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In this article, Greenwald and Rietveld examine ways consolidated groups reduce their income inclusions, and they review finalized regulations that will treat members of those groups as a single U.S. shareholder in certain cases for purposes of section 951(a)(2)(B).

Clever tax lawyers come up with clever transactions to lower their clients' taxes, and inevitably, the clever regulators at Treasury and the IRS get wind of these transactions and shut them down. Recently, Treasury and the IRS became aware that some consolidated return groups are taking the position that the group's aggregate inclusions under sections 951(a)(1)(A) (subpart F income) and 951A(a) (global intangible low-taxed income) are reduced by changing the location of ownership of the stock of a controlled foreign corporation within the group.[1] More specifically, taxpayers are taking the position that a group's aggregate pro rata share of a lower-tier CFC's subpart F income or tested income is reduced under section 951(a)(2)(B) by reason of a section 959(b) distribution made by the lower-tier CFC, together with a direct or indirect acquisition of stock of the lower-tier CFC by a member of the consolidated return group from another member of the consolidated return group.[2] Given the substantial amount of previously taxed earnings and profits (PTEP) in the U.S. tax system (following the enactment of sections 951A and 965), Treasury and the IRS understand that taxpayers are taking this position with increasing frequency in an attempt to significantly reduce their income inclusions under sections 951(a)(1)(A) and 951A(a).[3]

In response to these allegedly abusive transactions, Treasury and the IRS on December 9, 2022, issued proposed regulations (REG-113839-22) that would treat members of a consolidated group as a single U.S. shareholder in certain cases for purposes of section 951(a)(2)(B). On February 23, 2023, Treasury and the IRS published final regulations that made the proposed regulations final without modification thereto, as no public comments were received.[4]

In this article, we first review sections 1501, 1502, 951(a)(1)(A), 959, and 951(a)(2)(B), then describe the allegedly abusive transaction, and finally review the finalized regulations by way of two examples, each with an analysis of how the finalized regulations will prevent the allegedly abusive transaction.

[1] See the preamble to REG-113839-22.

[2] *Id.*

[3] *Id.*

[4] T.D. 9973.

Sections 1501 and 1502

According to section 1501, an affiliated group of corporations may elect to file a U.S. federal income tax return on a consolidated basis. Groups electing to file consolidated returns include all members' income items on a single return in lieu of filing separate returns for each member.

Section 1502 authorizes Treasury or its delegate to issue regulations for an affiliated group of corporations that join in filing (or that are required to join in filing) a consolidated return to clearly reflect the U.S. federal income tax liability of the consolidated group and to prevent the avoidance of that tax liability. For purposes of carrying out those objectives, section 1502 also permits Treasury to issue regulations that may be different from those that would apply if the corporations composing the consolidated group filed separate returns.[5]

Sections 951(a)(1)(A), 951A(a), and 959

Sections 951(a)(1)(A) and 951A(a) subject each U.S. shareholder[6] of a CFC[7] to U.S. federal income tax on certain income of the CFC, regardless of whether the CFC distributes the earnings and profits attributable to that income.

To avoid double taxation, a corresponding amount of the CFC's E&P is designated as PTEP under section 959 and generally is not subject to U.S. tax at the U.S. shareholder level when distributed either to a U.S. shareholder or to an upper-tier CFC.[8] Generally, PTEP is treated as distributed before E&P that is not PTEP, and a section 959(a) distribution is treated as not a dividend.[9]

Under section 951(a)(1)(A), a U.S. shareholder of a CFC must include in gross income its pro rata share of the CFC's subpart F income[10] if the U.S. shareholder owns[11] stock of the CFC on the last day of the CFC's tax year on which it is a CFC (the last relevant day).

Under section 951(a)(2)(A), a U.S. shareholder first determines its pro rata share of a CFC's subpart F income for a tax year. This amount, which is determined based on the U.S. shareholder's proportionate share of a hypothetical distribution by the CFC, represents subpart F income (unreduced by distributions during the tax year) allocable to stock of the CFC that the U.S. shareholder owns on the last relevant day.[12] This amount is then reduced by the amount described in section 951(a)(2)(B)[13] to arrive at the U.S. shareholder's net pro rata share of the CFC's subpart F income.

Section 951A(a) requires a U.S. shareholder of a CFC to include in gross income its GILTI inclusion amount.[14] A U.S. shareholder's GILTI inclusion amount is determined by taking into account the U.S. shareholder's pro rata share of tested items[15] of certain CFCs in which the U.S. shareholder owns stock, such as tested income, tested loss, and qualified business asset investment. A U.S. shareholder's pro rata share of a CFC's tested items is determined in the same manner as a U.S. shareholder's pro rata share of a CFC's subpart F income, subject to certain modifications.[16]

[5] Section 1502.

[6] Within the meaning of section 951(b) or section 953(c)(1)(A), if applicable.

[7] Within the meaning of section 957 or section 953(c)(1)(B), if applicable.

[8] *See* section 959(a) and (b), respectively.

[9] *See* section 959(c) and (d), respectively.

[10] As defined in section 952. In very general terms, subpart F income includes certain insurance income (see section 953); certain types of passive income, *e.g.*, dividends, interest, royalties, rents, and annuities (see section 954(c)); certain sales income (see section 954(d)); and certain services income (see section 954(e)). Under section 951(a)(2)(A), a U.S. shareholder's pro rata share of subpart F income is determined based on the U.S. shareholder's proportionate share of a hypothetical distribution by the CFC.

[11] Within the meaning of section 958(a).

[12] *See* section 951(a)(2)(A); reg. section 1.951-1(b) and (e).

[13] Discussed in detail below.

[14] *See* reg. section 1.951A-1(b).

[15] As defined in reg. section 1.951A-1(f)(5).

[16] *See* section 951A(e)(1) and reg. section 1.951A-1(d). In the preamble, Treasury and the IRS note that in many cases, a significant portion of a CFC's income has been (or will be) subject to U.S. tax under section 951(a)(1)(A) or 951A(a), including by reason of the transition tax imposed under section 965, which taxes non-PTEP of certain foreign corporations under section 951(a)(1)(A). As a result, there is (and will continue to be) a substantial amount of PTEP in the U.S. tax system.

Section 951(a)(2)(B)

Section 951(a)(2)(B) addresses cases in which stock of a CFC owned by a U.S. shareholder on the last relevant day was acquired by the U.S. shareholder during the CFC's tax year.

In these cases, section 951(a)(2)(B) generally reduces the U.S. shareholder's pro rata share of the CFC's subpart F income or tested income by the amount of distributions received by any other person during the tax year as a dividend on the acquired stock. However, the reduction is limited to the amount of the dividend that would have been received regarding the acquired stock if the CFC had distributed an amount equal to its subpart F income for the tax year multiplied by a fraction, the numerator of which is the number of days during the tax year that the U.S. shareholder did not own the acquired stock, and the denominator of which is the number of days in the tax year (the "section 951(a)(2)(B) fraction").

The reduction, as so limited, represents an amount of distributed income of the CFC on which the U.S. shareholder otherwise would be subject to U.S. tax under section 951(a)(1)(A) or section 951A(a) by reason of owning the acquired stock on the last relevant day, but that is not allocable to the period during which the U.S. shareholder did not own the acquired stock. The reduction is intended to prevent double taxation of subpart F income or tested income of the CFC that is distributed during the tax year. In turn, the limitation on the reduction is intended to ensure that income allocable to the U.S. shareholder's ownership period regarding the acquired stock is included in the U.S. shareholder's pro rata share.[17]

Consolidated Groups

A consolidated group member's inclusion under section 951(a)(1)(A) is determined at the member level in the same manner as the inclusion is determined for any domestic corporation that is a U.S. shareholder of a CFC.

A member's GILTI inclusion amount is determined by taking into account the aggregate of its pro rata share of the tested income of each tested income CFC[18] and its allocable share of the group's aggregate amount of other tested items.[19]

Response to Abusive Transactions

As noted above, Treasury and the IRS are aware that some consolidated groups are taking the position that a group's aggregate pro rata share of a lower-tier CFC's subpart F income or tested income is reduced under section 951(a)(2)(B) by reason of a section 959(b) distribution made by the lower-tier CFC, together with a direct or indirect acquisition of stock of the lower-tier CFC by a member from another member of the same consolidated return group.

According to Treasury and the IRS, this filing position does not clearly reflect a consolidated group's U.S. tax liability. The group's aggregate pro rata shares of subpart F income and tested income of a CFC — and thus the group's aggregate inclusions under sections 951(a)(1)(A) and 951A(a), respectively — should not be affected when ownership of stock of the CFC moves within the group.

Secondly, the filing position is inconsistent with section 951(a)(2)(B) and the purposes of that provision. The amount described in section 951(a)(2)(B) represents certain distributed income of a CFC on which a U.S. shareholder otherwise would be subject to U.S. tax under section 951(a)(1)(A) or section 951A(a) by reason of owning stock of the CFC on the last relevant day. E&P that already has been subject to U.S. tax, such as E&P comprising a section 959(b) distribution, cannot represent that income. Treating it as giving rise to a section 951(a)(2)(B) reduction inappropriately reduces U.S. taxation of a CFC's subpart F income or tested income. Furthermore, the reduction to U.S. tax could be permanent to the extent that a deduction under section 245A(a) is allowed when E&P corresponding to the untaxed income ultimately is distributed to a U.S. shareholder.

To address this inappropriate outcome and to clearly reflect a consolidated group's U.S. tax liability, the finalized regulations treat members of a consolidated group as a single U.S.

[17] *See generally* Technical Explanation of the Revenue Act of 1962, S. Rep. No. 87-1881, at 239 (1962), cited in the preamble to REG-113839-22.

[18] As defined in reg. section 1.951A-2(b)(1).

[19] *See* reg. section 1.1502-51.

shareholder for purposes of applying section 951(a)(2)(B) in the context of section 959(b) distributions.[20] When members are treated as a single U.S. shareholder, direct or indirect acquisitions of stock of a CFC by one member from another member do not give rise to a section 951(a)(2)(B) reduction because the numerator of the section 951(a)(2)(B) fraction reflects the period that both members owned stock of the CFC. As a result, the group's aggregate inclusions under sections 951(a)(1)(A) and 951A(a) regarding a CFC are not reduced under section 951(a)(2)(B) by reason of a section 959(b) distribution made by the CFC and changes in the location of ownership of stock of the CFC within the group.[21]

Two Examples in the Finalized Reg

Reg. section 1.1502-80(j)(2) provides two examples. These illustrate the application of reg. section 1.1502-80(j)(1).

For purposes of the examples, M1 and M2 are members of a consolidated group of which P is the common parent (the P group); each of CFC1, CFC2, and CFC3 is a CFC with the U.S. dollar as its functional currency; the tax year of all entities is the calendar year for federal income tax purposes; and a reference to stock owned means stock owned within the meaning of section 958(a).

Example 1

Facts

Throughout year 1, M1 directly owns all the stock of CFC1, which directly owns all the stock of CFC2. In year 1, CFC2 has $100x of subpart F income (as defined in section 952). M1's pro rata share of CFC2's subpart F income for year 1 is $100x, which M1 includes in its gross income under section 951(a)(1)(A). In year 2, CFC2 has $80x of subpart F income and distributes $80x to CFC1 (the CFC2 distribution). Section 959(b) applies to the entire CFC2 distribution. On December 29 in year 2, M1 transfers all its CFC1 stock to M2 in an exchange described in section 351(a). As a result, on December 31 of year 2 (the last day of year 2 on which CFC2 is a CFC), M2 owns 100 percent of the stock of CFC1, which owns 100 percent of the stock of CFC2.

Analysis

Under reg. section 1.1502-80(j)(1), in determining the amount described in section 951(a)(2)(B) that is attributable to the CFC2 distribution, all members of the P group are treated as a single U.S. shareholder for purposes of determining the part of year 2 during which the shareholder did not own the stock of CFC2. Thus, the ratio of the number of days in year 2 that the U.S. shareholder did not own the stock of CFC2 to the total number of days in year 2 is 0 to 365. The amount described in section 951(a)(2)(B) is $0, M2's pro rata share of CFC2's subpart F income for year 2 is $80x ($80x - $0), and M2 must include $80x in its gross income under section 951(a)(1)(A).

Example 2

Facts

The facts are the same as the facts of Example 1, except that M1 does not transfer its CFC1 stock to M2. Also, throughout year 1 and from January 1 of year 2 to December 29 of year 2, M2 directly owns all 90 shares of the only class of stock of CFC3. Further, on December 29 of year 2, CFC3 acquires all the CFC2 stock from CFC1 in exchange for 10 newly issued shares of the same class of CFC3 stock in a transaction described in section 368(a)(1)(B). As a result, on December 31 of year 2, M1 owns 10 percent of the stock of CFC2, and M2 owns 90 percent of the stock of CFC2.

Analysis

Under reg. section 1.1502-80(j)(1), in determining the amount described in section 951(a)(2)(B) that is attributable to the portion of the CFC2 distribution regarding each of the CFC2 shares that M1 owns on December 31 of year 2, and the CFC2 stock that M2 owns on that day, all members of the P group are treated as a single U.S. shareholder for purposes of determining the part of year 2 during which the shareholder did not own that stock. In each case, the ratio of the number of days in year 2 that the U.S. shareholder

[20] *See* reg. section 1.1502-80(j)(1).

[21] The finalized regulations do not apply in the context of dividends composed of non-PTEP. When such a dividend gives rise to a reduction under section 951(a)(2)(B), other rules may result in the dividend being (directly or indirectly) included in the gross income of a U.S. shareholder. *See, e.g.*, reg. section 1.245A-5 (limiting the deduction under section 245A(a) and the look-through exception to subpart F income under section 954(c)(6)).

Figure 1. Reg. Section 1.1502-80(j)(2) — Example 1

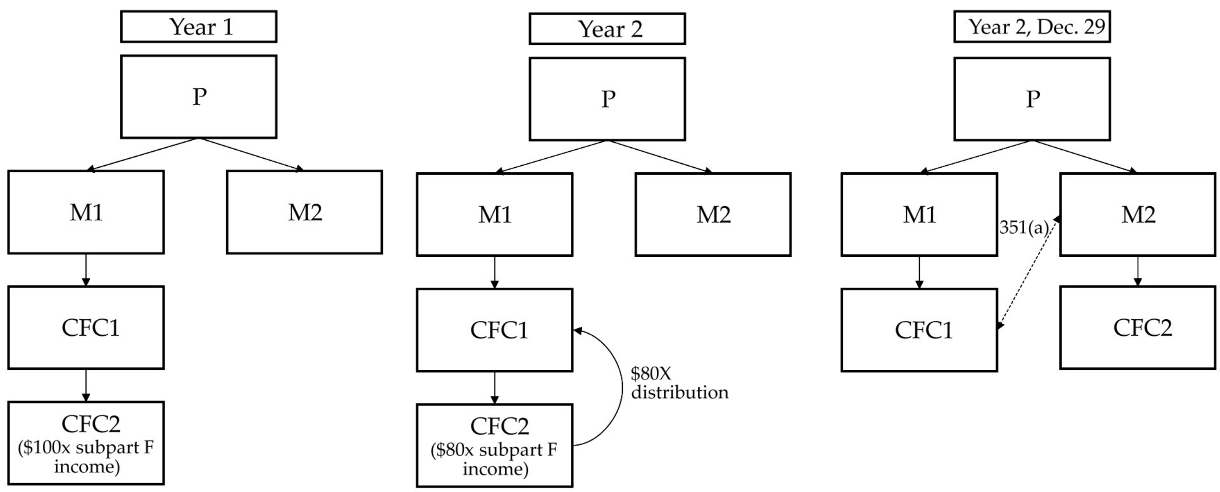
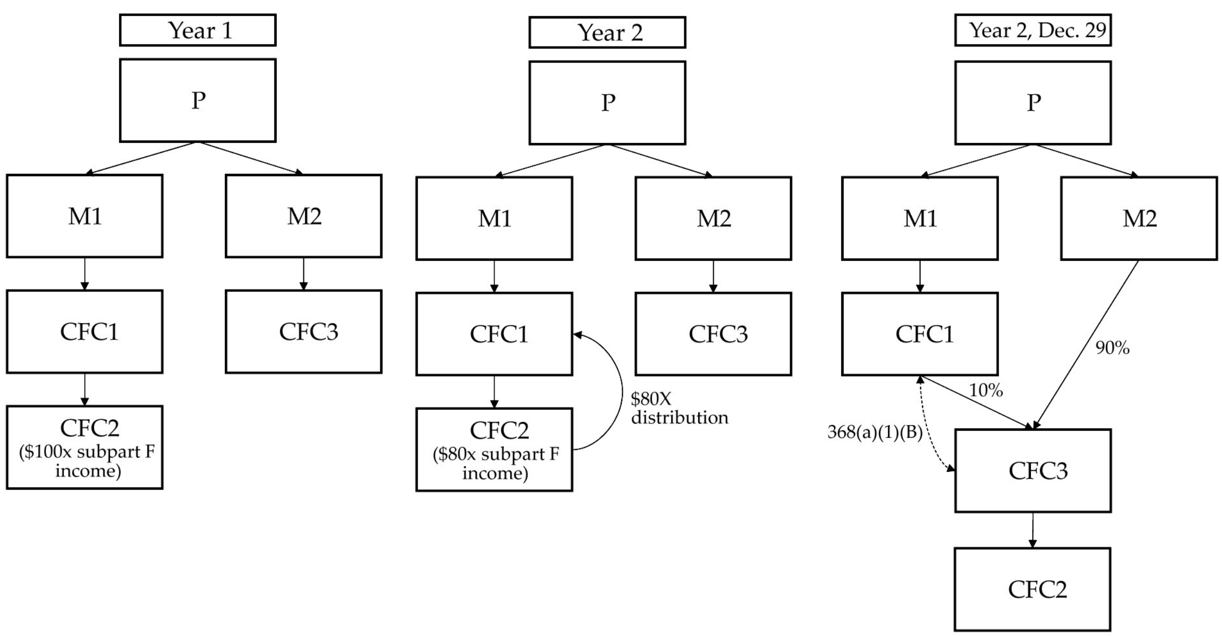


Figure 2. Reg. Section 1.1502-80(j)(2) — Example 2



did not own the stock to the total number of days in year 2 is 0 to 365, and the amount described in section 951(a)(2)(B) is $0. M1's and M2's pro rata shares of CFC2's subpart F income for year 2 are $8x ($8x - $0) and $72x ($72x - $0), respectively, and M1 and M2 must include $8x and $72x in gross income under section 951(a)(1)(A), respectively. (See figures 1 and 2.)

Applicability Date

Reg. section 1.1502-80(j) applies to tax years for which the original consolidated federal income tax return is due (without extensions) after February 23, the date the Treasury decision adopting these rules as final regulations was published in the *Federal Register*. ■