

October 17, 2019

IRS Issues Revenue Procedure and Proposed Regulations That Provide Limited Relief on Controlled Foreign Corporation Issues

On Tuesday, October 1, 2019, the Internal Revenue Service (“IRS”) and the Department of the Treasury (“Treasury”) issued Revenue Procedure 2019-40 (“Rev. Proc. 2019-40”) and released proposed regulations (the “Proposed Regulations”) that modestly narrow the implications of the 2017 repeal of Section 958(b)(4) of the U.S. Internal Revenue Code of 1986, as amended (the “Code”),¹ and provide limited filing and reporting relief. The guidance does not address the proliferation of “controlled foreign corporations” (“CFCs”) that resulted from the repeal of Section 958(b)(4), nor does it narrow the application of the “subpart F” or “global intangible low-taxed income” (“GILTI”) rules to these CFCs.

Current Law

As part of the Tax Cuts and Jobs Act, Pub. L. 115-97 (2017) (the “2017 Tax Act”), Congress repealed Section 958(b)(4), which had previously provided that certain constructive ownership rules did not apply in determining whether a foreign corporation was a CFC or a U.S. person was treated as owning shares of a CFC. A direct consequence of the repeal of Section 958(b)(4) is that many foreign corporations that do not have direct or indirect controlling U.S. shareholders, and that were not previously treated as CFCs, are now treated as CFCs and many U.S. persons are now deemed to be shareholders of these CFCs. This has resulted in increased tax liability as well as accompanying filing and reporting obligations for many U.S. taxpayers. Many believe, and legislative history suggests, that the consequences of the repeal of Section 958(b)(4) were far broader than Congress intended. Nevertheless, the release of Rev. Proc. 2019-40 and the Proposed Regulations confirms that the IRS and Treasury are unlikely to address the extensive effects of the repeal of Section 958(b)(4) through regulatory action, except in modest circumstances where the IRS and Treasury determine that there is pre-existing regulatory authority to do so.²

In addition to the proliferation of new CFCs and U.S. shareholders of CFCs, the repeal of Section 958(b)(4) has broad implications on many other rules that look to whether a foreign corporation is a CFC and creates reporting challenges for a broad class of U.S. shareholders (including U.S. shareholders that are only treated as constructively owning shares of the CFC as a result of the repeal of Section 958(b)(4)). These challenges

¹ All Section references are to the Code.

² Technical corrections legislation was proposed in 2018 to narrow the scope of the repeal of Section 958(b)(4), but this legislation has not progressed.

include making a determination on whether a foreign corporation is a CFC and calculating the amounts of subpart F income or GILTI inclusions with respect to a CFC.

The Proposed Regulations

Overview. The Proposed Regulations generally attempt to limit certain inappropriate results involving CFCs created by the repeal of Section 958(b)(4), which the guidance refers to as “foreign-controlled CFCs.”

Among the rules the Proposed Regulations address are Section 267(a)(2), relating to the timing of deductions for certain payments to related CFCs, and Section 1297(e), relating to the passive foreign investment corporation (“PFIC”) asset test. The Proposed Regulations also cover other areas of law,³ and are in some cases taxpayer favorable and in other cases are not.

- Generally, under Section 267, taxpayers using the accrual method may only deduct accrued but unpaid amounts owed to a related CFC if the amounts are included in the income of a U.S. shareholder of the CFC. The Proposed Regulations provide that this matching rule does not apply to amounts (other than interest) that are exempt from tax pursuant to a treaty if the CFC does not have any U.S. shareholders that would be required to include subpart F or GILTI income with respect to the CFC.
- Section 1297(e) requires a CFC to use the adjusted tax basis (rather than fair market value) of the CFC’s assets for purposes of determining whether a CFC is a PFIC. The repeal of Section 958(b)(4) resulted in a proliferation of PFICs, mostly because goodwill and intangible value, often a very valuable asset, in many cases has low or no tax basis. The Proposed Regulations modify the definition of a CFC for this purpose to disregard downward attribution from foreign persons, consistent with the application before the repeal of Section 958(b)(4). Consequently, a foreign corporation that is a CFC solely as a result of the repeal of Section 958(b)(4) may now use the fair market value of its assets (rather than adjusted basis) to determine whether it meets the asset test in Section 1297(a)(2) and is considered a PFIC.

Effective Date. The Proposed Regulations are proposed to apply on or after October 1, 2019. A taxpayer may rely on the Proposed Regulations with respect to any period before the date that these regulations are

³ Other provisions the Proposed Regulations address are: Section 332(d) (recharacterizing liquidations of certain U.S. corporations into foreign corporate parents as distributions); Treasury regulation § 367(a)-8(k) (exceptions to triggering events under gain recognition agreements); Section 672(f) (determining the extent to which the grantor trust rules apply to a trust); Section 706(b) (taxable year of a partnership and its partners); Section 863 (sourcing rules for space and ocean income and international communication income); Section 904(d) (look-through rules and active rents and royalties exception to characterizing certain income as passive category income); Section 6049 (requirement for CFCs to issue Forms 1099).

published as final regulations in the Federal Register so long as the taxpayer and all related U.S. persons consistently apply the relevant rule with respect to all foreign corporations.

Overview of Revenue Procedure 2019-40

Most significantly, Rev. Proc. 2019-40 implicitly confirms that, for purposes of the subpart F and GILTI rules, absent legislation, foreign-controlled CFCs are here to stay. Rev. Proc. 2019-40 does, however, provide several safe harbors relating to determinations of whether a U.S. person is a U.S. shareholder of a CFC and the reporting requirements imposed on a U.S. person that owns an interest in a CFC. While the safe harbors demonstrate a recognition that information satisfying the requirements of the Code and the Treasury regulations promulgated thereunder may not be available, they only provide limited relief and apply only in certain narrow circumstances.

- ***Safe Harbor for Determining CFC Status of Potential Foreign-Controlled CFCs: Duty to Inquire.*** Under a new safe harbor introduced by Rev. Proc. 2019-40, the IRS will accept a U.S. person's determination that a foreign corporation is not a CFC so long as the U.S. person does not have actual knowledge, has not received statements from the corporation, and/or does not have access to reliable publicly available information sufficient to determine whether the foreign corporation is a CFC for U.S. federal income tax purposes (the "Section 957 Safe Harbor"). A U.S. person who directly owns interests in a foreign entity (a "Top-Tier Entity") must, in order to rely on the Section 957 Safe Harbor, inquire of the Top-Tier Entity as to whether it meets the ownership requirements to be treated as a CFC for U.S. federal income tax purposes, including whether, how, and to what extent such Top-Tier Entity directly or indirectly owns stock of one or more foreign corporations, and whether, how, and to what extent such Top-Tier Entity owns directly or indirectly stock of, or an interest in, one or more domestic entities.
- ***Alternative Information.*** U.S. shareholders must report subpart F and GILTI inclusion amounts and complete Form 5471 with respect to any CFC in which they hold an interest. Rev. Proc. 2019-40 establishes a safe harbor permitting taxpayers to make determinations and calculations on the basis of certain forms of alternative information ("Alternative Information") if (i) the CFC is a foreign-controlled CFC and (ii) information satisfying current law requirements are not "readily available." The safe harbor establishes a hierarchy of categories of Alternative Information, with each category only eligible to be used for these purposes if preferred categories of Alternative Information are not "readily available." In the case of transactions entered after October 1, 2019, a person must use "reasonable efforts" to obtain the relevant information before concluding that information is not "readily available." For this purpose "reasonable efforts" include a "good faith attempt" to obtain the right to receive the information as part of the acquisition or investment agreements. Consequently, as a general matter, a U.S. person making direct or indirect investments in foreign corporations (including through investments in private equity funds) should negotiate for contractual rights to receive such information from the foreign corporation (or private equity

fund) to ensure the U.S. person is able to comply with its reporting requirements. A couple of additional points to note: (i) each Alternative Information category requires separate company information for the particular CFC (as opposed to consolidated or combined information for a group of CFCs), and (ii) Alternative Information may not be used for foreign tax credit calculations.

- ***Suspension of Penalties for Certain U.S. Persons.*** Rev. Proc. 2019-40 provides relief from penalties under Section 6038 (failure to timely furnishing information) and Section 6662 (underpayment of taxes) for taxpayers that properly rely on the safe harbors described above.

* * *

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Brian S. Grieve
+1-212-373-3768
bgrieve@paulweiss.com

Patrick N. Karsnitz
+1-212-373-3084
pkarsnitz@paulweiss.com

David W. Mayo
+1-212-373-3324
dmayo@paulweiss.com

Brad R. Okun
+1-212-373-3727
bokun@paulweiss.com

Lindsay B. Parks
+1-212-373-3792
lparks@paulweiss.com

Jeffrey B. Samuels
+1-212-373-3112
jsamuels@paulweiss.com

David R. Sicular
+1-212-373-3082
dsicular@paulweiss.com

Scott M. Sontag
+1-212-373-3015
ssontag@paulweiss.com

Associates Matthew B. Jordan and Valentine Lysikatos Carey contributed to this Client Memorandum.