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Top Ten Reasons To Limit §958(b)(4) Repeal

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As is by now well known, in the 2017 tax reform act, previously known as the Tax Cuts and Jobs Act,[1] Congress excised §958(b)(4) from the Internal Revenue Code.[2] Section 958 in general provides attribution and constructive ownership rules for purposes of determining who is considered to own stock of a foreign corporation, potentially making a U.S. person a 10% shareholder within the meaning of §951(b) (an "inclusion shareholder") and potentially making a foreign corporation a "controlled foreign corporation" (CFC) within the meaning of §957. Section 958(b)(4) had blocked downward attribution of ownership from a foreign person to a U.S. person down the chain. So, for example, if a foreign parent corporation owned 100% of the stock of both a U.S. and a foreign subsidiary, the parent's stock in the foreign subsidiary would not be attributed down to the U.S. subsidiary under §318(a)(3)(C) so as to make the foreign subsidiary a CFC. After the repeal of §958(b)(4), the foreign subsidiary would be a CFC.

It is understood that in repealing §958(b)(4), Congress was targeting a structure sometimes seen following inversions, in which a foreign person acquires stock of a U.S. corporation that itself owns preexisting CFCs. Some taxpayers may have tried to "de-CFC" those historic CFCs by issuing enough stock to the new foreign parent such that the historic CFCs were no longer controlled by the acquired U.S. corporation. However, the repeal of §958(b)(4) sweeps far more broadly than that type of structure. Apparently realizing this, Senators David Perdue (R-Ga.) and Orrin Hatch (R-Utah) placed into the Congressional Record the following colloquy:

> (Perdue) I would like to confirm my understanding of the modification of the section 958(b) stock attribution rules contained in the Tax Cuts and Jobs Act. The Senate Finance Committee explanation of this bill, as released by the Senate Budget Committee, definitively states, "This provision is not intended to cause a foreign corporation to be treated as a controlled foreign corporation with respect to a U.S. shareholder as a result of attribution of ownership under section 318(a)(3) to a U.S. person that is not a related person (within the meaning of Section 954(d)(3)) to such U.S. shareholder as a result of the repeal of section 958(b)(4)." I would like to confirm that the conference report language did not change or modify the intended scope this statement. As you know, I filed an amendment to the Senate bill, Senate amendment No. 1666 would have codified this explanatory text of the Finance Committee report. I also want to confirm that the Treasury Department and the Internal Revenue Service should interpret the stock attribution rules consistent with this explanation of the bill.
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> (Hatch) The Senator is correct. The conference report language for the bill does not change or modify the intended scope of the statement he cites. The Treasury Department and the Internal Revenue Service should interpret the stock attribution rules consistent with this explanation, as released by the Senate Budget Committee. I would also note that the reason his amendment No. 1666 was not adopted is because it was not needed to

[1] Pub. L. No. 115-97.

[2] Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended ("the Code").

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reflect the intent of the Senate Finance Committee or the conferees for the Tax Cuts and Jobs Act. I thank my friend from Georgia for his leadership on this issue to ensure that the stock attribution rules operate consistent with our intent and do not result in unintended consequences. I look forward to continuing to work with him on this important issue.

If the intent laid out in the colloquy were in fact the law, the issues described below would not be problematic. But the statute is not so limited, and Senator Hatch's statement that no legislative fix was needed is incorrect. Unless Treasury and the IRS can muster the courage to reach for regulatory authority to fix the problem based on the evident congressional intent, the result will be to treat as CFCs a wide range of foreign corporations that are not controlled by U.S. persons in any normal sense.

To encourage Treasury and the IRS to find their authority, or to spur Congress to fix this mistake, this article sets out my ''top ten'' list of things that will go terribly wrong if §958(b)(4) repeal is left unlimited. The list has been limited to 10 due to space constraints — a complete list would take a book. My list in fact builds upon two prior articles in this space by Edward Tanenbaum.[3]

1. *Subpart F Generally.* A faux CFC will be a CFC for all purposes of subpart F and the new GILTI[4] rules of §951A. Many of the untoward consequences of this are described in Edward Tanenbaum's previous articles. Note that some of the results may be taxpayer favorable; for example, a U.S. shareholder that sells stock of the faux CFC will have dividend income to the extent provided by §1248. Subpart F and GILTI inclusions, including pursuant to the transition tax in §965,[5] will give rise to positive basis adjustments under §961 and to previously taxed income (PTI). Given the ability to spread the §965 tax over eight years without interest, that basis and PTI will create arbitrage opportunities.

2. *Section 312(m).* Section 312(m) prohibits a downward adjustment to earnings and profits (E&P) of a foreign corporation that pays interest on an obligation that fails to meet the registration requirements of §163(f). There is an exception to this rule for a foreign corporation that is not a CFC and did not have a tax-avoidance purpose. If a foreign corporation is a CFC, it will be subject to the general rule, regardless of its purpose. This rule, of course, presupposes that a CFC is actually controlled by U.S. persons who should know better. The rule will have knock-on effects in determining the E&P of these faux CFCs taken into account under subpart F.

3. *Individual Expatriations.* Section 877 provides punitive tax rules for U.S. citizens or long-term green card holders who give up their status as such. Two rules in this section, §877(d)(1)(C) and §877(d)(4), come down especially hard on expatriates who own or form CFCs. That makes sense, given that these U.S. taxpayers are attempting to defer income through a controlled foreign corporation. But if it's only a faux CFC, in which the expatriate might own only a de minimis amount of stock, the equities start to look murkier.

4. *Subpart F Insurance Income.* The definition of a CFC for purposes of §953 was already wider than that of subpart F generally, but the repeal of §958(b)(4) will make it even more so. Under §512(b)(17), a U.S. tax-exempt organization can be subject to the unrelated business income tax if it is a shareholder of a CFC that has insurance income. It's difficult to believe that Congress intended to widen the UBTI net by repealing §958(b)(4).

5. *International Shipping and Aircraft Income.* Section 883 generally exempts income earned by foreign corporations from international ships and aircraft so long as the foreign corporation in question resides in a country granting U.S. carriers an equivalent exemption, and the foreign corporation is not ''treaty shopping.'' Section 883(c)(2) turns off the treaty shopping restriction for CFCs.

6. *PFICs — Basic Test.* Under §1297(d), a foreign corporation that is a CFC as to any U.S. inclusion shareholder cannot be a PFIC. The repeal of §958(b)(4) comes as a welcome relief to a number of U.S. shareholders (including some that may be caught even by the narrower rule Congress evidently intended to adopt) that sought to avoid the dreaded PFIC regime but could not otherwise qualify their foreign corporations as CFCs.

7. *Pop-Up PFICs.* A foreign corporation can be a PFIC with respect to less than 10% shareholders and a CFC with respect to 10% or greater shareholders. Under §1297(e)(2), if the foreign corporation is a CFC (and not publicly traded), it is required to apply the PFIC asset test of §1297(a)(2) by reference to the adjusted basis, rather the fair

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[3] *See* Tanenbaum, *The 2017 Tax Act: CFCs — The More the Merrier?* 47 Tax Mgmt. Int'l J. 202 (Mar. 9, 2018); *Downward Attribution CFCs*, 47 Tax Mgmt. Int'l J. 341 (May 11, 2018).

[4] Global low-tax intangible income.

[5] The repeal of §958(b)(4) was made retroactive to taxable years of foreign corporations beginning before January 1, 2018. It therefore radically altered the scope of §965, which had the same effective date.

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market value, of its assets. The use of adjusted basis will, in many cases, cause the corporation to be treated as a PFIC where it would not have been so treated had the fair market value test applied.

8. *PFIC Parent, CFC Sub.* Recall the simplest example of a faux CFC — a foreign subsidiary of a foreign parent that just happens to own a U.S. subsidiary. The results in such a case will usually be merely annoying, such as having to file CFC returns under §6038.[6] But it is possible that the foreign parent in such a case might be a PFIC as to some U.S. shareholders, with results too bizarre to detail here.

9. *Eligibility for §245A Deduction.* Dividends from a PFIC do not qualify for the §245A deduction, but dividends from a CFC do. Where the repeal of §958(b)(4) causes a foreign corporation that would otherwise have been a PFIC to become a CFC in the hands of a U.S. shareholder, a U.S. shareholder that is a corporation will be allowed the deduction.

10. *Portfolio Interest.* Section 881(c)(3)(C) and §881(c)(5) impose significant limitations upon the portfolio interest exemption as applied to interest received by CFCs. The policy behind these rules is not implicated in the case of a faux CFC.

This list has only scratched the surface. It is worth stepping back and asking why so many Code provisions that speak in terms of CFCs make no policy sense after the repeal of §958(b)(4).

Downward attribution makes sense where one is trying to define a related group of domestic entities. But in the cross-border context, most rules of the Code draw sharp distinctions between ''outbound'' and ''inbound'' ownership structures. We think of ''outbound'' cases as those in which a U.S. parent or group of U.S. shareholders invests in a foreign corporation. The rules applicable to this set of cases are found largely in subchapter N of the Code and in the PFIC provisions. Conversely, an inbound case is where a foreign corporation or group invests in a U.S. corporation. Because the United States has only limited taxing jurisdiction over foreign persons, the inbound rules are narrower in scope, and scattered throughout the Code. The major rules are found in the definitions and withholding tax rules for FDAP and in the effective connection rules of §864.

Allowing downward attribution from a foreign person to a U.S. person in order to make the U.S. person a deemed shareholder of another foreign affiliate confuses inbound and outbound paradigms that have been constructed over many years. Repeal of §958(b)(4) is not the first time that Congress has let its obsession with inversions cloud its understanding of how the Code's international rules fit together. The repeal should be repealed, and if it is not, Treasury should exercise its authority as far as it can to undo the damage.

[6] This requirement was wisely turned off by §5.02 of Notice 2018-13, suggesting that the IRS has authority to disregard the repeal of §958(b)(4) where another provision of the statute grants it wide regulatory discretion.

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