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Part III – Administrative, Procedural, and Miscellaneous

S Corporation Guidance under Section 958 (Rules for Determining Stock Ownership) and Guidance Regarding the Treatment of Qualified Improvement Property under the Alternative Depreciation System for Purposes of the QBAI Rules for FDII and GILTI

Notice 2020-XX

SECTION 1. OVERVIEW

This notice announces that the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) intend to issue regulations addressing the application of §§ 951 and 951A of the Internal Revenue Code (Code) to certain S corporations (as defined in § 1361(a)(1)) with accumulated earnings and profits, as described in § 316(a)(1) (AE&P). This notice also announces that the Treasury Department and the IRS intend to issue regulations addressing the treatment of qualified improvement property (QIP) under the alternative depreciation system (ADS) of § 168(g) for purposes of calculating qualified business asset investment (QBAI) for purposes of the foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI) provisions, which were added to the Code by the enactment of Public Law No. 115-97, 131 Stat. 2054 (2017), commonly referred to as the Tax Cuts and Jobs Act (TCJA).

Section 2 of this notice provides a summary of the current and proposed treatment of domestic partnerships for purposes of §§ 951 and 951A and the application of these rules to S corporations under § 1373(a). Section 2 of this notice also provides background on §§ 168, 250, and 951A as they relate to QBAI for purposes of FDII and GILTI and the treatment of QIP under the ADS. Section 3 of this notice describes proposed regulations that the Treasury Department and the IRS intend to issue concerning the application of §§ 951 and 951A to S corporations (forthcoming S corporation regulations). Section 4 of this notice describes proposed regulations that the Treasury Department and the IRS intend to issue concerning the treatment of QIP under the ADS for purposes of calculating QBAI for FDII and GILTI (forthcoming QIP-QBAI regulations). Section 5 of this notice describes the proposed applicability dates of the forthcoming regulations. Section 6 of this notice requests comments. Section 7 of this notice provides information regarding collections of information. Section 8 of this notice provides drafting and contact information.

SECTION 2. BACKGROUND

.01 Overview of §§ 951 and 951A

Section 951(a) of the Code generally requires a United States shareholder (as defined in § 951(b)) (U.S. shareholder), to include in its gross income its pro rata share of subpart F income (as defined in § 952) of a controlled foreign corporation (as defined in § 957) (CFC) and the amount determined under § 956 with respect to such shareholder for such year (but only to the extent not excluded from gross income under § 959(a)(2)) (subpart F inclusion).

Section 951A(a) requires a U.S. shareholder of any CFC for any taxable year to include in gross income the shareholder's GILTI for such taxable year (GILTI inclusion amount). The U.S. shareholder's GILTI inclusion amount is calculated based on certain items – such as tested income, tested loss, and QBAI – of each CFC owned by the U.S. shareholder (tested items). See §1.951A-1(c) of the Income Tax Regulations. In general, a U.S. shareholder's GILTI inclusion amount is determined by reference to the U.S. shareholder's pro rata share of the tested items based on the stock of all the CFCs that the U.S. shareholder owns within the meaning of § 958(a). See § 951A(e)(1) (cross referencing § 951(a)(2)). The GILTI provisions in § 951A, enacted in § 14201(a) of the TCJA, apply to taxable years of foreign corporations beginning after December 31, 2017, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end. See § 14201(d) of the TCJA.

Section 951(b) defines a U.S. shareholder, with respect to any foreign corporation, as a United States person (U.S. person) that owns (within the meaning of § 958(a)), or is considered as owning by applying the ownership rules of § 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such corporation or 10 percent or more of the value of all shares of all classes of stock of the foreign corporation. See also §1.951-1(g). Section 957(c) generally defines a U.S. person for purposes of subpart F by reference to § 7701(a)(30), which defines a U.S. person as a citizen or resident of the United States, a domestic partnership, a domestic corporation, and certain estates and trusts.

.02 S corporations

For purposes of subparts A and F of part III (§§ 901 through 909 and §§ 951 through 965, respectively), and part V (§ 999), of subchapter N of chapter 1, § 1373(a) provides that an S corporation is treated as a partnership and the shareholders of the S corporation are treated as partners of the partnership. Section 1373(a) thus causes S corporations, which are domestic corporations, to be treated in the same manner as domestic partnerships for purposes of §§ 951 and 951A.

(1) Entity Treatment of Domestic Partnerships and S Corporations

Historically, a domestic partnership or S corporation was generally treated as a U.S. shareholder that had a subpart F inclusion with respect to a CFC owned under § 958(a) by the partnership or S corporation (entity treatment). Under entity treatment, an S corporation determines its subpart F inclusion at the entity level. An S corporation shareholder takes into account the shareholder's pro rata share of the S corporation's subpart F inclusion, regardless of whether the S corporation shareholder itself is a U.S. shareholder of the CFC under § 951(b). See generally § 1366(a). A similar approach applied to domestic partnerships under entity treatment.

(2) Aggregate Treatment of Partners of Foreign Partnerships

Under § 958(a)(2), a partner in a foreign partnership is treated as owning proportionately the stock of a CFC owned by the foreign partnership (aggregate treatment) for purposes of subpart F, which includes § 951A. Accordingly, if a partner in a foreign partnership is a U.S. shareholder with respect to a CFC owned by the partnership, the U.S. shareholder-partner will directly include in gross income the pro rata share of subpart F income of the CFC and directly determine the partner's GILTI

inclusion amount by reference to the pro rata share of tested items of the CFC. See §§ 951(a) and 951A(e)(1).

(3) Hybrid Treatment for GILTI Purposes Under 2018 Proposed Regulations

On October 10, 2018, the Treasury Department and the IRS published a notice of proposed rulemaking (REG-104390-18) in the Federal Register (83 FR 51072) under § 951A (2018 proposed regulations). Section 1.951A-5 of the 2018 proposed regulations (proposed § 1.951A-5) provided a “hybrid approach” to a domestic partnership that is a U.S. shareholder (U.S. shareholder partnership) of a CFC (partnership-owned CFC). Under the hybrid approach, a U.S. shareholder partnership would determine its GILTI inclusion amount, and the partners of the partnership that were not also U.S. shareholders of the partnership-owned CFC would take into account their distributive share of the partnership’s GILTI inclusion amount. See proposed §1.951A-5(b). Partners that also were U.S. shareholders of a partnership-owned CFC would not take into account their distributive share of the partnership’s GILTI inclusion amount. Instead, such partners would be treated as proportionately owning the stock of the partnership-owned CFC within the meaning of § 958(a) as if the domestic partnership were a foreign partnership. See proposed §1.951A-5(c).

Because § 1373(a) treats S corporations as partnerships for purposes of subpart F, the hybrid approach in the 2018 proposed regulations also applied to S corporations that held stock of a CFC. For example, proposed §1.951A-5(g)(5) (Example 5) applied entity treatment (outlined in section 2.02(1) of this notice) to an S corporation shareholder that was not a U.S. shareholder of a CFC owned by the S corporation (S corporation-owned CFC), and aggregate treatment (outlined in section 2.02(2) of this

notice) to an S corporation shareholder that was a U.S. shareholder of the S corporation-owned CFC.

(4) Aggregate Treatment for GILTI Purposes under 2019 Final Regulations

On June 21, 2019, the Treasury Department and the IRS published final regulations (T.D. 9866) in the Federal Register (84 FR 29288) under § 951A (final regulations). The final regulations did not adopt the hybrid approach included in the 2018 proposed regulations and instead adopted aggregate treatment for domestic partnerships. Accordingly, under the final regulations, a domestic partnership does not have a GILTI inclusion amount, and therefore no partner of the partnership has a distributive share of a GILTI inclusion amount. See §1.951A-1(e)(1). Rather, for purposes of determining the GILTI inclusion amount of any partner of a domestic partnership, each partner is treated as proportionately owning the stock of a CFC owned by the partnership within the meaning of § 958(a) in the same manner as if the domestic partnership were a foreign partnership. Because only a U.S. person that is a U.S. shareholder can have a GILTI inclusion amount, a partner that is not a U.S. shareholder of a partnership-owned CFC does not have a GILTI inclusion amount determined by reference to the partnership-owned CFC. Section 1.951A-1(e)(1) applies to taxable years of foreign corporations beginning after December 31, 2017, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end. See §1.951A-7.

(5) Aggregate Treatment for Subpart F and GILTI Purposes Under 2019 Proposed Regulations

On June 21, 2019, concurrent with the final regulations, the Treasury Department and the IRS published a notice of proposed rulemaking (REG-101828-19) in the Federal Register (84 FR 29114) under § 958 (2019 proposed regulations). Section 1.958-1 of the 2019 proposed regulations (proposed § 1.958-1) mirrored the aggregate treatment of domestic partnerships for purposes of GILTI inclusions as set forth in the final regulations, and also extended it to apply for purposes of subpart F inclusions. See proposed §1.958-1(d)(1). Accordingly, subject to certain exceptions in proposed §1.958-1(d)(2), for purposes of §§ 951 and 951A and any other provision that applies by reference to § 951 or 951A, the 2019 proposed regulations provided that a domestic partnership is not treated as owning stock of a foreign corporation within the meaning of § 958(a); instead, a domestic partnership is treated in the same manner as a foreign partnership for purposes of determining the persons that own stock of the foreign corporation within the meaning of § 958(a). See proposed §1.958-1(d)(1). Under proposed §1.958-1(d)(2), a domestic partnership is treated as an entity for purposes of determining whether any U.S. person (including the domestic partnership) is a U.S. shareholder, whether any U.S. shareholder is a controlling domestic shareholder (as defined in §1.964-1(c)(5)), or whether any foreign corporation is a CFC.

Consistent with the final regulations with respect to GILTI, under the 2019 proposed regulations a partner that is not a U.S. shareholder with respect to a partnership-owned CFC does not take into account a subpart F inclusion or GILTI inclusion amount by reference to the partnership-owned CFC.

The 2019 proposed regulations are proposed to apply to taxable years of foreign corporations beginning on or after the date of publication of the Treasury decision adopting the rules as final regulations in the Federal Register. See proposed §1.958-1(d)(4). Subject to a consistency requirement, however, the 2019 proposed regulations provide that a domestic partnership may apply the regulations, once finalized, to taxable years of a foreign corporation beginning after December 31, 2017, and to taxable years of the domestic partnership in which or with which such taxable years of the foreign corporation end. See *id.*

(6) Applicability to S Corporations

Under § 1373(a), an S corporation is treated as a partnership and its shareholders as partners for purposes of §§ 951 and 951A, among other provisions. Therefore, for purposes of determining a GILTI inclusion amount under §1.951A-1(e), as well as determining a subpart F inclusion or GILTI inclusion amount under proposed §1.958-1(d), an S corporation is not treated as owning stock of a foreign corporation within the meaning of § 958(a) but instead is treated in the same manner as a foreign partnership (each S corporation shareholder is treated as proportionately owning the stock of the S corporation-owned CFC). Under this aggregate treatment, § 961(a) applies to increase a U.S. shareholder's basis in the shares of the S corporation when the U.S. shareholder has a subpart F inclusion or GILTI inclusion amount attributable to the S corporation-owned CFC. The preamble to the final regulations stated that the Treasury Department and the IRS are studying the application of § 1373(a) with respect to § 951A, as well as the broader implications of treating S corporations as partnerships for purposes of subpart F, and requested comments. See 84 FR 29317.

(7) Distribution Rules Regarding S Corporations

Paragraphs (b) and (c) of § 1368 provide for the annual treatment of distributions of property made by an S corporation with respect to its stock to which (but for § 1368(a)) § 301(c) would apply. Section 1368(b) addresses the treatment of such distributions by an S corporation that does not have AE&P. Specifically, § 1368(b)(1) provides that a distribution by an S corporation is not included in the gross income of the shareholder to the extent that the amount of the distribution does not exceed the adjusted basis of the S corporation's stock. Section 1368(b)(2) provides that, if the amount of the distribution exceeds the adjusted basis of the S corporation's stock, that excess is treated as gain from the sale or exchange of property.

Section 1368(c) addresses the treatment of distributions by an S corporation that has AE&P (for example, if the S corporation had generated earnings and profits during its prior status as a C corporation) and therefore has an accumulated adjustments account (AAA), as defined by § 1368(e)(1). AE&P does not include amounts that would increase an S corporation's AAA. See § 1371(c). The S corporation's AAA achieves dual congressional purposes by ensuring that (i) distributions of income already taxed to its shareholders will be tax-free and (ii) distributions of AE&P generated by a former C corporation will be taxed as dividends (as defined in § 316) when ultimately distributed. See S. Rept. 97-354, at 3258, 97th Cong. 2nd Sess. (Sept. 29, 1982). Accordingly, to achieve the first-described congressional purpose, an S corporation's AAA functions similarly to the basis-adjustment rules set forth in § 1367 and is adjusted positively to account for income taxed to its shareholders. See § 1368(e)(1). AAA is limited to income generated by the corporation during its status as an S corporation and

preserves the single-level-of-tax treatment to S corporation shareholders that is fundamental to subchapter S of chapter 1 of the Code (subchapter S).

With regard to distributions of property by S corporations with AE&P (relating to the second-described congressional purpose), § 1368(c) first applies the distribution to the S corporation's AAA. Specifically, § 1368(c)(1) provides that the treatment of the portion of the distribution that does not exceed the S corporation's AAA is governed by § 1368(b), and not included in a shareholder's gross income if that amount does not exceed the shareholder's adjusted basis in the S corporation's stock. See also § 1368(b)(1). For the portion of the distribution that does not exceed the S corporation's AAA, but which exceeds the shareholder's adjusted basis in the S corporation's stock, that amount is treated as gain from the sale or exchange of property. See §§ 1368(c)(1) and 1368(b)(2). After the application of § 1368(c)(1), any remaining portion of that distribution that exceeds the amount of the S corporation's AAA is treated as a dividend (as defined in § 316) to the extent of the S corporation's remaining AE&P. See § 1368(c)(2). Lastly, the portion of the distribution remaining after the application of § 1368(c)(1) and (2) is governed by § 1368(b) (that is, either not included in gross income or treated as gain depending on the shareholder's basis in the S corporation's stock). See § 1368(c)(3).

(8) Application of Aggregate Treatment to S Corporations with AE&P

The aggregate treatment provided in the final regulations, as applied to S corporations with AE&P, does not result in a positive adjustment of AAA because the GILTI inclusion amount arises at the shareholder level, rather than at the S corporation level. See §1.951A-1(e). If an S corporation with AE&P distributes property to its

shareholders, for example, to provide its shareholders with funds to pay the resulting federal income tax arising from their GILTI inclusion amount with respect to stock of CFCs owned by the S corporation, the S corporation would need an amount of AAA equal to the amount of that distribution to prevent the distribution from being included in such shareholders' gross income to the extent of AE&P. See generally § 1368(c). Although the S corporation could generate additional AAA as needed through a distribution from a CFC, comments have asserted that such an approach could result in foreign withholding taxes or undesired reductions in working capital that otherwise would be devoted to the CFC's businesses.

As stated in section 2.02(7) of this notice, § 1368(c)(1) provides that tax-free distribution treatment to shareholders of an S corporation with AE&P results only to the extent the S corporation has sufficient AAA to support the distribution. In the absence of enough AAA, § 1368(c)(2) requires the distribution to be taxed as a dividend (as defined in § 316) to the S corporation's shareholders to the extent of the S corporation's AE&P. In other words, if an S corporation has no AAA, the amount of the adjusted basis in a shareholder's S corporation stock—including any positive basis adjustment under § 961(a) resulting from a shareholder's GILTI inclusion—does not affect dividend treatment. Once the S corporation exhausts its AE&P, distributions are once again applied to shareholder stock basis. Comments regarding the application of the final regulations to S corporations and their shareholders focused on these interactions between the aggregate treatment and the distribution rules for AE&P under subchapter S.

(9) Notice 2019-46 – Domestic Partnerships and S Corporations Filing Under Proposed GILTI Regulations

Following the June 21, 2019, publication of the final regulations, the Treasury Department and the IRS became aware that certain domestic partnerships and S corporations had furnished Schedules K-1 to their partners and shareholders for the 2018 taxable year on or before the publication date of the final regulations and had relied on proposed §1.951A-5. See section 2.04 of Notice 2019-46, 2019-37 I.R.B. 695 (Aug. 23, 2019). To reduce compliance and processing burdens resulting from the need to issue corrected Schedules K-1 consistent with the final regulations, Notice 2019-46 announced the intent of the Treasury Department and the IRS to issue regulations that would permit certain domestic partnerships or S corporations to apply the 2018 proposed regulations, including the hybrid approach in proposed §1.951A-5, in their entirety, for taxable years that ended before June 22, 2019. See section 3 of Notice 2019-46.

.03 QBAI rules for FDII and GILTI

For purposes of applying § 951A, a U.S. shareholder has to determine its “net CFC tested income” and “net deemed tangible income return.” Net CFC tested income is generally defined as the excess (if any) of the aggregate of the shareholder’s pro rata share of the tested income of each CFC with respect to which such shareholder is a U.S. shareholder for the taxable year of the shareholder over the aggregate of the shareholder’s pro rata share of the tested loss of each such CFC. See § 951A(c) and §1.951A-1(c)(2). The U.S. shareholder’s GILTI inclusion amount is then determined by reducing net CFC tested income by net deemed tangible income return. See § 951A(b)(1). Section 951A(b)(2) and §1.951A-1(c)(3) define the term “net deemed tangible income return” as the excess of 10 percent of the aggregate of such U.S. shareholder’s

pro rata share of the QBAI of each CFC with respect to which the shareholder is a U.S. shareholder for the taxable year, over a certain amount of interest expense.

Section 951A(d)(1) and §1.951A-1(b) define QBAI, with respect to any CFC for any taxable year, as the quarterly average of the aggregate adjusted bases in specified tangible property used in the CFC's trade or business and of a type for which a depreciation deduction is allowable under § 167.

The definition of QBAI in § 951A(d) also applies for purposes of determining deemed tangible income return under § 250. See § 250(b)(2)(B) and §1.250(b)-2(b). Section 250 generally allows a domestic corporation a deduction equal to 37.5 percent (21.875 percent for taxable years after 2025) of its FDII (as defined in § 250(b)(1) and §1.250(b)-1(b)). For purposes of FDII, QBAI is used to determine the deemed tangible income return of a corporation, which in turn reduces the amount of foreign-derived intangible income of a corporation. See § 250(b)(1)-(2). Section 250(b)(2)(B) and §1.250(b)-2 incorporate the definition of QBAI in § 951A(d)(3), with some modifications.

(1) Adjusted Basis for Purposes of QBAI

Section 951A(d)(3)¹ requires a taxpayer to calculate QBAI by determining the adjusted basis of property using the ADS under § 168(g) “notwithstanding any provision of this title (or any other provision of law) which is enacted after the date of the enactment of [§ 951A].”

ADS depreciation under § 168(g) is determined by using the straight-line method (without regard to salvage value), the applicable convention determined under § 168(d), and the applicable recovery period as determined under the table in § 168(g)(2)(C). On

¹ As enacted, § 951A(d) contains two paragraphs designated as paragraph (3). The § 951A(d)(3) of the Code discussed in this notice relates to the determination of the adjusted basis in property for purposes of calculating QBAI.

December 22, 2017, the date of enactment of the TCJA, § 168(g)(2)(C) provided that the recovery period for purposes of ADS depreciation for nonresidential real property, as defined in § 168(e)(2)(B), was 40 years. Nonresidential real property is defined under § 168(e)(2)(B) as section 1250 property (that is, any depreciable real property not described in § 1245) that is not residential rental property, as defined in § 168(e)(2)(A), or property with a class life of less than 27.5 years. Section 168(g)(2)(C)(i) provided that the recovery period for property not described in § 168(g)(2)(C)(ii) or (iii) is the property's class life. Class life is generally determined under Rev. Proc. 87-56, 1987-2 C.B. 674; however, § 168(g)(3) specifies class lives for certain types of property for ADS purposes.

(2) Qualified Improvement Property

Effective for property placed in service after December 31, 2017, § 13204 of the TCJA amended § 168(e) by removing references to qualified leasehold improvement property, qualified restaurant improvement property, and qualified retail improvement property, and adding a definition for QIP. Under § 168(e)(6), as amended by the TCJA, QIP generally is defined as certain improvements to an interior portion of a building that is nonresidential real property if such improvements are placed in service after the date the building was first placed in service. See § 1.168(b)-1(a)(5)(i)(A) and (ii).

(3) QIP's 20-year ADS Recovery Period

Section 2307(a) of the Coronavirus Aid, Relief, and Economic Security Act, P.L. 116-136, 134 Stat. 281 (March 27, 2020) (CARES Act), titled "Technical Amendments Regarding Qualified Improvement Property" amended the TCJA rules regarding the treatment of QIP under § 168(e) and (g) (technical amendment). Under the technical

amendment, §2307(a)(1)(A) of the CARES Act amended § 168(e) by adding clause (vii) to paragraph (3)(E), providing that QIP is classified as 15-year property, § 2307(a)(1)(B) of the CARES Act amended the definition of QIP in § 168(e)(6) by providing that the improvement must be “made by the taxpayer,” and § 2307(a)(2) of the CARES Act amended the table in § 168(g)(3)(B) to provide a class life of 20 years for QIP for purposes of the ADS. Under § 2307(b) of the CARES Act, the technical amendment is effective as if its provisions had been included in § 13204 of the TCJA and, therefore, applies to property placed in service after December 31, 2017. According to the Description of the Tax Provisions of Public Law 116-136, the Coronavirus Aid, Relief, and Economic Security (“CARES”) Act, prepared by the Staff of the Joint Committee on Taxation and published on April 23, 2020 (JCX-12R-20), when Congress enacted § 13204(a)(4)(b)(i) of the TCJA to add the definition of QIP in § 168(e)(6), it intended for QIP to be classified as 15-year property under § 168(e)(3)(E), with a 15-year recovery period under the general depreciation system in § 168(a) and a 20-year ADS recovery period but inadvertently omitted such language from the statute. See JCX-12R-20 at 69-70. The conference report under the TCJA also states that Congress intended QIP to be classified as 15-year property under the general depreciation system and be assigned a 20-year ADS recovery period. See Conference Report to Accompany H.R. 1, H.R. Rept. 115-466, at 366-367, 115th Cong. 1st Sess. (Dec. 15, 2017).

SECTION 3. FORTHCOMING S CORPORATION REGULATIONS ADDRESSING QUALIFYING S CORPORATIONS WITH AE&P

.01 Purpose and Scope

The Treasury Department and the IRS intend to issue S corporation regulations under § 958 of the Code to ease the transition of S corporations with AE&P on [INSERT

DATE THIS NOTICE IS RELEASED] from the historic entity treatment and the hybrid treatment under proposed §1.951A-5 (and illustrated in §1.951A-5(g)(5) (Example 5)) to the aggregate treatment required under the final regulations (transition rules). The forthcoming regulations will ensure that distributions of income already taxed to S corporation shareholders will be tax-free, and AE&P generated by a former C corporation will be taxed as dividends when distributed.

The Treasury Department and the IRS intend the transition rules to assist S corporations with AE&P and their shareholders by allowing them to recognize the GILTI inclusion amount at the entity level so it is treated as an item of income, thereby increasing its AAA before allocation to the shareholders. This increase in AAA will allow S corporations to distribute property to shareholders and avoid dividend treatment. To achieve this result, the Treasury Department and the IRS expect to provide rules and examples consistent with those set forth in sections 3.02 and 3.03, respectively, of this notice. These transition rules are expected to apply solely to S corporations with “transition AE&P,” as defined in section 3.02(3) of this notice.

.02 Transition Rules

(1) Elective Entity Treatment

With respect to a taxable year, an S corporation is subject to entity treatment if (a) it (and its shareholders, if applicable) makes an election described in section 3.02(2) of this notice, (b) it has elected S corporation status before June 22, 2019, (c) it would be treated as owning stock of a CFC on June 22, 2019, within the meaning of § 958(a) if entity treatment applied,² (d) it has transition AE&P (as defined in section 3.02(3) of this

² In other words, elective entity treatment is not available when, if entity treatment otherwise applied, an S corporation would only be considered to own stock of a CFC under § 958(b) or not at all. For example, where an individual shareholder directly owns 100 percent of the stock of a CFC, and the shareholder owns 50 percent of the stock of an S corporation, that S corporation would be considered under §§ 318(a)

notice) on [INSERT DATE THIS NOTICE IS RELEASED], or on the first day of any subsequent taxable year, and (e) it maintains records to support the determination of the transition AE&P amount. Entity treatment means that an S corporation that owns stock of a CFC is treated as owning within the meaning of § 958(a) the CFC stock for purposes of applying § 951A. Thus, the S corporation determines its GILTI inclusion amount, and its shareholders take into account their distributive share of that GILTI inclusion amount. See section 2.02(1) of this notice.

(2) Time and Manner of Making an Election

With respect to the first taxable year ending on or after [INSERT DATE THIS NOTICE IS RELEASED], an S corporation may irrevocably elect to apply entity treatment on a timely filed (including extensions) original Form 1120-S. For taxable years of an S corporation ending before [INSERT DATE THIS NOTICE IS RELEASED] and after June 21, 2019, the S corporation and all of its shareholders may irrevocably elect the entity treatment provided in section 3.02(1) of this notice on timely filed (including extensions) original returns or on amended returns filed by March 15, 2021, by attaching a statement thereto.

The election is made by attaching a statement to the Federal tax return. The election statement must identify the election being made, include the amount of transition AE&P as described in section 3.02(3) of this notice, and, where applicable, be signed by a person authorized to sign the return required to be filed under § 6037. Form 1120-S, K-1s must be prepared consistent with the S corporation's election for shareholders to comply with § 6037(c).

(3)(C) and 958(b) to own all of the stock of CFC, but none of the stock under § 958(a). Therefore, in such a case, elective entity treatment is not available to the S corporation.

(3) Transition AE&P

For purposes of this notice, the term “transition AE&P” means, with respect to an S corporation and its shareholders, the amount of AE&P of the S corporation calculated as of [INSERT DATE THIS NOTICE IS RELEASED], reduced as described in section 3.02(5) of this notice. Transition AE&P is not increased as a result of transactions occurring (or entity classification elections described in §301.7701-3 filed) after [INSERT DATE THIS NOTICE IS RELEASED].

(4) Transition AE&P Not Transferable

For purposes of this notice, transition AE&P of an S corporation is not transferrable to another person under any provision of the Code (for example, under §§ 312(h) or 381 by reason of § 1371(a)). In other words, the transferee of the transition AE&P would receive AE&P not transition AE&P.

(5) Reduction Solely by Distributions

An S corporation with transition AE&P is treated as having no transition AE&P if, beginning after [INSERT DATE THAT NOTICE IS RELEASED], the S corporation distributes in one or more distributions a cumulative amount of AE&P equal to or greater than the amount of the S corporation’s transition AE&P as of [INSERT DATE THAT NOTICE IS RELEASED].

(6) Required Aggregate Treatment

Except as provided in Notice 2019-46, aggregate treatment applies to an S corporation if the S corporation has not made an election described in section 3.02(1) of this notice to apply the transition rules. In the case of an S corporation that has made an election to apply entity treatment as described in section 3.02(1) of this notice,

aggregate treatment applies beginning with the S corporation's first taxable year for which the S corporation has no transition AE&P on the first day of that year, and to each subsequent taxable year of the S corporation. For purposes of this section 3.02(6), aggregate treatment means the treatment of an S corporation provided under § 1.951A-1(e).

.03 Examples

The following examples illustrate the rules set forth in section 3.02 of this notice.

(1) Example 1 – S corporation with transition AE&P--(a) Facts. Individual A and Individual B, each U.S. citizens, respectively own 5% and 95% of the single class of stock of SCX, an S corporation. SCX's sole asset is 100% of the single class of stock of FC, a CFC, which SCX has held since June 1, 2019. Neither Individual A or Individual B own shares, directly or indirectly, in any other CFC. Individual A, Individual B, SCX, and FC all use the calendar year as their taxable year. On January 1, 2021, SCX has transition AE&P of \$100x and AAA of \$0. SCX elects to apply the transition rules under section 3.02(1) of this notice. During the 2021 taxable year, FC has \$200x of tested income (within the meaning of §1.951A-2(b)(1)) and \$0 of QBAI (within the meaning of §1.951A-3(b)).

(b) Analysis--(i) S corporation-level. As an S corporation with transition AE&P on the first day of the taxable year (here, January 1, 2021), SCX is treated as owning (within the meaning of § 958(a)) all the stock of FC for purposes applying § 951A. Accordingly, SCX, a U.S. shareholder of FC, determines its GILTI inclusion amount under §1.951A-1(c)(1) for its 2021 taxable year. SCX's pro rata share of FC's tested income is \$200x, and its pro rata share of FC's QBAI is \$0. SCX's net CFC tested income (within the meaning of §1.951A-1(c)(2)) is \$200x, and its net deemed tangible income return (within the meaning of §1.951A-1(c)(3)) is \$0. As a result, SCX's GILTI inclusion amount for 2021 is \$200x. At the end of 2021, SCX increases its AAA by \$200x to reflect the GILTI inclusion amount. Because SCX computes its income as an individual under § 1363(b), it cannot take a § 250 deduction for any GILTI inclusion amount. See § 1.250(a)-1(c)(1).

(ii) S corporation shareholder-level. Neither Individual A nor Individual B is treated as owning the stock in FC within the meaning of § 958(a). Accordingly, Individual A and Individual B include in gross income their pro rata shares of SCX's GILTI inclusion amount as described in § 1366(a), which is \$10x (\$200x x 5%) for Individual A and \$190x (\$200x x 95%) for Individual B.

(2) Example 2 – Effect of distribution on transition AE&P--(a) Facts. The facts are the same as in Example 1 of this section 3.03, except that, on December 31, 2021, SCX

distributes \$300x to its shareholders. In addition, FC has an additional \$200x of tested income (within the meaning of §1.951A-2(b)(1)) and \$0 of QBAI (within the meaning of §1.951A-3(b)) during the 2022 taxable year.

(b) Analysis--(i) Determination of transition AE&P. Before taking into account the distribution on December 31, 2021, the results for taxable year 2021 are the same as set forth in paragraphs (b)(i) and (b)(ii) of Example 1 of this section 3.03. \$200x, the portion of SCX's \$300x distribution that does not exceed AAA, is subject to § 1368(c) (1). The remaining distribution of \$100x is treated as a dividend under § 316 to the extent of SCX's AE&P. As of January 1, 2022, SCX has \$0 of transition AE&P under section 3.02(5) of this notice because the cumulative amount of SCX's distributions out of AE&P after [INSERT DATE OF THIS NOTICE] equals or exceeds the amount of SCX's transition AE&P as of [INSERT DATE OF THIS NOTICE].

(ii) S corporation-level. Because SCX has no transition AE&P as of January 1, 2022, aggregate treatment applies to SCX for its taxable year 2022 and for each subsequent taxable year. As a result, for purposes of determining a GILTI inclusion amount in its taxable year 2022, SCX is not treated as owning (within the meaning of § 958(a)) the FC stock; instead, SCX is treated in the same manner as a foreign partnership for purposes of determining the FC stock owned by Individual A and Individual B under § 958(a)(2). See § 1.951A-1(e)(1). Accordingly, SCX does not have a GILTI inclusion amount for its 2022 taxable year (or for any subsequent taxable year) and therefore will not increase its AAA as a result of its ownership of FC stock for its taxable year 2022 (or for any subsequent taxable year).

(iii) S corporation shareholder-level--(A) Individual A. For purposes of determining the GILTI inclusion amount of Individual A for taxable year 2022, Individual A is treated as owning 5% of the FC stock under section 958(a). Individual A is not, however, a U.S. shareholder of FC because Individual A owns (within the meaning of § 958(a) and (b)) less than 10% (that is, only 5%) of the FC stock. Accordingly, Individual A does not have a GILTI inclusion amount for taxable year 2022.

(B) Individual B. For purposes of determining the GILTI inclusion amount of Individual B for taxable year 2022, Individual B is treated as owning 95% of the FC stock under section 958(a). In addition, Individual B is a U.S. shareholder of FC because Individual B owns (within the meaning of § 958(a) and (b)) at least 10% (that is, 95%) of the FC stock. Accordingly, Individual B's pro rata share of FC's tested income is \$190x ($\$200x \times 0.95$), and Individual B's pro rata share of FC's QBAI is \$0. Individual B's net CFC tested income is \$190x, and Individual B's net deemed tangible income return is \$0. As a result, Individual B's GILTI inclusion amount for taxable year 2022 is \$190x.

.04 PTEP Rules Addressing Transition from Entity to Aggregate Treatment

The Treasury Department and the IRS expect to amend the regulations under §§ 959 and 961 concerning previously taxed earnings and profits to provide rules to address the transition of S corporations from entity treatment to aggregate treatment.

SECTION 4. FORTHCOMING QIP-QBAI REGULATIONS ADDRESSING THE TREATMENT OF QIP FOR PURPOSES OF FDII AND GILTI

The Treasury Department and the IRS expect the forthcoming QIP-QBAI regulations under §§ 250 and 951A of the Code to clarify that the technical amendment to § 168 enacted in § 2307(a) of the CARES Act applies to determine the adjusted basis of property under § 951A(d)(3) as if it had been enacted as part of § 13204 of the TCJA. The Treasury Department and the IRS have determined that this clarification is consistent with congressional intent that the provisions of the technical amendment be given effect as if included in § 13204 of the TCJA.

SECTION 5. APPLICABILITY DATES

The forthcoming S corporation regulations will provide that the transition rules and examples set forth in sections 3.02 and 3.03 of this notice may be applied to taxable years of S corporations ending on or after June 22, 2019. For rules applicable to taxable years ending before June 22, 2019, see Notice 2019-46. Until the date of issuance of the forthcoming S corporation regulations, an S corporation and its shareholders may rely on the rules set forth in sections 3.02 and 3.03 of this notice provided that the S corporation and its shareholders that are U.S. shareholders of the CFC consistently apply the rules set forth in sections 3.02 and 3.03 of this notice with respect to all CFCs whose stock the S corporation owns within the meaning of § 958(a) of the Code.

Consistent with § 2307(b) of the CARES Act, the forthcoming QIP-QBAI regulations will provide that the rules described in section 4 of this notice will apply retroactively. In the case of the regulations under § 951A, the forthcoming QIP-QBAI regulations will apply to taxable years of foreign corporations beginning after December 31, 2017, and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end. In the case of the regulations under § 250, the forthcoming QIP-QBAI regulations will apply to taxable years of U.S. persons beginning after December 31, 2017. See § 7805(b)(2). Before the issuance of the forthcoming QIP-QBAI regulations, U.S. shareholders and domestic corporations (including any individuals that elect to apply § 962) may rely on the rules described in section 4 of this notice, provided they consistently apply those rules for purposes of FDII and GILTI under sections 250 and 951A to such taxable years.

Pursuant to Section IV. of the Policy Statement on the Tax Regulatory Process issued by the Treasury Department and the IRS on March 5, 2019, if no proposed regulations or other guidance is released within 18 months after [INSERT DATE THAT NOTICE IS PUBLISHED IN THE INTERNAL REVENUE BULLETIN], taxpayers may continue to rely on the rules described in this notice but, until additional guidance is issued, the Treasury Department and the IRS will not assert a position adverse to the taxpayer based in whole or in part on this notice.

SECTION 6. REQUEST FOR COMMENTS

The Treasury Department and the IRS request comments addressing the intended transition rules of the forthcoming S corporation regulations set forth in section 3 of this notice.

The Treasury Department and the IRS also request comments on the rules of the forthcoming QIP-QBAI regulations described in section 4 of this notice. The Treasury Department and the IRS request comments on whether an alternative rule should be provided that would allow a corrective adjustment in the first taxable year ending after the rules in section 4 of this notice become final for taxpayers that took a position that is inconsistent with the rules described in section 4 of this notice on a return filed before [INSERT DATE THAT NOTICE IS RELEASED] and do not file an amended return for such year. Comments on this issue should address what limitations might be needed on any such alternative rule, such as in cases where there have been changes in ownership of a CFC.

Comments should be submitted by [INSERT DATE 60 DAYS FROM ISSUANCE OF THIS NOTICE]. Commenters are strongly encouraged to submit public comments electronically via the Federal eRulemaking Portal at www.regulations.gov (indicate IRS and Notice 2020-XX) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The IRS expects to have limited personnel available to process public comments that are submitted on paper through mail. Until further notice, any comments submitted on paper will be considered to the extent practicable. The Treasury Department and the IRS will publish for public availability any comment submitted electronically, and to the extent practicable any comment submitted on paper, to its public docket. Send paper submissions to: CC:PA:LPD:PR (Notice 2020-XX), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044.

SECTION 7. PAPERWORK REDUCTION ACT

The collections of information in section 3.02(2) of this notice are reflected in the submission to the Office of Management and Budget (OMB) for review in accordance with Paperwork Reduction Act (44 U.S.C. § 3507(c)) (PRA) that is associated with OMB control number 1545-2291. The collections of information in section 3.02(2) of this notice will be submitted to IRS in conjunction with Form 1120S, which is approved under OMB control number 1545-0123. These submissions will be updated in the ordinary course.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collections of information are required to notify the IRS both that an S corporation has elected to apply entity treatment described in section 3.02 of this notice and of the amount of transition AE&P described in section 3.02(3) of this notice. The collections of information are required in order for the transition rules described in section 3.02 of this notice to apply. The likely respondents are business or other for-profit institutions.

The burdens associated with the reporting requirements in section 3.02(2) of this notice would be so minor as to not impact the estimated burdens provided in such submission.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by § 6103.

SECTION 8. DRAFTING AND CONTACT INFORMATION

The principal authors of this notice are Jennifer N. Keeney of the Office of Associate Chief Counsel (Passthroughs & Special Industries) and Edward J. Tracy, Jorge M. Oben, and Larry R. Pounders of the Office of Associate Chief Counsel (International). For further information regarding the S corporation issues described in this notice, contact Ms. Keeney at (202) 317-6850 or Mr. Tracy at (202) 317-6934 (not toll-free numbers). For further information regarding the QIP-QBAI issues described in this notice, contact Jorge M. Oben or Larry R. Pounders at (202) 317-6934 (not a toll-free number).