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# IRS and Treasury Issue Proposed Regulations on Consolidated Group Ownership of CFC Stock for Certain Purposes

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The IRS and Treasury released proposed regulations on December 9, 2022 that, according to the preamble to the proposed regulations, is aimed at eliminating an approach taken by some consolidated groups to minimize income inclusions of their "pro rata share" under sections 951 ("subpart F" income) and 951A ("GILTI"). The preamble describes the approach involving the "shifting" of ownership in the stock of lower-tier controlled foreign corporations ("CFCs") between different members of the group during a taxable year.[1]

**Background**

Under section 951(a)(2)(A), a United States shareholder's "pro rata share" of subpart F income or GILTI of a lower-tier CFC generally is the amount that would have been distributed with respect to the CFC stock that the shareholder owns, directly or indirectly, if, on the last day in the CFC's taxable year in which it is a CFC, the CFC had distributed (pro rata) its subpart F income and GILTI income (or, if the CFC was not a CFC for its entire year, a proportionate amount of that income). Section 951(a)(2)(B) requires the shareholder's inclusions be reduced by the amount of any dividends received with respect to such stock by any other person during that taxable year (with the amount of the reduction generally capped at a portion of the subpart F income and GILTI, respectively, of the CFC for the part of the year during which the shareholder did not directly or indirectly own the CFC stock).

Under section 959(b), the earnings and profits of a lower-tier CFC attributable to amounts that are, or have been, included in the gross income of a United States shareholder as subpart F income or GILTI, generally is not, when distributed to an upper-tier CFC, included in the gross income of the upper-tier CFC for purposes of computing the upper-tier CFC's subpart F income or GILTI. In the preamble to the proposed regulations, the IRS and Treasury observed that, as a result of the 2017 Tax Cuts and Jobs Act, "there is (and will continue to be) a substantial amount of previously taxed earnings and profits ("PTEP") in the U.S. tax system."

**Proposed Regulations**

The proposed regulations would provide that, when stock of a lower-tier CFC is transferred within a consolidated group, the consolidated group members are treated as a single United States shareholder so that the member that owns (within the meaning of section 958(a)) the lower-tier CFC stock at the end of the year cannot reduce its subpart F or GILTI inclusion by reason of section 951(a)(2)(B) for section 959(b) distributions by the lower-tier CFC before the transfer. The new rule would apply to taxable years for which the original consolidated income tax return is due (without extensions) after the date on which

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a Treasury decision adopting these rules as final regulations is published in the Federal Register.

Example 1 of the proposed regulations describes a situation in which P owns M1 and M2, and all three entities are U.S. corporations that together file a consolidated return. Throughout Year 1, M1 owns all of the stock of CFC1, which, in turn, owns all of the stock of CFC2. In Year 1, CFC2 has $100 of subpart F income. M1's pro rata share of CFC2's subpart F income for Year 1 is $100, which M1 includes in its gross income under section 951(a)(1)(A). In Year 2, CFC2 has $80 of subpart F income and distributes $80 to CFC1 (the "CFC2 Distribution"). Because the distribution consists of subpart F income, and because it is made to an upper-tier CFC, section 959(b) applies, and CFC1 is not required to include it in gross income. On December 29 of Year 2, M1 transfers all of 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 all of the stock of CFC1, which owns all of the stock of CFC2.

Under current law, because M2 owned the CFC1 stock on the last day of Year 2, sections 951(a)(2)(B) and 959(b) require M2 to reduce its subpart F inclusion by the $80 dividend from CFC2 to CFC1, subject to a cap based on the portion of the year during which CFC2 was owned by M1, even though M1 and M2 are both members of the same consolidated group. Because the transfer occurred on December 29, the operation of section 951(a)(2)(B) would result in a substantial reduction in any subpart F inclusion with respect to CFC2 for Year 2.

The proposed regulations would provide that section 951(a)(2)(B) would not apply to this fact pattern because all of the members of the P consolidated group are treated as a single United States shareholder for purposes of determining the portion of the tax year in which a shareholder did not own the stock of a CFC. Accordingly, because M1 and M2 (both members of the P consolidated group) together owned the stock of CFC2 for all of Year 2, M2 would be treated as owning the stock of CFC2 for the entire year. Thus, the section 951(a)(2)(B) multiplicand would be $0 (0 days (the number of days that M2 did not own CFC2 stock)), and M2 would be required to include the full (unreduced) $80 subpart F income in its gross income under section 951(a)(1)(A).

Example 2 of the proposed regulations shows the application of the same rule in the context of the transfer of a lower-tier CFC between two upper-tier CFCs; as in the first example, there is no reduction in the aggregate inclusion amount by reason of section 951(a)(2)(B). The example goes on to note that the two members of the consolidated group must include their pro rata shares of the lower-tier CFC's subpart F income based on their relative ownership of the lower-tier CFC on December 31 of Year 2.

**Additional Guidance Expected; "No Inference"**

The IRS and Treasury are widely expected to issue additional proposed regulations addressing issues involving PTEP, an area that is closely related to subpart F and GILTI inclusions, so it is somewhat surprising that the government saw fit to issue this short and discrete proposed regulation as a standalone item rather than including it in the larger guidance package. In addition, it is notable that the proposed regulation includes "no inference" language, meaning that taxpayers are forewarned that the IRS may consider challenging positions contrary to rule of the proposed regulations before their finalization.

Please contact any Gibson Dunn tax lawyer for updates on this issue.

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[1] Prop. Treas. Reg. § 1.1502-80(j) (Dec. 9, 2022). All "section" references are to the Internal Revenue Code of 1986, as amended, and all "Prop. Treas. Reg. §" are to the proposed regulations. Because the rule contained in the proposed regulations would apply only in the context of consolidated groups, the IRS and Treasury included the proposed

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regulations in the section 1502 consolidated return regulations rather than in the regulations governing either subpart F and GILTI inclusions under sections 951 and 951A, or the distribution of previously taxed earnings and profits under section 959.

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Gibson Dunn lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you usually work, the authors, or any of the following leaders and members of the firm's Tax and Global Tax Controversy and Litigation practice groups:

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