corporation, partnership, trust or estate is attributed "up" to its shareholders, partners or beneficiaries, generally in proportion to their interests in the corporation, partnership, trust or estate from which attribution occurs.[11] A general limitation to this rule provides that a shareholder isn't considered to own stock held by a corporation unless the shareholder owns at least 50% of the corporation (by value), but this threshold is reduced to 10% for purposes of the CFC rules.[12] There's no minimum ownership threshold for attribution "up" from a partnership, trust or estate to its partners or beneficiaries.[13]

Downward attribution to entities. Ownership of foreign corporate stock may also be attributed "down" to a corporation, partnership, trust or estate by its shareholders, partners or beneficiaries, respectively. A shareholder must own at least 50% of the stock of a corporation (by value) for stock held by the shareholder to be attributed down to the corporation, but there's no minimum ownership threshold for downward attribution from a partner or beneficiary to a partnership, trust or estate.[14]

Reattribution. The attribution rules allow reattribution of ownership (that is, successive application of the attribution rules) subject to certain limitations. Generally, reattribution occurs "up and down," and not "down and up." For example, stock in a foreign corporation held by a trust may be attributed up to a beneficiary of such trust and then reattributed down to a partnership in which the beneficiary is a partner. However, there wouldn't be reattribution up to other partners of that partnership with respect to the same stock. The attribution rules also prevent reattribution among family members (that is, if family member B is considered to own shares held by family member A by virtue of family attribution, such shares won't be reattributed from family member B to family member C solely by reason of their family relationship).[15]

Legislative History

Until its repeal by TCJA, former Section 958(b)(4) prevented the downward attribution of foreign corporate stock from a non-U.S. shareholder, partner or beneficiary to a U.S. corporation, domestic partnership, domestic trust or domestic estate.[16] The legislative history relating to the repeal of Section 958(b)(4) strongly indicates that the repeal was never intended to be wholesale, but, instead, was intended to be limited in scope and narrowly targeted to address certain "abusive" transactions.

According to the Senate Finance Committee's final conference report, changes to Section 958(b)(4) were intended to address specific "de-control" transactions in which a foreign corporate parent of a U.S. shareholder of a CFC caused the underlying foreign corporation to fail to constitute a CFC by acquiring more than 50% of the foreign corporation's stock in exchange for cash or property. Further, the Senate Finance Committee stated in its explanation to the Joint Committee on Taxation that the repeal of Section 958(b)(4) "is not intended to cause a foreign corporation to be treated as a CFC with respect to a United States shareholder as a result of [downward attribution] to a U.S. person that is not a related person within the meaning of 954(d)(3) to such United States shareholder as a result of the repeal of 958(b)(4)."[17] Section 954(d)(3) provides that a person is a related party if the person is an individual, corporation, partnership, trust or estate that controls, or is controlled by, the CFC, or the person is a corporation, partnership, trust or estate controlled by the same person or persons that control the CFC.

> It seems clear that the intent of Congress was to limit repeal of Section 958(b)(4) to situations in which a U.S. shareholder controlled or was related under Section 954(d)(3) to the U.S. person to which ownership was attributed.

In sum, it seems clear that the intent of Congress

was to limit the repeal of Section 958(b)(4) to situations in which a U.S. shareholder controlled or was related under Section 954(d)(3) to the U.S. person to which ownership was attributed.[18] Nevertheless, because the TCJA removed 958(b)(4) from the IRC in its entirety, taxpayers must now await the passage of a TCJA technical correction package or further guidance from Treasury and the Internal Revenue Service regarding the impact of Section 958(b)(4)'s repeal.

Examples

The following examples illustrate some of the counterintuitive ways in which taxpayers can become ensnared in the downward attribution rules and the significant—and often adverse—U.S. tax impacts that can result:

Example 1: Foreign parent with U.S. and foreign subsidiaries. A common structure that will be impacted by the repeal of Section 958(b)(4) is a foreign parented multinational group with both U.S. and foreign corporate subsidiaries that are majority-owned by the foreign parent corporation. In this example, the foreign corporate parent is family-owned by four non-U.S. family members and one U.S. shareholder, each owning 20% of the stock, respectively. (See "Constructive Ownership," this page.)

In this scenario, there isn't sufficient U.S. ownership to cause the foreign parent corporation to be treated as a CFC. However, because the foreign parent owns at least 50% of the stock of at least one U.S. corporate subsidiary, the parent's stock in its foreign subsidiaries will be attributed down to the U.S. corporate subsidiary, causing such U.S. corporate subsidiary to become a U.S. shareholder of the foreign corporate subsidiaries whose stock was attributed downward. Because the U.S. corporate subsidiary is now deemed to own more than 50% of the stock of the foreign subsidiaries by way of attribution from the foreign parent, the foreign corporate subsidiaries would become CFCs. The unfortunate result is that the single U.S. family member who owns 20% of the stock of the foreign parent will now be subject to Subpart F income and GILTI inclusions with respect to his 20% indirect share of the earnings of the foreign corporate subsidiaries, even though the foreign parent itself would avoid CFC status.[19]

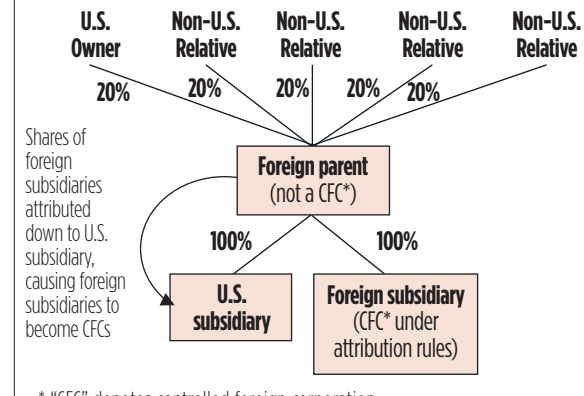
Example 2: Other common shareholders of U.S. and foreign companies. Overlapping ownership of U.S. and offshore structures by individuals and trusts is another common situation in which downward attribution can produce adverse results. (See "Overlapping Ownership," p. 57.) Suppose that 100% of the stock of a foreign corporate holding company with various operating subsidiaries overseas is owned 25% each by four irrevocable trusts, two of which are foreign nongrantor trusts with non-U.S. beneficiaries and two of which are U.S. nongrantor trusts with U.S. beneficiaries. Assume that each trust benefits a different sibling and his descendants. Further suppose that the trusts decide to co-invest in a U.S. company (USCO) in equal 25% shares.[20]

Putting aside downward attribution, the foreign corporations in the structure wouldn't be CFCs because these corporations aren't more than 50% owned by U.S. shareholders. However, if USCO is a partnership, all of the shares of the foreign holding company held by the four trusts would be attributed downward to USCO, causing the foreign holding company and its subsidiaries to become CFCs (as they would now be considered to be 100% owned by USCO, a U.S. shareholder). The two U.S. nongrantor trusts would then be subject to Subpart F income and GILTI inclusions with respect to their 25% interests in the foreign companies.

In contrast, if USCO was a corporation rather than

Constructive Ownership

U.S. corporate subsidiary becomes a U.S. shareholder of the foreign corporate subsidiaries whose stock was attributed downward



* "CFC" denotes controlled foreign corporation

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a partnership, there wouldn't be downward attribution from any shareholder because each trust owns only 25% of USCO's stock, and 50% ownership would be required under IRC Section 318(a)(3)(C) for stock owned by any of the trusts to be attributed down to USCO.[21] Further, because each trust benefits a different sibling's lineal branch, there wouldn't be family attribution among the trust beneficiaries and thus, no single trust's constructive ownership would reach 50%. This is a situation in which choice of entity clearly has a significant impact on the outcome.[22]

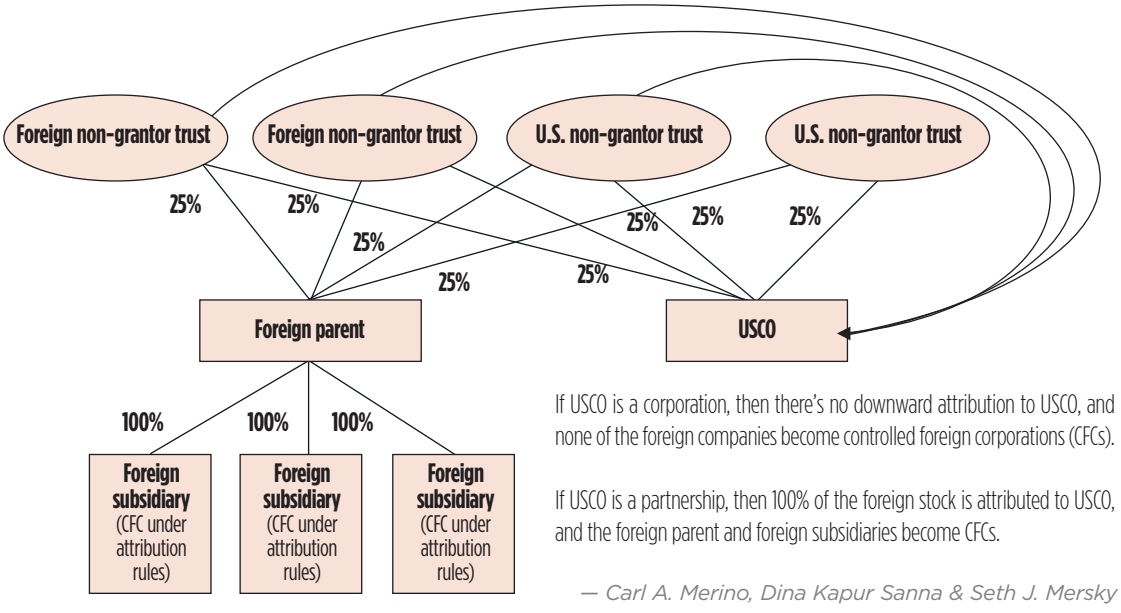
Example 3: Loss of portfolio interest exemption (vacation home and investment holding company)— While much attention has been focused on the impact of Section 958(b)(4)'s repeal on U.S. taxpayers, it also can affect inbound investment structures with no U.S. beneficial owners due to the interplay between the CFC rules and the so-called "portfolio interest exemption."

Generally, nonresident alien individuals and foreign corporations are subject to a 30% gross basis withholding tax on their receipt of U.S. source fixed, determinable annual or periodic (FDAP) income that isn't effectively connected with the conduct of a U.S. trade or business. FDAP income typically includes interest, dividends, rents and royalties received from U.S. sources.[23] However, there's a major exception to the 30% withholding tax for "portfolio interest" received from U.S. sources. Portfolio interest generally includes most interest received from U.S. sources other than certain contingent interest, interest received from certain related parties and interest effectively connected with the conduct of a U.S. trade or business.[24]

For many years, foreign investors have relied on the portfolio interest exemption to make tax-free investments in U.S. bonds and other debt offerings, both as individual investors and in the commercial planning context. However, CFCs are ineligible to receive tax-free portfolio interest payments.[25] Thus, the inadvertent treatment of many foreign corporations as CFCs as a result of Section 958(b)(4)'s repeal may now make many foreign corporations ineligible to receive tax-free portfolio interest as a result of such corporations being treated as CFCs. The example below illustrates this result:

Overlapping Ownership

Choice of entity has a significant impact on the outcome



If USCO is a corporation, then there's no downward attribution to USCO, and none of the foreign companies become controlled foreign corporations (CFCs).

If USCO is a partnership, then 100% of the foreign stock is attributed to USCO, and the foreign parent and foreign subsidiaries become CFCs.

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Assume that foreign individual (FI) owns a vacation home located in the United States. FI's U.S. vacation home is held through a foreign "blocker" structure: FI owns 100% of the stock of a foreign parent corporation ("FCO 1"), which in turn owns 100% of the stock of a USCO subsidiary. USCO holds title to the vacation home. This common planning structure, which interposes a foreign blocker corporation between the non-U.S. individual and the underlying U.S. situs asset, is designed to shield FI from U.S. estate tax exposure with respect to the underlying property. While only FCO 1 is required for U.S. estate tax protection purposes, interposing a U.S. subsidiary such as USCO offers other benefits, such as an easy mechanism for repatriating earnings after a sale of the underlying property without being subject to a second-level branch profits tax (particularly if FCO 1 will hold other assets) and avoiding mandatory withholding taxes on the sale of the property itself.[26]

In this example, further assume that FI also owns 100% of the outstanding stock of a second foreign corporation (FCO 2) that holds FI's U.S.-based, publicly traded investment assets, including both stock in publicly traded corporations and a portfolio of corporate and Treasury bonds. This structure is also common to prevent the application of U.S. estate tax on FI's death and, further, to segregate U.S. investment assets from ownership of U.S. real property so that independent post-mortem U.S. tax planning can be undertaken for both asset classes on FI's death.[27]

Because FI owns 100% of both FCO 1 and FCO 2, FI's ownership of FCO 2 will be attributed down through FCO 1 to USCO, causing USCO to become a U.S. shareholder with respect to FCO 2. As a result, FCO 2 would also be classified as a CFC (on account of USCO's 100% constructive ownership). As a CFC, FCO 2 wouldn't be eligible for the portfolio interest exemption and would therefore be subject to a 30% U.S. withholding tax on interest payments received from its bond portfolio. This outcome results solely from the downward attribution rules. As such, FI may consider holding any portfolio debt instruments directly or through a disregarded entity.[28] See "Inbound Investment Structures," this page.

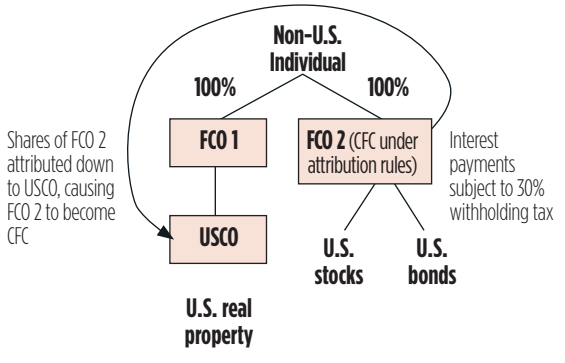
Impact in the commercial context. A discussion of commercial inbound investment structures is beyond the scope of this article, but the loss of eligibility for the portfolio interest exemption may have a broad impact on many existing inbound structures that were created to take advantage of the portfolio interest exemption. Often, foreign investors making U.S. inbound investments will capitalize a foreign corporation that will, in turn, acquire nonvoting stock of a U.S. corporate subsidiary funded by the foreign corporation with a mix of debt and equity. In many instances, the nonvoting shares held by the foreign corporate investor will represent well over 50% of the value of the issuer.[29] There are numerous scenarios in which shares of the foreign debt-holding corporation could be attributed down to the U.S. subsidiary that issued the debt, thus potentially disqualifying the foreign corporation from eligibility for the portfolio interest exemption. This could upend expectations for a number of existing structures that were carefully negotiated based on expectations of tax-free returns on the debt portion of the investment.

Proposed Rules

Recently issued proposed Treasury regulations and Rev. Proc. 2019-40 provide limited relief for certain taxpayers who would otherwise be deemed to have ownership interests in CFCs that are classified as such solely as a result of downward attribution. Rev. Proc. 2019-40 provides that the IRS won't challenge a taxpayer's determination that a foreign corporation isn't a CFC if the corporation is a "foreign controlled" CFC as a result of downward attribution, and the taxpayer satisfies a duty

Inbound Investment Structures

FCO 2 would also be classified as a controlled foreign corporation (CFC)



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of inquiry. This safe harbor exception applies if: (1) a U.S. person doesn't have actual knowledge, hasn't received information and can't obtain reliable public information to determine if a foreign corporation is a CFC; and (2) the U.S. person inquires of the foreign entities in which such U.S. person directly owns an interest whether the entity in question is a CFC and asks for information relevant to whether any subsidiaries may be CFCs.

If a taxpayer determines that he owns stock in a foreign controlled CFC but is unable to obtain the requisite information to accurately determine his share of Subpart F income or GILTI inclusions, such U.S. person may compute his income attributable to those income categories based on alternative available information, such as by using audited or unaudited financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP), international financial reporting standards, GAAP of the jurisdiction where the foreign corporation is located or other records used by the corporation for tax reporting or internal control purposes.

Building on earlier guidance issued in Notice 2018-13, Rev. Proc. 2019-40 also announced the IRS' intention to revise the Form 5471 instructions to limit the information required to be reported by certain U.S. shareholders of foreign controlled CFCs. Rev. Proc. 2019-40 is effective for the last taxable year of a foreign corporation beginning before Jan. 1, 2018 and each subsequent taxable year of such corporation and for taxable years of U.S. shareholders in which or with which such taxable years of the foreign corporation end.

Finally, the newly issued proposed regulations provide very limited relief to taxpayers by confirming that foreign controlled CFCs resulting from downward attribution won't be treated as CFCs only in certain limited circumstances. The proposed regulations make revisions to existing regulations issued under IRC Sections 267, 332, 367, 706, 863, 904, 1297 and 6049 for such purpose. For example, the regulatory changes to Section 267 provide relief for amounts paid to treaty-eligible foreign controlled CFCs, but, notably, the regulations don't specify that a foreign controlled CFC resulting from downward attribution is eligible for the portfolio interest exemption. Thus, the loss of eligibility for the portfolio interest exemption illustrated in Example 3 above still stands. The proposed regulations, if issued in final form, would apply on or after Oct. 1, 2019, but taxpayers may rely on them currently so long as they do so consistently with respect to a particular provision.[30]

Impact

As illustrated in the examples above, the repeal of Section 958(b)(4) affects structures in ways far afield of what was contemplated in TCJA's legislative history, including effects on purely inbound investment structures with no U.S. beneficial owners. Until Congress directly addresses the matter, downward attribution will continue to create tax uncertainty and complexity for both U.S. and non-U.S. taxpayers alike.

Endnotes

1. REG-104223-18.
2. Internal Revenue Code Section 957(a).
3. For this purpose, a "U.S. person" is defined in IRC Section 7701 to include U.S. citizens and residents, domestic corporations, domestic partnerships and domestic trusts and estates.
4. IRC Section 951(b).
5. Sections 951(b) and 957(a). Pre-Tax Cuts and Jobs Act, U.S. shareholder status was determined solely by voting power.
6. Sections 951(a) and 951A(a). While "traditional" Subpart F income was generally limited to passive investment income and certain types of related party sales and services income, global intangible low taxed income expanded the overall controlled foreign corporation (CFC) regime to pick up most types of active business income as well.
7. Section 951(a), IRC Section 958(a). In determining a person's proportionate interest in a foreign corporation, partnership, trust or estate, the Treasury regulations generally look to such person's share of the income of such entity. *See* Treasury Regulations Section 1.958-1(c)(2).
8. Sections 951(b), 957(a) and 958(b).
9. IRC Sections 318(a)(1) and 958(b).
10. Section 958(b)(1). Note that ownership could be attributed from a non-U.S. family member to a U.S. corporation, partnership or trust of which such non-U.S. person was a shareholder, partner or beneficiary.
11. Section 318(a)(2). In the case of a grantor trust, ownership is attributed to the grantor.
12. Sections 318(a)(2)(C) and 958(b)(3).
13. Note that if a corporation, partnership, trust or estate owns more than 50% of the voting stock of another corporation, then it will be deemed to own 100% of the voting stock of such other corporation for purposes of reattribution to its own shareholders, partners or beneficiaries. Section 958(b)(2).
14. Section 318(a)(3).
15. Section 318(a)(4).
16. Section 958(b)(1), which blocks family attribution from nonresident alien relatives, was left untouched.

17. H.R. Conf. Rep't 115-466, 115th Cong., 1st Sess, p. 633 (Dec. 15, 2017).
18. Note that proposed Treasury regulations issued on May 17, 2019 would limit downward attribution under Section 318(a)(3) for purposes of determining whether two corporations are "related" within the meaning of Section 954(d)(3). This has implications for whether payments received by a CFC from another foreign corporation would be considered to have been received from a "related" foreign corporation for purposes of the Subpart F income exceptions under Sections 954(c)(3) and (6). *See* REG-125135-15.19.
19. As illustrated in Example 2, depending on ownership of the foreign parent, it may be possible to structure around downward attribution by setting up a "sister" structure for the U.S. subsidiaries.
20. The foreign nongrantor trusts might invest directly or through their own foreign blocker corporations.
21. We note that while Section 958(b)(2) reduces the ownership threshold for upward attribution from a corporation to 10% for purposes of the CFC rules, the threshold is still 50% for downward attribution to a corporation.
22. The foreign trusts might prefer a corporation over a partnership anyway to shield themselves from return filing obligations in the United States.
23. IRC Sections 871(a) and 881(a).
24. Sections 871(h) and 881(c). Certain other requirements must be met for U.S.-source interest to qualify as portfolio interest, but those requirements are beyond the scope of this article.
25. Section 881(c)(3)(C).
26. If foreign corporation (FC0) 1 owned the property directly and sold it, the buyer would generally be required to withhold 15% of the proceeds under the withholding provisions of the Foreign Investment in Real Property Tax Act. *See* IRC Section 1445(a).
27. There could be opportunities to step up the basis of the assets of FC0 2 without triggering significant taxes by way of one or more entity classification elections. Such opportunities wouldn't be available if the investment portfolio was held under the same "roof" as the U.S. real property holdings.
28. Debt instruments eligible for the portfolio interest exemption generally aren't considered U.S. situs assets in the hands of a nonresident alien living abroad. *See* IRC Section 2105(b).
29. There are restrictions on the amount of stock in the issuer that the foreign investor may acquire without losing eligibility for the portfolio interest exemption, but the 10% ownership limitation only applies to voting stock.
30. As discussed in note 18, *supra*, proposed regulations issued on May 17, 2019 would prevent downward attribution from causing foreign corporations to be considered "related" for purposes of Section 954(d)(3).

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