

TRANSITION TAX – PROPOSED REGULATIONS ARE HERE

Authors

Elizabeth V. Zanet
Rusudan Shervashidze
Beate Erwin

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The Treasury Department and the I.R.S. recently published proposed regulations on Code §965 (the “Proposed Regulations”). Introduced by the Tax Cuts and Jobs Act of 2017 (“T.C.J.A.”), Code §965 requires a “U.S. Shareholder” (see in detail below) to pay income tax on its *pro rata* share of previously untaxed foreign earnings held in a controlled foreign corporation (“C.F.C.”) and in certain other foreign corporations.¹ The tax imposed by Code §965 is commonly referred to as the transition tax. It is designed to tax deferred foreign income prior to the transition to a “participation exemption” system of taxation for the foreign portion of dividends from C.F.C.’s and certain other foreign corporations and, hence, is also a “toll tax.”² Because this tax is imposed irrespective of whether profits of a qualifying foreign corporation are actually distributed to its U.S. Shareholders, it is also referred to as a “mandatory repatriation tax.”

Prior to the Proposed Regulations, the Treasury Department and I.R.S. issued guidance on this new Code provision under Notices 2018-7,³ 2018-13,⁴ and 2018-26⁵ and Revenue Procedure 2018-17.⁶ The Proposed Regulations generally follow the prior guidance but, in addition, provide long awaited clarification on calculation, special election, and payment procedures.

CODE §965 BACKGROUND

In order to discuss the calculation and the workings of Code §965, several significant terms must be understood.

Transition tax applies to an S.F.C. that is a “deferred foreign income corporation” (“D.F.I.C.”).⁷

An S.F.C. is (i) any C.F.C. and (ii) any foreign corporation in which one or more U.S. corporations is a U.S. Shareholder.⁸ For Code §965 purposes, a U.S. Shareholder

¹ Code §965.

² Conceptually, the exempting of foreign-source dividends under this rule is a dividend received deduction (“D.R.D.”) rather than a participation exemption, as provided for example under Canadian law or the E.U. Parent/Subsidiary Directive. Apart from the operation of a D.R.D. and with very limited exceptions, it does not provide for an exemption of capital gains.

³ 2018-4 I.R.B. 317 (Dec. 29, 2017).

⁴ 2018-6 I.R.B. 341 (Jan. 19, 2018).

⁵ 2018-9 I.R.B. 384 (Fed. 13, 2018).

⁶ 2018-16 I.R.B. 480 (Apr. 2, 2018).

⁷ Code §965(d)(1).

⁸ Code §§965(e)(1)(A) and (B). An S.F.C. does not include any corporation that is

is a U.S. person (e.g., a citizen, resident, corporation, partnership, trust, or estate) that owns 10% or more of the vote of the foreign corporation.⁹ A C.F.C. is a foreign corporation in which one or more U.S. Shareholders own more than 50% of the voting rights of all of the classes of stock that are entitled to vote.

A D.F.I.C. is an S.F.C. that has “accumulated post-1986 deferred foreign income” on one of two possible measurement dates, discussed below. Accumulated post-1986 deferred foreign income is “post-1986 E&P” defined below, but excludes earnings attributable to income effectively connected to a U.S. trade or business¹⁰ or, in the case of a C.F.C., income that, if distributed to a U.S. Shareholder, would have been previously subject to U.S. taxation under the rules applicable to C.F.C.’s.¹¹

Post-1986 E&P is E&P of the foreign corporation computed under the applicable rules and accumulated in tax years beginning after December 31, 1986, through one of the two applicable measurement dates, discussed below. The amount is determined without a reduction for dividends distributed during the tax year. This reflects the general ordering rule of Subpart F and actual dividends – Subpart F applies first, and dividends are not taxed a second time if and to the extent attributable to previously taxed income. For individual U.S. Shareholders, this means they are taxed at ordinary income rates and not favorable long-term capital gains tax rates that might otherwise apply to qualified dividends.

The transition tax applies to the last tax year of a D.F.I.C. that begins before January 1, 2018. For that tax year, the Subpart F Income under Code §951 (also referred to as a Code §951 inclusion) of a D.F.I.C. must be increased by the greater of its accumulated post-1986 deferred foreign income as of November 2, 2017, or December 31, 2017, (the “E&P measurement dates”). The increase in income is the “Code §965(a) earnings” amount. The U.S. Shareholder must treat the increase as Subpart F Income.

Under Code §965(b), if a U.S. Shareholder is a shareholder of at least one D.F.I.C. and at least one foreign corporation that has an E&P deficit (an “E&P deficit foreign corporation”), the increase in income discussed above is reduced (but not below zero) by the U.S. Shareholder’s aggregate foreign E&P deficit. This amount is the “Code §965(a) inclusion” amount. The amount by which the foreign E&P deficit decreased the Code §965(a) earnings amount is treated as previously taxed income (“P.T.I.”) under the rules of Code §959.

Instead of prescribing a fixed tax rate on the Code §951 inclusion, Code §965 allows a deduction to be applied to net income that is calculated to achieve a specific tax rate. This is referred to as the rate equivalent percentage method. In substance, the equivalent of a partial D.R.D. is computed so that the tax imposed will equal the target rate when divided by net income before the deduction.

a Passive Foreign Investment Income Company (“P.F.I.C.”), as defined in Code §1297, with respect to the shareholder. Code §965(e)(3).

⁹ The definition of U.S. Shareholder was broadened under the T.C.J.A. to include a U.S. person that owns 10% or more of the vote or value of a foreign corporation. However, the expanded definition does not apply for transition tax purposes. See, Com. Report, p. 485, fn. 1503.

¹⁰ Code §965(d)(2)(A).

¹¹ Code §965(d)(2)(B).

“Code §965 allows a deduction to be applied to net income that is calculated to achieve a specific tax rate.”

The effective tax rates applicable to income inclusions under this rule are adjusted by way of a deduction set forth in Code §965(c). In other words, the “exemption” is in the form of a partial deduction (the “Code §965(c) deduction”). As a result, the Code §965 deduction results in a partial “exemption” of the Code §965 inclusion amount. The Code §965(c) deduction is an amount necessary to produce a 15.5% tax rate on accumulated post-1986 E&P held in the form of cash or cash equivalents and an 8% tax rate on all other earnings. The foreign tax credit is not allowed for the applicable percentage of foreign taxes paid or accrued (or treated as paid or accrued) with respect to any amount for which a Code §965(c) deduction is allowed.

Code §965 permits the taxpayer to make certain elections. Under Code §965(h), a U.S. Shareholder may elect to defer payment of the transition tax liability by paying the amount in installments over eight years. The first five installments must each equal 8% of the transition tax liability; the sixth installment must equal 15%; the seventh installment must equal 20%; the eighth and final installment must equal 25%. The installment payments are not subject to an interest charge. Certain “acceleration events” will cause the taxpayer to lose the benefit of deferral by accelerating the payment of the unpaid portion of all remaining installments to the date of the acceleration event, discussed under **Elections and Payments** below. Note that although the payment of the net tax liability under Code §965 is deferred, the amount must be reported on an IRC 965 Transition Tax Statement.

In the case of an S-corporation that is a U.S. Shareholder of a D.F.I.C., Code §965(i) permits each shareholder of the S-corporation to elect to defer payment of the transition tax liability until a “triggering event.” A triggering event occurs when the corporation ceases to be an S-corporation or is sold or liquidated, or the taxpayer transfers stock of the S-corporation (including a transfer by death).

STEP-BY-STEP CALCULATION OF THE TRANSITION TAX

Based on the foregoing, determining the amount of transition tax requires the following steps:

1. Measure post-1986 E&P of S.F.C.'s.
2. Allocate E&P deficits.
3. Calculate aggregate foreign cash position or cash equivalent amounts.
4. Compute allowed deductions under Code §965(c).
5. Determine foreign tax credits.

THE PROPOSED REGULATIONS

Definitions

The following definitions are addressed in the Proposed Regulations. These definitions generally are consistent with prior guidance.

E&P Deficit Foreign Corporation – For purposes of determining the status of an S.F.C. as a D.F.I.C. or an E&P deficit foreign corporation, it must first be determined

whether the S.F.C. is a D.F.I.C. In broad terms, D.F.I.C. status trumps classification as an E&P deficit foreign corporation. More specifically, if an S.F.C. meets the definition of a D.F.I.C., it is classified solely as a D.F.I.C. and not also as an E&P deficit foreign corporation, notwithstanding the fact that the S.F.C. otherwise satisfies the E&P deficit foreign corporation definition. Thus, only in the event an S.F.C. does not meet the definition of a D.F.I.C., must it be determined whether it is an E&P deficit foreign corporation. Under certain circumstances described in the Proposed Regulations, an S.F.C. may be classified as neither a D.F.I.C. nor an E&P deficit foreign corporation despite having post-1986 E&P greater than zero or a deficit in accumulated post-1986 deferred foreign income.¹²

Accumulated Post-1986 Deferred Foreign Income – In the case of a C.F.C. that has shareholders that are not U.S. Shareholders on an E&P measurement date, the accumulated post-1986 deferred foreign income of the C.F.C. on the E&P measurement date is reduced by amounts that would be those described in Code §965(d)(2)(B) if the shareholders were U.S. Shareholders. In such cases, the principles of Revenue Ruling 82-16, 1982-1 C.B. 106, apply in order to determine the amounts by which accumulated post-1986 deferred foreign income is reduced.¹³

Cash Measurement Dates – For the purpose of computing the Code §965(a) inclusion, the cash measurement dates are as follows:

- The first cash measurement date of an S.F.C. is the close of the last tax year of the S.F.C. that ends after November 1, 2015, and before November 2, 2016, if any.
- The second cash measurement date of an S.F.C. is the close of the last tax year of the S.F.C. that ends after November 1, 2016, and before November 2, 2017, if any.
- The final cash measurement date of an S.F.C. is the close of the last tax year of the S.F.C. that begins before January 1, 2018, and ends on or after November 2, 2017, if any.

The proposed regulations provide that a U.S. Shareholder takes into account its *pro rata* share of the cash position of an S.F.C. as of any cash measurement date of the S.F.C. on which it is a U.S. Shareholder of the S.F.C., regardless of whether the U.S. Shareholder is a U. S. Shareholder of the S.F.C. as of any other cash measurement date, including the final cash measurement date of the S.F.C.¹⁴

Cash Position – The Proposed Regulations define the term “cash-equivalent asset” to include derivative financial instruments held by the S.F.C. that are not a *bona fide* hedging transaction.¹⁵ “Derivative financial instruments” include notional principal contracts, options contracts, forward contracts, futures contracts, short positions in securities and commodities, and any similar financial instruments.¹⁶

Pro Rata Share – The Proposed Regulations provide that, for purposes of

¹² Prop. Treas. Reg. §§1.965-1(f)(17)(ii); 1.965-1(g), Example 5.

¹³ Prop. Treas. Reg. §1.965-1(f)(7)(i)(C)

¹⁴ Prop. Treas. Reg. §§1.965-1(f)(24), (31), (25), (30)(iii).

¹⁵ Prop. Treas. Reg. §1.965-1(f)(13)(v).

¹⁶ Prop. Treas. Reg. §1.965-1(f)(18).

determining a U.S. Shareholder's *pro rata* share of the specified E&P deficit of an E&P deficit foreign corporation that has multiple classes of stock outstanding, the specified E&P deficit is allocated among the holders of the corporation's common stock and in proportion to the value of the holding. The Proposed Regulations also clarify that, for purposes of determining a shareholder's *pro rata* share of a specified E&P deficit, the value of the common stock is determined as of the last day of the last tax year of the E&P deficit foreign corporation that begins before January 1, 2018.¹⁷

Domestic Pass-Thru Entity – The Proposed Regulations define the term “domestic pass-thru entity” to mean a pass-thru entity that is a U.S. person that is a partnership, S-corporation, or any other person to the extent that the income or deductions of such person are included in the income of one or more direct or indirect owners or beneficiaries of the person.¹⁸

Domestic Pass-Thru Owner's Share – In the case of a domestic pass-thru entity that is a U.S. Shareholder with respect to one or more D.F.I.C.'s, each domestic pass-thru owner takes into account its share of the aggregate Code §965(a) inclusion amount with respect to stock of one or more D.F.I.C.'s of the domestic pass-thru entity and its share of the Code §965(c) deduction amount (each a “domestic pass-thru owner's share”), regardless of whether the domestic pass-thru owner is also a U.S. Shareholder with respect to the D.F.I.C. This gives rise to a Code §965(a) inclusion and a Code §965(c) deduction for the domestic pass-thru owner.¹⁹ An aggregate Code 965(a) inclusion amount for a U.S. Shareholder's inclusion year and the related Code 965(c) deduction must be allocated in the same proportion. For example, if a domestic pass-thru owner is allocated 50% of the aggregate Code §965(a) inclusion amount with respect to stock of a domestic pass-thru entity, the domestic pass-thru owner must be allocated 50% of the related Code §965(c) deduction amount. If the domestic pass-thru owner is also a U.S. Shareholder with respect to the D.F.I.C. because it owns stock of the D.F.I.C., the Code §965(a) inclusion amount with respect to the stock of the domestic pass-through owner and the Code §965(c) deduction amount with respect to such amount are determined separately from the domestic pass-thru owner's share of the aggregate Code §965(a) inclusion amount and Code §965(c) deduction amount of the domestic pass-thru entity.²⁰

Adjustments to E&P and Basis

E&P Adjustments

The Proposed Regulations provide rules on the interaction between Code §965 and the P.T.I. regulations under Code §959, which are consistent with prior guidance.²¹ The following ordering rules are set forth in the Proposed Regulations for computing adjustments to E&P for purposes of determining the Code §965(a) inclusion and the treatment of P.T.I. distributions:²²

¹⁷ Prop. Treas. Reg. §1.965-1(f)(30)(ii).

¹⁸ Prop. Treas. Reg. §1.965-1(f)(19).

¹⁹ Prop. Treas. Reg. §§1.965-1(f)(21), (37), (41).

²⁰ Prop. Treas. Reg. §1.965-3(g).

²¹ Notice 2018-07, §3.02(d).

²² Prop. Treas. Reg. §1.965-2(b).



1. Compute Subpart F Income without regard to Code §965(a).
2. Account for the treatment of distributions from one S.F.C. to another S.F.C. made before January 1, 2018, for the purposes of Code §959.
3. Compute the U.S. Shareholder's Code §965(a) inclusion amount.
4. Take into account the treatment of all distributions from the S.F.C. (other than those described in the second step) determined under Code §959.
5. Determine any Code §956 inclusion (relating to investments in U.S. property) with respect to the S.F.C., including any P.T.I.

Basis Adjustments

In general, under Code §961(a), a U.S. Shareholder's basis in the stock of a C.F.C. (or its basis in property by reason of which it indirectly owns stock of a C.F.C.) is increased by the amount required to be included in its gross income as Subpart F Income. Under Code §961(b), the basis is reduced by the amount received that is excluded from gross income because it is P.T.I.

The Proposed Regulations state that a U.S. Shareholder's basis in the stock of a D.F.I.C. is increased by the shareholder's Code §965(a) inclusion and P.T.I.²³

As discussed above, when the Code §965(a) earnings amount of a D.F.I.C. is reduced by a foreign E&P deficit of a Code §965(b) E&P deficit foreign corporation, the reduction amount is treated as P.T.I. The Proposed Regulations state that the allocation of the deficit foreign E&P does not result in an automatic basis increase.²⁴ However, the Proposed Regulations provide for the possibility of an election to apply basis adjustments.²⁵

Basis adjustment rules in the case of an individual U.S. Shareholder that elected to be treated as a corporation under a Code §962 election (discussed below) were not addressed and have been reserved.

Gain Reduction Rule

In the case of a reduction of basis resulting from excluding P.T.I. from gross income, Code §961(b)(2) states that to the extent that the amount excluded exceeds the adjusted basis of the stock (or property), that amount is treated as gain. In such a case, the Proposed Regulations provide a gain reduction rule. Under the rule, the amount of the gain is reduced (but not below zero) by an amount equal to the Code §965(a) previously taxed E&P.²⁶ Notably and contrary to Notice 2018-13, the regulations remain silent on distributions by a lower tier C.F.C. to its C.F.C. parent.

Foreign Tax Credits and Deductions

Code §965(g)(1) states that no credit is allowed under Code §901 (the Code section that governs credits for foreign taxes directly paid or accrued by the taxpayer) for the

²³ Prop. Treas. Reg. §1.965-2(e).

²⁴ Prop. Treas. Reg. §1.965-2(f).

²⁵ Prop. Treas. Reg. §1.965-2(f)(2).

²⁶ Prop. Treas. Reg. §1.965-2(g).

“U.S. citizens that live outside the U.S. and are subject to tax on a net basis in their jurisdiction of residence are not allowed a credit nor a deduction for net basis taxes imposed on the receipt of Code §§965(a) or (b) previously taxed E&P.”

“applicable percentage” of any taxes paid or accrued, or treated as paid or accrued, with respect to any amount for which the Code §965(c) deduction is allowed. As discussed above, the Code §965(c) deduction is the deduction that lowers the tax rate on the Code §965(a) inclusion to 15.5% on accumulated post-1986 E&P attributable to cash and cash equivalents and 8% on the remaining earnings. The applicable percentage is a haircut on the foreign taxes related to the Code §965(a) inclusion, generally in proportion to the amount by which the Code §965(c) deduction reduces the tax on the Code §965(a) inclusion.

Note that no deduction is allowed for any amount for which a credit is disallowed under Code §965(g)(1). Thus, foreign taxes paid or accrued with respect to any amount for which the Code §965(c) is allowed are neither creditable nor deductible.

The Proposed Regulations state that “taxes paid or accrued” refers to taxes paid or accrued directly by the taxpayer under Code §901 (e.g., withholding taxes) and taxes “treated as paid or accrued.” The latter include foreign income taxes deemed paid by the taxpayer under Code §960 (i.e., income taxes paid by the foreign corporation), foreign income taxes allocated to any entity under Treas. Reg. §1.901-2(f) (4), and a distributive share of taxes paid by a partnership.²⁷ This is an important clarification because the statute does not explicitly refer to indirect foreign income taxes.

The Proposed Regulations state that neither a deduction nor a credit is allowed under Code §901 for the applicable percentage of any foreign income taxes attributable to a distribution of Code §965(a) previously taxed E&P or Code §965(b) previously taxed E&P. Thus, withholding taxes imposed on a U.S. Shareholder on an actual distribution of Code §§965(a) or (b) previously taxed E&P are not creditable nor deductible. Further, U.S. citizens that live outside the U.S. and are subject to tax on a net basis in their jurisdiction of residence are not allowed a credit nor a deduction for net basis taxes imposed on the receipt of Code §§965(a) or (b) previously taxed E&P.

Code §960 provides the rules for crediting indirect foreign taxes paid or accrued on Subpart F Income. Former Code §960(a)(3)²⁸ states that any portion of a distribution from a foreign corporation received by a domestic corporation which is excluded from gross income as P.T.I. is treated as a dividend from the foreign corporation to the domestic corporation solely for the purpose of taking into account any foreign taxes which were not deemed paid by the domestic corporation for any prior tax year. The Proposed Regulations state that a credit allowed under Code §960(a)(3) applies only with respect to foreign income taxes imposed on an upper-tier foreign corporation on distributions of Code §965(a) or (b) previously taxed E&P from a lower-tier foreign corporation.²⁹ In addition, foreign income taxes attributable to the portion of a Code §965(a) earnings amount that was reduced by Code §965(b) are not creditable.³⁰

²⁷ Prop. Treas. Reg. §1.965-5(b).

²⁸ Under the T.C.J.A., Code §960(a)(3) was replaced with Code §960(b). The Proposed Regulations only address the application of Code §960 before the effective date of Code §960(b). The preamble to the Proposed Regulations states that future regulations will address the application of Code §960(b).

²⁹ Prop. Treas. Reg. §1.965-5(c)(1)(ii).

³⁰ *Id.*

Code §965(c) Deductions

Determination of Aggregate Foreign Cash Position

The Proposed Regulations provide that, for purposes of determining the aggregate foreign cash position of a U.S. Shareholder, certain obligations, such as accounts receivable, accounts payable, short-term obligations, or derivative financial instruments between related S.F.C.'s are disregarded on the corresponding cash measurement dates of the S.F.C.'s to the extent of the smallest of the U.S. Shareholder's ownership percentages of stock those dates.³¹

Further, the aggregate foreign cash position is reduced by amounts of net accounts receivable, actively traded property, and short-term obligations to the extent such amounts are attributable to amounts taken into account in determining the U.S. Shareholder's *pro rata* share of the cash position of another S.F.C. on such cash measurement date and to the extent it is not already disregarded. To disregard assets under this rule, the U.S. Shareholder must attach a statement to its timely-filed return.³²

Determination of Aggregate Foreign Cash Position for a U.S. Shareholder's Inclusion Year

The Proposed Regulations provide that in the case of a U.S. Shareholder that has a Code §965(a) inclusion amount in more than one tax year, the amount of the aggregate foreign cash position taken into account in the first tax year will equal the lesser of the U.S. Shareholder's aggregate foreign cash position or the aggregate Code §965(a) inclusion amount taken into account by the U.S. Shareholder in that tax year. Furthermore, the amount of the U.S. Shareholder's aggregate foreign cash position taken into account in any succeeding tax year will be the lesser of (i) the excess, if any, of its aggregate foreign cash position over the amount of its aggregate foreign cash position taken into account in preceding tax years or (ii) the aggregate Code §965(a) inclusion amount taken into account by the U.S. Shareholder in such succeeding taxable year.³³

In addition, the Proposed Regulations provide that, for purposes of determining the aggregate foreign cash position of a U.S. Shareholder for a tax year in which it takes into account a Code §965(a) inclusion amount, the U.S. Shareholder may assume that its *pro rata* share of the cash position of any S.F.C. whose last tax year beginning before January 1, 2018, ends after the date the return for such tax year of the U.S. Shareholder is timely filed (including filing date extensions) will be zero as of the cash measurement date with which the tax year of the S.F.C. ends.

If a U.S. Shareholder's *pro rata* share of the cash position of an S.F.C. was treated as zero pursuant to the above rule for a U.S. Shareholder's inclusion year (an "estimated U.S. Shareholder inclusion year"), the final cash measurement date amount, in fact, exceeds the average of the first and second cash measurement date amounts with respect to the U.S. Shareholder, and its aggregate Code §965(a) inclusion amount, in fact, exceeds the final cash measurement date amount, then interest and penalties will not be imposed if the U.S. Shareholder makes appropriate

³¹ Prop. Treas. Reg. §1.965-3(b)(1).

³² Prop. Treas. Reg. §1.965-3(b)(2).

³³ Prop. Treas. Reg. §1.965-3(c)(2).

adjustments by amending the return for the estimated U.S. Shareholder inclusion year to reflect the correct aggregate foreign cash position by the due date (including filing date extensions) for the return for the year after the estimated U.S. Shareholder inclusion year.³⁴

Treatment of Code §965(c) Deductions Under Certain Code Provisions

The Proposed Regulations provide that a Code §965(c) deduction is not treated as an itemized deduction for any purpose.³⁵

In the case of a domestic partnership or S-corporation, the Proposed Regulations state that: (i) the aggregate amount of its Code §965(a) inclusions net of the aggregate amount of its Code §965(c) deductions is treated as a separately stated item of net income solely for purposes of calculating basis, and (ii) the aggregate amount of its Code §965(a) inclusions equal to the aggregate amount of its Code §965(c) deductions is treated as income exempt from tax solely for purposes of calculating basis under certain provisions of the Code.³⁶

Disregarding Certain Transactions

The Proposed Regulations disregard certain transactions for purposes of applying Code §965. In particular, Prop. Treas. Reg. §1.965-4 provides rules that disregard (i) transactions undertaken with a principal purpose of reducing the U.S. Shareholder's Code §965 tax liability, (ii) certain changes in method of accounting and entity classification elections, and (iii) certain transactions occurring between E&P measurement dates.³⁷ Note that for purposes of these anti-abuse rules, if a domestic partnership is a U.S. Shareholder, a domestic partner (that is not otherwise treated as U.S. Shareholder) is treated as a U.S. Shareholder.³⁸

The application of the anti-avoidance rules³⁹ is based on whether there is a "change in the amount of a Code §965 element" rather than a change in the Code §965 tax liability.⁴⁰ For this purpose, generally, there is a change in the amount of a Code §965 element if there is a reduction of a Code §965(a) inclusion amount or aggregate foreign cash position, or an increase in deemed paid foreign income taxes as a result of a Code §965(a) inclusion.⁴¹

The Proposed Regulations disregard certain transactions occurring between E&P measurement dates. The amounts paid or incurred between related S.F.C.'s of a U.S. Shareholder between E&P measurement dates that would otherwise reduce such an S.F.C.'s post-1986 E&P as of December 31, 2017, are disregarded for



³⁴ Prop. Treas. Reg. §1.965-3(c)(3).

³⁵ Prop. Treas. Reg. §1.965-3(f)(1).

³⁶ Code §§705(a)(1)(B) with respect to the determination of a partner's basis with regards to tax exempt income, Code §1367(a)(1)(A) with respect to certain transfers of property by U.S. persons to foreign corporations, and Treas. Reg. §1.1367-1(f) in this context.

³⁷ Prop. Treas. Reg. §1.965-4.

³⁸ Prop. Treas. Reg. §1.965-4(e)(2).

³⁹ Prop. Treas. Reg. §1.965-4(b)-(e).

⁴⁰ Prop. Treas. Reg. §1.965-4(b)(1).

⁴¹ Prop. Treas. Reg. §§1.965-4(d), (e)(1).

purposes of determining the post-1986 E&P of both S.F.C.'s as of December 31, 2017.⁴²

In addition, a specified transaction will be treated *per se* as abusive (*i.e.*, as having a principal purpose of changing the amount of a Code §965 element of a U.S. Shareholder) for purposes of the anti-avoidance rule. A “specified transaction” reduces E&P in one or more of the following ways: (i) a complete liquidation of an S.F.C. to which Code §331 applies; (ii) a sale or other disposition of stock by an S.F.C.; or (iii) a distribution by an S.F.C. that reduces the E&P of the S.F.C. according to Code §312(a)(3).

Elections and Payments

Prop. Treas. Reg. §1.965-7 discusses elections under Code §965. These include an election to pay the net tax liability in installments under Code §965(h),⁴³ an election under Code §965(i) for an S-corporation shareholder to defer the net tax liability until a triggering event,⁴⁴ and an election by a real estate investment trust (“R.E.I.T.”) to defer the inclusion of its aggregate amount of Code §965(a) inclusions and Code §965(c) deductions over an eight-year period.⁴⁵

The Proposed Regulations state that relief for late filing under Treas. Reg. §§301.9100-2 or 301.9100-3 (relating to rules for requests for extensions) of any election under Code §965, including the elections above, is not available.⁴⁶

Code §965(h) permits a taxpayer to elect to pay the net tax liability in eight installment payments. The Proposed Regulations refer to the net tax liability subject to the deferral election under Code §965(h) as the “section 965(h) net tax liability.” The election may be made by a Code §958(a) U.S. Shareholder or a domestic pass-thru owner with respect to a domestic pass-thru entity that is a Code §958(a) U.S. Shareholder but not a domestic pass-thru entity itself.

Under Code §965, an acceleration event will cause the unpaid portion of remaining installments to be due on the date of such event. An acceleration event includes: an addition to tax for failure to timely pay any installment, a liquidation or sale of substantially all the assets of the taxpayer (including in a title 11 or similar case, a cessation of the business by the taxpayer or any similar circumstance).⁴⁷

The Proposed Regulations add the following acceleration events:

- In the case of an individual, the death of the person or any event that results in the person no longer being a U.S. person, including a resident alien becoming a nonresident alien.
- In the case of a person that was not a member of any consolidated group, the person becoming a member of a consolidated group.

⁴² Prop. Treas. Reg. §1.965-4(f).

⁴³ Prop. Treas. Reg. §1.965-7(b).

⁴⁴ Prop. Treas. Reg. §1.965-7(c).

⁴⁵ Prop. Treas. Reg. §1.965-7(d).

⁴⁶ See, e.g., Prop. Treas. Reg. §§1.965-7(b)(2)(ii), 1.965-7(c)(2)(ii), and 1.965-7(d)(3)(ii).

⁴⁷ Code §965(h)(3).

- In the case of a consolidated group, the group ceasing to exist, including as a result of an acquisition.

As a general note, these rules should be helpful to prevent an acceleration event in many common business transactions.

The Proposed Regulations address the issue of a taxpayer that elected installment payment and incorrectly computed its net tax liability. Two instances are distinguished for purposes of these rules: In the case of the I.R.S. assessing a deficiency, or the taxpayer timely filing a return, or filing an amended return, the deficiency or additional liability must be prorated to the installments. This rule does, however, not apply in the case of negligence, intentional disregard or fraud. In such case, the deficiency payment must be made on notice or demand by the I.R.S. or the additional liability must be paid with the tax return or amended tax return. Thus, an addition to tax with respect to an installment payment that is not due to negligence, intentional disregard or fraud is not an acceleration event.

The Proposed Regulations state that each shareholder of an S-corporation, other than a domestic pass-thru entity, that is a U.S. Shareholder of a D.F.I.C. may elect to defer the net tax liability until the shareholder's taxable year that includes a triggering event described Code §965(i). The Proposed Regulations refer to the net tax liability subject to the deferral election under Code §965(i) as the "section 965(i) net tax liability."

The consequences of an acceleration event in the case of a Code §965(h), or a triggering event in the case of a Code §965(i) election, will not occur if the taxpayer transfers its section 965(h) net tax liability or section 965(i) net tax liability to an eligible transferee under a transfer agreement. The Proposed Regulations set forth the requirements for such transfer agreements. Relief for late filing of a transfer agreement is not available.⁴⁸

Application to Individuals

In addition to rules interpreting Code §965, the Proposed Regulations include rules on Code §962, a provision that allows an individual U.S. Shareholder to elect to be treated as a domestic corporation solely for the purposes of computing his or her income tax under Code §951(a) (relating to Subpart F Income and the net tax liability under Code §965, which is treated as Subpart F Income) and Code §960 (relating to indirect foreign tax credits for foreign taxes paid by a C.F.C.).

The Proposed Regulations state that an individual domestic pass-thru owner that is a U.S. Shareholder with respect to a D.F.I.C. may make a Code §962 election with respect to the individual's share of the domestic pass-thru entity's Code §965(a) inclusion amount. However, an individual domestic pass-thru owner that is not a U.S. Shareholder with respect to a D.F.I.C. may not make a Code §962 election with respect to the individual's share of the domestic pass-thru entity's Code §965(a) inclusion amount.⁴⁹

For the purpose of computing the Code §965(c) deduction, the Proposed Regulations clarify that, under a Code §962 election, the Code §965(c) deduction should be allowed with respect to the tax imposed under Code §11 rather than under Code

⁴⁸ Prop. Treas. Reg. §§1.965-7(b)(3)(iv)(B)(2)(i), 1.965-7(c)(3)(iv)(B)(2)(i).

⁴⁹ Prop. Treas. Reg. §1.962-2(a).

"An individual U.S. Shareholder that does not make a Code §962 election may be subject to tax under Code §965 at rates higher than the rates for corporate U.S. Shareholders."

§1.⁵⁰ Thus, the Proposed Regulations clarify that an individual U.S. Shareholder that does not make a Code §962 election may be subject to tax under Code §965 at rates higher than the rates for corporate U.S. Shareholders because his or her starting point for computing the Code §965(c) deduction will be the individual income tax rate (as high as 39.67% for 2017 and 37% from 2018 onwards) rather than the corporate rate.

Further, the Proposed Regulations clarify that a Code §965(c) deduction taken to compute taxable income under Code §11 cannot be deducted again at the individual level.⁵¹ That is, under a Code §962 election, the Code §965(c) deduction is not allowed for the purposes of determining the individual's actual taxable income.

The Proposed Regulations clarify whether a U.S. person that must pay the net investment income tax ("N.I.I.T.") on a Code §965(a) inclusion is entitled to take a Code §965(c) deduction on that amount. The N.I.I.T. is a 3.8% tax on net investment income, including dividends, of an individual, trust, or estate. The Proposed Regulations conclude that the Code §965(c) deduction was not intended to be applied against the N.I.I.T. on a Code §965(a) inclusion because the N.I.I.T. provision is a non-income tax provision outside of Chapter 1 of the Code.⁵² For the same reason, the Code §965(h) election to pay in eight installments does not apply to the N.I.I.T. on the Code §965(a) inclusion.

Effective Date

The Proposed Regulations apply beginning the last tax year of a foreign corporation that begins before January 1, 2018. With respect to a U.S. person, the Proposed Regulations apply beginning the tax year in which or with which such taxable year of the foreign corporation ends. If they are issued in final form, they will apply retroactively.

CONCLUSION

While the Proposed Regulations do not address all questions raised by practitioners and their clients, they provide, *inter alia*, useful guidance on calculating the tax liability for this "toll-tax." Taxpayers and their advisors should thus review these regulations and reassess their calculations based thereupon. This is of specific importance, as this one-time application to 2017 tax years has an impact far beyond. Hence, it affects subsequent tax periods – whether by means of installment payments or by determining P.T.I.

In addition, it will be interesting to see the public comments received by the I.R.S. and the Treasury. The deadline for public comments was set to 60 days after the publication of the regulations in the Federal Register, which was dated August 9, 2018.

⁵⁰ Prop. Treas. Reg. §1.962-1(b)(1)(i).

⁵¹ *Id.*

⁵² The N.I.I.T. is codified Chapter 2A, Subtitle A, Code §1411.