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October 29, 2018

Hon. Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20024

Re: Comments on the Proposed Regulations Addressing Section 965

Dear Commissioner Rettig:

Enclosed please find comments on the Proposed Regulations under and related to Section 965 of the Internal Revenue Code, other than comments that are specific to the application of the Proposed Regulations to S corporations, which will be submitted separately. These comments are submitted on behalf of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association.

The Section of Taxation would be pleased to discuss these comments with you or your staff.

Sincerely,

Eric Solomon
Chair, Section of Taxation

Enclosure

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AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

Comments on Proposed Regulations Addressing Section 965

These comments ("Comments") are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Devon M. Bodoh, Kimberly J. Majure, Paul J. Crispino, Carol P. Tello, Ari Berk, Morgan Hann, Magda B. Szabo, Dave Warco, John A. Karasek, Robert Kantowitz, Alexey Manasuev, and Alfonso J. Dulcey. The Comments have been reviewed by Joan Arnold of the Section's Committee on Government Submissions.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments. Additionally, while the Section's diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

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Date: October 29, 2018

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I. Executive Summary

Section 965¹ was originally enacted as part of the American Jobs Creation Act of 2004.² Effective only for the 2004 and 2005 tax years, section 965 generally allowed the voluntary repatriation of the earnings of at least 10-percent owned foreign subsidiaries of U.S. corporations.

Public Law 115-97 (the “2017 Tax Act” or the “Act”), enacted on December 22, 2017, amended section 965 to impose a mandatory income inclusion by certain shareholders of deferred earnings of certain U.S.-owned foreign corporations.³ On August 1, 2018, the Internal Revenue Service (the “Service”) and the Department of Treasury (“Treasury”) published proposed regulations under section 965 (the “Proposed Regulations”).⁴ We applaud Treasury and the Service for issuing the Proposed Regulations. We agree with many of the positions taken. We do, however, find that there are certain positions that we recommend be reconsidered, and there are areas in which additional clarification would be helpful. A detailed outline of the rules of section 965 under the Act is below, as is the guidance provided by Treasury and the Service, in parts II.A and B of this letter.

Our recommendations are summarized below and discussed in more detail in parts II.C-F and II.G (which addresses certain miscellaneous recommendations) of this letter.

We summarize certain aspects of section 965 here to provide context for the summary of the recommendations. Under section 965, the tax rate for U.S. corporations that experience an inclusion pursuant to section 965 is an effective tax rate of 8% (for non-cash and non-cash-equivalent assets) and 15.5% (for cash or cash-equivalent assets). Because the effective tax rate is achieved through a deduction defined in relation to the corporate tax rate, different rates apply to individuals that are U.S. shareholders within the meaning of section 951(b) (a “U.S. shareholder”) of foreign corporations, including those who own through entities taxed as partnerships, or disregarded entities, and S corporations.⁵ The income inclusion is based on the “accumulated post 1986 deferred

¹ All references to a section are to the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.

² American Jobs Creation Act of 2004, Pub. L. No. 108-357 (2004).

³ An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub. L. No. 115-97 (2017) (sometimes referred to as the “Tax Cuts and Jobs Act” or “TCJA”).

⁴ See Notice of Proposed Rulemaking, *Guidance Regarding the Transaction Tax Under Section 965 and Related Provisions*, 83 Fed. Reg. 39514 (2018).

⁵ Under section 951(b), as in effect for 2017, a U.S. person was a U.S. shareholder of a foreign corporation if that U.S. person owned, within the meaning of section 958(a), or was considered as owning by applying the constructive ownership rules of section 958(b), 10% or more of the voting stock of the foreign corporation. The Act amended section 951(b) by expanding the definition of U.S. shareholder to include ownership of 10% or more of the total value of all classes of stock of such foreign corporation, for tax years of foreign corporations beginning after 12/31/2017 and to tax years of U.S. shareholders with or within which such taxable years of foreign corporation ends. See P.L. 115-97, § 14214(a). A “U.S. person” includes a citizen or resident of the United States, a domestic partnership, a domestic corporation, any estate other than a foreign estate within the meaning of section 7701(a)(31), and any trust controlled by a U.S. person or to which a

foreign income” of the relevant foreign corporations.⁶ In calculating that amount, a U.S. shareholder is generally permitted to offset positive earnings in one entity with losses in another related entity.

In calculating the taxes that are due as a result of the income inclusion, a U.S. shareholder that is a corporation that had the ability to claim foreign tax credits pursuant to section 902 (as in existence for 2017) is able to claim foreign tax credits as a result of the section 965 inclusion, with certain reductions in amounts.

Our principal recommendations regarding the Proposed Regulations and related guidance are grouped into three categories: (A) the application of section 965 to passthrough entities (other than S corporations) and individuals, (B) the application of the netting of accumulated post-1986 deferred foreign income with deficits in other related entities, and (C) issues in applying the foreign tax credit.

A. Comments Regarding Passthrough Entities and Individuals

We respectfully recommend that Treasury and the Service consider issuing the following guidance with regard to passthrough entities and individuals:

1. Clarify that a controlled domestic partnership within the meaning of Proposed Regulation section 1.965-1(e)(2) (a “CDP”)⁷ that is treated as a foreign partnership for purposes of the Proposed Regulations is treated as a foreign partnership with respect to all partners of the partnership (and not solely with respect to U.S. persons who are U.S. shareholders).
2. Provide that, for purposes of the specified basis adjustment rules for foreign passthrough entities under Proposed Regulation section 1.965-2(h)(5)(ii), the principles of section 743(b) be applied for purposes of associating a specified basis adjustment made by a foreign passthrough entity⁸ with the section 958(a) U.S. shareholder⁹ with respect to whom the specified basis adjustment is made.
3. Clarify that specified basis adjustments made by a foreign passthrough entity are subject to reduction for distributions made by a specified foreign corporation, as

court within the United States is able to exercise primary supervision over its administration. I.R.C. §§ 7701(a)(3), 957(c). An S corporation is defined in section 1361. Note that these comments do not include our comments with respect to the application of section 965 to S corporations, which will be submitted separately.

⁶ I.R.C. § 965(a).

⁷ The Proposed Regulations define a CDP, with respect to a U.S. shareholder, as “a domestic partnership that is controlled by the [U.S.] shareholder and persons related to the [U.S.] shareholder.” Prop. Reg. § 1.965-1(e)(2). For this purpose, “control is determined based on all the facts and circumstances, except that a partnership will be deemed to be controlled by a United States shareholder and related persons if those persons, in the aggregate, own (directly or indirectly through one or more partnerships) more than 50 percent of the interests in the partnership capital or profits.” *Id.*

⁸ A foreign pass-through entity is a foreign partnership or foreign estate or trust. Prop. Reg. § 1.965-2(i).

⁹ The “section 958(a) U.S. shareholder” is the U.S. person who owns the requisite amount of voting stock directly or indirectly, as described in section 958(a). I.R.C. § 958(a).

defined in Proposed Regulation section 1.965-1(f)(45) (an “SFC”),¹⁰ under the rules of section 961(b)(1) in the same manner as if the section 958(a) stock¹¹ or applicable property¹² were owned directly by the section 958(a) U.S. shareholder.

4. Clarify that a CDP that is treated as a foreign partnership for purposes of the Regulations under section 965 is treated as foreign passthrough entity for purposes of the specified basis adjustment rules under Proposed Regulation section 1.965-2(h)(5)(ii).
5. For purposes of section 958(b), apply the de minimis exception to the downward attribution rule using a threshold of less-than-five-percent of the interests in a partnership’s capital and profits for general partners, partners active in the management of the partnership, or partners with certain information rights, and a threshold of less-than-fifteen-percent of such interests for all other partners.
6. Provide guidance to take into account an SFC’s share of the cash position of a partnership in which the SFC is partner.
7. Coordinate the Questions and Answers about Reporting Related to Section 965 on 2017 Tax Returns available on the Service’s website, as well as Publication 5259, with the final Regulations.
8. Clarify whether an acceleration event in which a resident alien becomes a non-resident alien results in the potential for a permanent deferral of the non-resident’s section 1411 tax liability for section 965 income.
9. Allow changes in method of accounting from fiscal year-end SFCs to calendar year-end SFCs.
10. Permit individual U.S. shareholders the ability to revoke a section 962 election that was made after the passage of the Act and before the issuance of the Proposed Regulations.

B. Comments Regarding Deficits, Basis Adjustments, and Gain Reduction Rule

We respectfully recommend that Treasury and the Service consider issuing the following guidance with regard to deficits, basis adjustments and the gain reduction rule:

1. We recommend that it would be appropriate to reconsider the position in Proposed Regulation section 1.965-1(f)(22) that a deficit in post-1986 earnings

¹⁰ An SFC is defined as any controlled foreign corporation within the meaning of section 957 (“CFC”) and any foreign corporation with respect to which one or more domestic corporations is a U.S. shareholder. I.R.C. § 965(e)(1).

¹¹ Section 958(a) stock is, generally, stock of a foreign corporation owned (directly or indirectly) by a U.S. shareholder within the meaning of section 958(a). Prop. Reg. § 1.965-1(f)(32).

¹² The term “applicable property” means, with respect to a section 958(a) U.S. shareholder and an SFC, property owned by the section 958(a) U.S. shareholder by reason of which the section 958(a) U.S. shareholder is considered under section 958(a)(2) as owning section 958(a) stock of the SFC. Prop. Reg. § 1.965-2(i)(1). A section 958(a) U.S. shareholder is a U.S. person who holds the requisite 10% or more of the stock of the foreign corporation directly, or indirectly, as prescribed in section 958(a)

- and profit (“E&P”) exists only if the deficit exceeds the aggregate of an SFC’s post-1986 E&P treated as previously taxed income (“PTI”) described in section 959(c)(1) and (c)(2). We recognize, however, that Treasury and the Service may believe that adopting such a position requires a legislative change. In that case we recommend that the issue be addressed in the preamble to the final regulations.
2. We recommend that the final regulations not apply the downward basis adjustment rule of section 961(b) to a U.S. shareholder’s aggregate foreign E&P deficit allocated to a deferred foreign income corporation (“DFIC”)¹³ under section 965(b)(2) (“section 965(b) PTI”) and that the final regulations not require a section 961(b) downward basis adjustment for distributions of section 965(b) PTI.
 3. We recommend that the final regulations adopt a special ordering rule that would apply the gain reduction rule first to PTI that is available as a result of an inclusion under section 956(a) (“section 965(a) PTI”) and then to section 965(b) PTI only after all section 965(a) PTI has been distributed.

C. Comments Regarding Foreign Tax Credits

We respectfully recommend that Treasury and the Service issue the following guidance with regard to foreign tax credits in relation to section 965:

1. In the final regulations, clarify the rule in Proposed Regulation section 1.965-1(f)(29)(ii) by providing a method pursuant to which a U.S. shareholder of an SFC can allocate foreign tax credits to the taxable year of the SFC ending before December 31, 2017. This could include referencing estimated tax payments actually made by such SFC or by applying a ratio, in which the portion of foreign tax credits deemed paid by such SFC would equal the portion of current-year E&P accrued by such SFC as of November 2, 2017 over the end of year E&P of such SFC.
2. In the final regulations, eliminate the restriction set forth in Proposed Regulation section 1.965-5(b) and permit a credit for the full amount of withholding taxes actually incurred on a distribution of previously taxed income from the SFC, rather than merely the “applicable percentage” of such taxes.
3. Unify the calculation and reporting of foreign tax credits on IRS Form 1118 such that taxpayers can streamline reporting of such amounts and have a single reference point for utilizing foreign tax credits in future years.
4. Clarify that references in Proposed Regulation section 1.965-5(c)(1)(ii) to “upper-tier foreign corporation,” “distribution,” and “lower-tier foreign corporation” are to principles of foreign law and not U.S. tax classification such that foreign taxes imposed in respect of a distribution from a lower-tier partnership or lower-tier disregarded entity are eligible for a foreign tax credit under section 960(a)(3).

¹³ A DFIC is defined as any specified foreign corporation of a U.S. shareholder which has accumulated post-1986 deferred foreign income greater than zero. I.R.C. § 965(d)(1).

5. We recommend that the final regulations permit access to foreign income taxes related to a hovering deficit through either (i) increasing the post-1986 foreign income taxes of the DFICs to which the associated hovering deficit is allocated under section 965(b), or (ii) increasing the post-1986 foreign income taxes of the E&P deficit foreign corporation to which the hovering deficit relates for the inclusion year. We recognize this would require reconsidering the position taken in the Proposed Regulations, but for the reasons set forth below, we believe it is the better approach.

II. Detailed Discussion

A. Background

1. The 2017 Tax Act and Subpart F Generally

Prior to the enactment of the Act on December 22, 2017, the United States had what is generally referred to as a worldwide system of taxation. Ultimately, income earned in the United States or by foreign subsidiaries was expected to be subject to U.S. taxation. Under this system, however, a U.S. person that held stock in a foreign corporation could defer the inclusion in its U.S. taxable income of the earnings of the foreign subsidiary until the income was repatriated or required to be included under an anti-deferral rule, the most relevant of which for purposes of these comments is subpart F, which was enacted in 1962.¹⁴

Under section 951(a)(1)(a), a U.S. shareholder with respect to a CFC is required to include in its gross income its pro rata share of a CFC's foreign personal holding company income (e.g., dividends, interest, royalties, and gain from sales of property that produce such passive income), and foreign base company sales and services income,¹⁵ on a current basis (i.e., in the U.S. shareholder's taxable year in or with which the taxable year of the CFC ends).¹⁶ In addition, section 951(a)(1)(b) requires an inclusion of the earnings of the CFC that are invested in "United States property."

The Act introduced perhaps the most significant changes to U.S. corporate and international taxation since subpart F was enacted in 1962. The rules of subpart F are retained, but the Act adds an additional anti-deferral regime known as GILTI¹⁷ and, importantly, it provides that if the specified 10-percent owned foreign corporation¹⁸ has earnings that have not been included in the income of a U.S. shareholder under subpart F or GILTI, a domestic C corporation that is a U.S. shareholder of a the specified 10-percent owned foreign corporation is entitled to a 100% dividends received deduction for the "foreign sourced portion," within the meaning of section 245A(c), of dividends received from the specified 10-percent owned foreign corporation provided certain other requirements are met.¹⁹

¹⁴ Subpart F is sections 951-959 of the Code.

¹⁵ See I.R.C. § 952.

¹⁶ I.R.C. § 951(a). During 2017, a foreign corporation was a CFC if U.S. shareholders own more than 50 percent of the total combined voting power of the foreign corporation's stock, or stock representing more than 50 percent of the total value of the corporation, on any day during the foreign corporation's taxable year, so long as such ownership existed for 30 days. I.R.C. § 957(a). As noted above, a U.S. shareholder's stock ownership for purposes of determining CFC status may be either direct or indirect under section 958(a), or constructive under section 958(b).

¹⁷ I.R.C. § 951(a).

¹⁸ I.R.C. § 957(a).

¹⁹ The U.S. C corporation shareholder must hold the stock of the specified 10-percent owned foreign corporation for 365 days or more during the 731-day period beginning on the date that is 365 days before the ex-dividend date. I.R.C. § 246(c)(5)(A). The foreign corporation must maintain its status as a specified 10-percent owned foreign corporation, and the domestic corporation must qualify as the foreign corporation's U.S. shareholder, during the 731-day period. I.R.C. § 246(c)(5)(B). The dividend paid by the specified 10-

Section 245A applies to distributions made after December 31, 2017. As a transition to the revised tax system, the Act requires U.S. shareholders to take into account as subpart F income the deferred earnings of CFCs. This transition rule, also known as mandatory repatriation, is codified in section 965, discussed below.

Notably, section 245A does not benefit any U.S. shareholders other than U.S. C corporations, but all U.S. shareholders are subject to the application of section 965. As such, while C corporation U.S. shareholders transition to a quasi-territorial tax regime starting in the 2018 tax year, individual U.S. shareholders have the burden of the inclusion under section 965, without the future benefit of the section 245A deduction.

2. Section 965 Generally

Section 965 was originally enacted as part of the American Jobs Creation Act of 2004. A temporary provision for years 2004 and 2005, section 965 provided an election by a U.S. shareholder to take an 85% dividend received deduction for cash dividends received from its CFCs. The 85% dividends received deduction generally reduced the U.S. shareholder's effective tax rate to five and a quarter percent.

As amended by the Act, section 965 provides the following rules to determine the amount a U.S. shareholder of a DFIC must include as income (such income inclusion, the "section 965 inclusion").

a) Inclusion

Section 965(a) provides that, in the case of the last taxable year of a DFIC within the meaning of section 965(d)(1) that begins before January 1, 2018, the subpart F income of such corporation as otherwise determined under section 952 for such taxable year will be increased by the greater of the following:

- (i) The accumulated post-1986 deferred foreign income of such corporation as of November 2, 2017; or
- (ii) The accumulated post-1986 deferred foreign income of such corporation as of December 31, 2017 (such dates, the "Measurement Dates," and the greater of the amounts described in clauses (i) and (ii), the "section 965(a) earnings amount").²⁰

Regarding any U.S. shareholder, a DFIC is defined by section 965(d)(1) as any SFC²¹ within the meaning of section 965(e) of such U.S. shareholder that has positive accumulated post-1986 deferred foreign income as of the Measurement Dates. Section 965(d)(2) defines accumulated post-1986 deferred foreign income as post-1986 earnings and profits, except to the extent that earnings and profits are attributable to income of the

percent owned foreign corporation must also not be a "hybrid dividend" within the meaning of section 245A(e).

²⁰ See also Prop. Reg. § 1.965-1(f)(36) (defining the term "section 965(a) earnings amount").

²¹ As noted earlier, section 965(e) defines an SFC as any CFC as well as any foreign corporation with respect to which one or more domestic corporations is a U.S. shareholder. Section 965(e)(3) provides that an SFC does not include a passive foreign investment company within the meaning of section 1297 which is not also a CFC with respect to the U.S. shareholder.

SFC that is effectively connected with the conduct of a U.S. trade or business or, in the case of a CFC, would be excludable as PTI of a U.S. shareholder under section 959. Section 965(d)(2) thus serves to prevent earnings that have already been subject to U.S. taxation from being included again in U.S. taxable income. Section 965(d)(3) defines post-1986 E&P as an SFC's earnings and profits ("E&P") as described in sections 964(a) and 986 that was accumulated in taxable years beginning after December 31, 1986, and determined as of the applicable Measurement Date, without reduction for any dividends during the last taxable year that begins before January 1, 2018, unless those dividends were distributed to another SFC. Furthermore, section 965(d)(3) states that post-1986 E&P should only take into account periods the foreign corporation was an SFC. Accordingly, if at some period during the post-1986 life of a foreign corporation, the corporation was not a CFC or did not have a U.S. shareholder, the E&P accumulated during that period should not be subject to the section 965 transition tax.

Section 965(b) provides rules pursuant to which the section 965(a) earnings amount may be reduced by certain deficits in E&P in related CFCs, resulting in the amount to be included under section 965(a) (the "section 965(a) inclusion amount"). Specifically, section 965(b)(1) states that, in the case of a taxpayer that is a U.S. shareholder with respect to at least one DFIC and at least one E&P deficit corporation, the amount of such inclusion will be reduced by the amount of the U.S. shareholder's aggregate foreign E&P deficit that is allocable to that DFIC.

Section 965(b)(3)(A) defines an aggregate foreign E&P deficit with respect to any U.S. shareholder as the lesser of the following:

- (i) The aggregate of the U.S. shareholder's pro rata shares of the specified E&P deficits of the E&P deficit foreign corporations of such shareholder; or
- (ii) The aggregate of the U.S. shareholder's pro rata shares of the accumulated post-1986 deferred foreign income of all DFICs of such shareholder.

Section 965(b)(4) provides for adjustments to the E&P of a DFIC and an E&P deficit foreign corporation to account for the allocation of deficits under section 965(b)(1). In the case of a DFIC, for purposes of applying section 959, section 965(b)(4)(A) increases the DFIC's E&P for purposes of calculating its PTI in an amount equal to the U.S. shareholder's section 965(b) PTI. In the case of an E&P deficit foreign corporation, section 965(b)(4)(B) increases the E&P of such corporation by the amount of its specified E&P deficit taken into account under section 965(b)(1), and, for purposes of section 952, such increase is attributable to the same activity to which the deficit was attributable.

Section 965(f)(1) generally provides that the determination of any U.S. shareholder's pro rata share of any amount with respect to an SFC should be made under rules similar to the rules of section 951(a)(2) by treating the amount in question in the same manner as subpart F income and treating the SFC as a CFC.²² Section 965(f)(2) provides special rules for domestic passthrough entities, which provide that the amount of

²² It is important to note that while the income inclusion occurs as an increase to subpart F income, it is not actually subpart F income. As a result, the subpart F rules do not apply to section 965, except to the extent they are specifically made applicable.

income included by the U.S. shareholder under section 951(a) by reason of section 965(a) that is equal to the section 965(c) deduction amount by reason of the inclusion (such deduction discussed below) is treated as income exempt from tax for purposes of sections 705(A)(1)(B) and 1367(a)(1)(A), but is not treated as income exempt from tax for purposes of determining whether an adjustment is made to an accumulated adjustment account within the meaning of section 1368(e)(1) (“AAA”) of an S corporation.

b) Rate on Inclusion

To the extent that a U.S. shareholder has a section 965 inclusion, the U.S. shareholder is entitled to a deduction in the year of inclusion pursuant to section 965(c). This deduction is the sum of the following:

- (i) The U.S. shareholder’s 8 percent rate equivalent percentage of the excess, if any, of the subpart F inclusion over the amount of the U.S. shareholder’s aggregate foreign cash position;²³ and
- (ii) The U.S. shareholder’s 15.5 percent rate equivalent percentage of the amount of the U.S. shareholder’s aggregate foreign cash position as does not exceed the subpart F inclusion.²⁴

The term “aggregate foreign cash position” for purposes of section 965(c) is defined with respect to any U.S. shareholder as the greater of the following:

- (i) The aggregate of such U.S. shareholder’s pro rata shares of the cash position of each SFC of the U.S. shareholder determined as of the close of the last taxable year of the specified corporation that begins before January 1, 2018; or
- (ii) The average of the aggregate of such U.S. shareholder’s pro rata share of the cash position of each SFC of the U.S. shareholder determined as of the close of the last taxable year of the specified corporation that ends before November 2, 2017, plus the aggregate of such U.S. shareholder’s pro rata share of the cash position of each SFC of the U.S. shareholder determined as of close of the taxable year which precedes that taxable year.²⁵

The cash position of any SFC is the sum of the following:

- (i) The cash held by the SFC;

²³ Section 965(c)(2)(A) defines the 8 percent rate equivalent percentage with respect to any U.S. shareholder for any taxable year as the percentage that would result in the amount to which such percentage applies being subject to an effective 8 percent rate of taxation determined by taking into account a deduction equal to such percentage of such amount and the highest rate of tax specified in section 11 for that taxable year. Furthermore, in the case of any taxable year of a U.S. shareholder to which section 15 applies (i.e., a taxable year which includes the effective date of a change in the rate of taxation, as is the case with the reduction of the corporate tax rate to 21 percent pursuant to § 13001 of the Act), the weighted average of the rates under section 11 should be applied.

²⁴ Section 965(c)(2)(B) defines the 15.5 percent rate equivalent percentage with respect to any U.S. shareholder for any taxable year as the percentage that would have been obtained under section 965(c)(2)(A) had 8 percent been replaced by 15.5 percent.

²⁵ See I.R.C. § 965(c)(3)(A).

- (ii) The net accounts receivable of the SFC, defined as the excess of the SFC's accounts receivable over the SFC's accounts payable as determined consistent with the rules of section 461 regarding the taxable year of deduction; and
- (iii) The fair market value of (i) personal property of a type that is actively traded and for which there is an established financial market, (ii) commercial paper, certificates of deposit, or government securities; (iii) any foreign currency, (iv) any obligation with a term of less than one year, and (v) any asset which the Secretary identifies as being economically equivalent to any of the preceding assets and which is held by the SFC.

In order to prevent double counting, section 965(c)(3)(D) states that the cash position of a given SFC does not have to be taken into account by a U.S. shareholder if that U.S. shareholder can demonstrate that the cash position has already been taken into account by the U.S. shareholder with respect to another SFC.

Further, section 965(c)(3)(E) provides that an entity other than an SFC (e.g., a partnership) will be treated as an SFC for purposes of determining a U.S. shareholder's aggregate foreign cash position if any interest in that entity is held by an SFC of the U.S. shareholder and the entity would qualify as an SFC if the entity existed in corporate form. Thus, such entities net their accounts receivable and accounts payable at the legal entity level and do not net at the CFC level.

c) Foreign Tax Credits

For U.S. shareholders that are C corporations, a credit for foreign taxes deemed paid²⁶ by the SFC would normally have been available when the earnings of the SFC were brought into U.S. income. Under section 965(g)(1), however, no credit is allowed under section 901 for the "applicable percentage" of any taxes paid or accrued (or treated as paid or accrued) with respect to any amount for which a deduction is allowed under section 965. Section 965(g)(2) defines the term "applicable percentage" as the amount (expressed as a percentage) equal to the sum of the following two amounts:

- (i) 0.771 multiplied by the ratio of (A) the section 965(a) inclusion amount in excess of the U.S. shareholder's aggregate foreign cash position, divided by (B) the section 965(a) inclusion amount, and
- (ii) 0.557 multiplied by the ratio of (A) the amount of the section 965(a) inclusion amount equal to the U.S. shareholder's aggregate cash position, divided by (B) the section 965(a) inclusion amount.

Section 965(g)(3) further disallows any deduction for any taxes for which credit is not allowed under section 901 by reason of section 965(g)(1) (determined by treating the taxpayer as having elected the benefits of subpart A of part III of subchapter N). Section 965(g)(4) provides a coordination rule with section 78. Under this coordination rule, section 78 shall apply only to so much of taxes paid or accrued by reason of the section 965(a) inclusion to the extent such taxes bear the same proportion to the amount of taxes as:

²⁶ Pursuant to section 902 as it existed prior to the Act.

- (i) the excess of (A) the section 965(a) inclusion amount, over (B) the section 965(c) deduction with respect to such amount, bears to
- (ii) the section 965(a) inclusion amount.²⁷

d) Tax Liability Payment

Pursuant to section 965(h), if a U.S. shareholder elects no later than the due date of the tax return for the taxable year described in section 965(a) (i.e., the last taxable year that begins before January 1, 2018), the section 965 net tax liability may be paid in eight installments as follows:

- (i) 8 percent of the net tax liability in the case of the first five installments (i.e., 40% in total);
- (ii) 15 percent of the net tax liability in the case of the sixth installment;
- (iii) 20 percent of the net tax liability in the case of the seventh installment; and
- (iv) 25 percent of the net tax liability in the case of the eighth installment.²⁸

For purposes of these installment payments, the section 965 net tax liability is the following:

- (i) The U.S. shareholder's net income tax (defined as the regular tax liability reduced by credits allowed under subparts A, B, and D of Part IV of subchapter A) for the taxable year in which an amount is included under section 951(a)(1) by reason of section 965; less
- (ii) The U.S. shareholder's net income tax for such taxable year determined without regard to section 965 and without regard to any income or deduction properly attributable to a dividend received by such U.S. shareholder from any DFIC.²⁹

The first installment must be paid on the due date of the tax return for the taxable year described in section 965(a), determined without regard to any extension of time for filing, and each succeeding installment must be paid on the due date of the tax return for the taxable year following the taxable year for which the preceding installment was made.³⁰ Section 965(h) also provides for the acceleration of the required payments upon the occurrence of certain events, including an addition to tax for failure to timely pay an installment, as well as the proration of any assessed deficiencies in the net tax liability among installments payable.³¹

²⁷ I.R.C. § 965(g)(4).

²⁸ I.R.C. § 965(h)(1).

²⁹ I.R.C. § 965(h)(6).

³⁰ I.R.C. § 965(h)(2).

³¹ I.R.C. § 965(h)(3)-(4).

e) Recapture for Expatriated Entities

Section 965(l) provides special rules for “expatriated entities” within the meaning of section 7874(a)(2) and the regulations thereunder.³² Specifically, if a deduction under section 965(c) is allowed to a U.S. shareholder and such U.S. shareholder first becomes an expatriated entity during the ten year period beginning on the date of the enactment of the Act (i.e., December 22, 2017), then the tax imposed under section 965 shall be increased for the first taxable year in which such U.S. shareholder became an expatriated entity by an amount equal to 35% of the deduction allowed under section 965(c), and no credits shall be allowed against such increase in tax.³³

f) Election Not to Apply NOL Deduction

Section 965(n)(1) allows a U.S. shareholder of a DFIC to make an election to not take into account the “amount described in section 965(n)(2)” for purposes of (i) determining the amount of the U.S. shareholder’s net operating loss deduction within the meaning of section 172 (“NOL”) for the taxable year, or (ii) determining the amount of taxable income for the taxable year which may be reduced by NOL carryovers or carrybacks to the taxable year under section 172.

The amount described in section 965(n)(2) is the sum of (i) the amount required to be taken into account under section 951(a) by reason of section 965(a) (taking into account deductions under section 965(c)), plus (ii) in the case of a domestic corporation that elects to take a foreign tax credit under section 901, the taxes deemed paid by the corporation under section 960(a) and (b) for the taxable year with respect to the amount described in section 965(n)(2)(A) which are treated as a dividend under section 78.³⁴

The U.S. shareholder must make the election no later than the due date (including extensions) for filing the return of tax for the taxable year and must be made in such manner as the Secretary provides.³⁵

3. Sections 959, 961, and 962

a) Section 959

Section 959 provides rules to ensure that earnings of a CFC that have been previously taxed under section 951(a) (i.e., subpart F income or investments in U.S. property) to a U.S. shareholder (such earnings commonly referred to as PTI) are not taxed a second time when that PTI is actually distributed to the applicable U.S. shareholder.³⁶ Further, section 959 incorporates a “successor in interest” concept whereby PTI is not taxed a second time when distributed to any other U.S. person who acquired shares from

³² An expatriated entity does not include a surrogate foreign corporation within the meaning of section 7874(a)(2)(B) if such entity is treated as a domestic corporation under section 7874(b).

³³ I.R.C. § 965(l)(1).

³⁴ I.R.C. § 965(n)(2).

³⁵ I.R.C. § 965(n)(3).

³⁶ S. Rep. No. 87-1881, at 256-59 (1962); H.R. Rep. No. 87-1447, A101-03 (1962).

such a U.S. shareholder.³⁷ Thus, under section 959(a)(1), PTI is not included in the gross income of a U.S. shareholder when such amounts are actually distributed to that U.S. shareholder (or a successor in interest).³⁸ To accomplish this result, section 959(c) provides ordering rules that modify the application of section 316 with respect to a distribution from a CFC. In particular, section 959(c) provides that every dividend defined in section 316 is sourced first from PTI E&P and then, to the extent necessary, from non-PTI E&P.³⁹ To the extent that a distribution is excluded from gross income under section 959(a), that distribution is not treated as a dividend, though it does reduce E&P.⁴⁰ In applying section 316, as modified by section 959, PTI is deemed distributed on a last-in, first-out basis.⁴¹

Section 959(c) applies the ordering rules “to the earnings and profits attributable to amounts included in gross income under section 951(a)(1)(A)” and does not specify that such earnings must have been included with respect to those shares upon which the distribution or redemption is made. Similarly, the applicable regulations state “none of the amounts so taxed [i.e., amounts included pursuant to subpart F,] are taxed again when actually distributed directly, or indirectly through a chain of ownership described in 958(a), to U.S. shareholders or to such shareholders’ successors in interest.”⁴²

b) Section 961

Section 961(a) provides that a U.S. shareholder shall increase its adjusted basis in property that it owns directly and through which it indirectly owns a CFC by an amount that is required to be included in gross income under 951(a) with respect to such CFC, but only to the extent such amount was included in the gross income of the U.S. shareholder. An increase in basis in a CFC held directly by the U.S. shareholder is made with respect to each share of stock.⁴³

Conversely, section 961(b) provides that a U.S. shareholder shall reduce its adjusted basis in shares or other property with respect to which it receives an amount which is excluded from gross income under section 959. Further, to the extent an amount received under section 959 exceeds the adjusted basis of the stock on which it is received,

³⁷ I.R.C. § 959(a). Regulations require a successor-in-interest be able to prove of the identity of the interest so acquired. *See* Reg. § 1.959-1(d).

³⁸ In addition, section 959(b) provides that amounts treated as PTI will not, when distributed through a chain of ownership described in section 958(a), be included in the gross income of another CFC in such chain for purposes of applying section 951(a) to such other CFC.

³⁹ Section 959(c) provides that, for purposes of applying section 959(a), section 316(a)(2) (i.e., current year E&P) is applied to the extent thereof, and then to section 316(a)(1) (i.e., accumulated E&P) as follows: (1) first to E&P attributable to previously taxed U.S. property investments, (2) then to E&P attributable to previously taxed subpart F income, and (3) then to all other E&P (i.e., non-PTI E&P). *See* also Reg. § 1.959-3(b). A CFC’s distribution, once allocated to a particular section 959(c) category, is further allocated within such category on a LIFO basis. I.R.C. § 959(c); Reg. § 1.959-3(b).

⁴⁰ I.R.C. § 959(d).

⁴¹ I.R.C. § 316(a).

⁴² Reg. § 1.959-1(a).

⁴³ Reg. § 1.961-1(b)(2).

the U.S. shareholder shall recognize gain from the sale or exchange of property pursuant to section 961(b). Treasury regulations provide that the adjustment shall be made on a share-by-share basis and that to the extent the amount of the reduction exceeds the adjusted basis, the shareholder shall recognize gain from the sale or exchange of property.⁴⁴

c) Section 962

Section 962, as amended by the Act, provides that an individual that is a U.S. shareholder may elect to be taxed as a domestic corporation on the amounts included in income under section 951(a).⁴⁵ Treasury regulations provide that, if an election is made under section 962, amounts included in gross income under section 951(a) by the individual are treated as if they were received by a domestic corporation for purposes of section 960.⁴⁶ Treasury regulations, however, also provide that taxable income determined for purposes of applying section 11 (i.e., taxes imposed on corporations) is not reduced by any deduction of the U.S. shareholder.⁴⁷

**4. Administrative Guidance Related to Section 965 Issued
Between the Act and the Issuance of the Proposed Regulations**

a) Notices and Revenue Procedures

(1) Notice 2018-07

Treasury and the Service issued the first piece of section 965 guidance in Notice 2018-07.⁴⁸ Notice 2018-07 addresses initial questions with respect to computing aggregate foreign cash positions of U.S. shareholders and post-1986 E&P, as well as application of section 961, treatment of affiliated groups and foreign currency gain or loss.

(a) Aggregate Foreign Cash Position

**(i) Allocation Between Multiple
Inclusion Years**

Notice 2018-07 addresses concerns of U.S. shareholders that own SFCs with multiple inclusion years. In such a situation, double-counting of a U.S. shareholder's aggregate foreign cash position can result because the same cash assets may be accounted for in more than one taxable year. Notice 2018-07 indicates that Treasury and the Service intend to issue regulations providing that where a U.S. shareholder has an inclusion in multiple taxable years, the aggregate foreign cash position taken into account

⁴⁴ Reg. § 1.961-2(b), (c).

⁴⁵ I.R.C. § 962(a). An election under section 962 applies only for purposes of chapter 1 of the Code.

⁴⁶ Reg. § 1.962-1(a).

⁴⁷ Reg. § 1.962-1(b)(1)(i).

⁴⁸ Notice 2018-7, 2018-4 I.R.B. 317.

in the first taxable year will equal the lesser of: (a) a U.S. shareholder's aggregate foreign cash position, or (b) the aggregate section 965(a) inclusion amount for that taxable year.⁴⁹ Aggregate foreign cash positions in succeeding years will be reduced by the aggregate foreign cash position taken into account in any preceding taxable year.⁵⁰

Similarly, if a U.S. shareholder has multiple inclusion years, the cash measurement date for an SFC may be after the U.S. shareholder's return date for an inclusion year. For example, a U.S. shareholder may have an inclusion for the calendar year 2017, but may also own an SFC with a November 30, 2018, cash measurement date. Accordingly, a U.S. shareholder may not be able to determine its cash position for the first taxable year in which the shareholder has a section 965(a) inclusion. Notice 2018-07 provides that a U.S. shareholder can assume that its pro rata share of the cash position of an SFC with an inclusion year ending after the due date for the U.S. shareholder's return for such taxable year will be zero as of the cash measurement date with which the inclusion year ends.⁵¹ Since the cash position may change, adjustments to the section 965(c) deduction will be required where the aggregate cash position amount described in section 965(c)(3)(A)(i) is in fact greater than the aggregate cash position amount described in section 965(c)(3)(A)(ii).⁵²

(ii) Treatment of Related-Party Transactions

Without further exemption, intercompany net accounts receivable and short-term obligations may increase the cash position of the U.S. shareholder even where the proceeds are used for non-cash assets or operating expenses. Notice 2018-07 indicates that Treasury and the Service intend to issue regulations providing that any receivable from or payable to related SFCs will be disregarded to the extent of common ownership by the U.S. shareholder. The section 954(d)(3) definition of related party will be used for purposes of determining common ownership.⁵³

(iii) Treatment of Derivative Financial Instruments and Hedging Transactions

Notice 2018-07 indicates the intent of Treasury and the Service to issue regulations addressing the treatment of derivative financial instruments, including options contracts, notional principal contracts, futures contracts, forward contracts, short positions in securities and commodities and similar financial instruments.⁵⁴ The cash position of an SFC will include the fair market value of each such instrument where it is not considered a "bona fide hedging transaction." The value of any particular derivative

⁴⁹ Notice 2018-7, § 3.01(a).

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *Id.*

⁵³ Notice 2018-7, § 3.01(b).

⁵⁴ Notice 2018-7, § 3.01(c).

financial instrument taken into account may be positive or negative, but the aggregate amount taken into account for all such instruments may not be less than zero. Instruments between related parties will be disregarded pursuant to the rules governing the treatment of related party transactions.

A bona fide hedging transaction is defined pursuant to Regulation section 1.954-2(a)(4)(ii).⁵⁵ If a derivative financial instrument is a bona fide hedging transaction and is used to hedge a cash-equivalent asset, the value of the asset being hedged must be adjusted by the fair market value of the bona fide hedging transaction.⁵⁶ Positive and negative values are taken into account, but only to the extent that the cash-equivalent asset hedging transaction does not reduce the value of the hedged asset below zero. A bona fide hedging transaction used to hedge an asset that is not a cash-equivalent asset or a liability is not included in the cash position of an SFC.

(b) Accumulated Post-1986 E&P

**(i) Adjustments for Payments
Between Measurement Dates**

Congress intended for Treasury and the Service to issue regulations addressing potential double-counting for amounts paid between related SFCs between Measurement Dates.⁵⁷ For example, deductible payments and dividend payments made between Measurement Dates can inflate the accumulated post-1986 deferred foreign income taken into account because the accumulated post-1986 E&P of the SFC included in the section 965(a) inclusion amount is the greater amount as of the two Measurement Dates. Notice 2018-07 states the intent of Treasury and the Service to issue regulations making adjustments to the E&P of the recipient and payor SFCs for payments made between measurement dates between related (but not unrelated) SFCs.⁵⁸

**(ii) Diminution of E&P by
Distributions**

To prevent double-counting of earnings, section 965(d)(3)(B) provides that the post-1986 E&P of an SFC are reduced for dividends distributed to another SFC during the inclusion year.

Notice 2018-07 indicates the intent of Treasury and the Service to issue regulations clarifying that the amount by which an SFC's post-1986 E&P is reduced is limited to the amount by which the post-1986 E&P of the recipient SFC is increased because of the distribution.⁵⁹

⁵⁵ Notice 2018-07 indicates the intent of Treasury and the Service to expand the identification requirements of Regulation section 1.954-2(a)(4)(ii) to SFCs which are not CFCs.

⁵⁶ Notice 2018-7, § 3.01(c).

⁵⁷ Notice 2018-7, § 3.02(a).

⁵⁸ *Id.*

⁵⁹ Notice 2018-7, § 3.02(b).

(iii) Adjustments for E&P for Non-U.S. Shareholders

Notice 2018-07 indicates the intent of Treasury and the Service to issue regulations providing that the accumulated post-1986 deferred foreign income of a CFC with non-U.S. shareholders will be reduced for PTI under section 965(d)(2)(B) as if the non-U.S. shareholders were U.S. shareholders. The principles of Rev. Rul. 82-16, 1982-1 C.B. 106 will be applied.⁶⁰

(iv) Coordination between Sections 959 and 965 in the Inclusion Year

Notice 2018-07 indicates the intent of Treasury and the Service to issue regulations describing the following ordering rules for determining the amount of income inclusion under sections 951, 956 and 965 and distributions under section 959.

- (i) The subpart F income of a DFIC and the U.S. shareholder's inclusion under section 951(a)(1)(A) is calculated without regard to section 965.
- (ii) The treatment of distributions made before January 1, 2018 by the DFIC to another SFC is calculated under section 959.
- (iii) The section 965(a) inclusion amount of the DFIC and the U.S. shareholder's inclusion is determined.
- (iv) The treatment of all distributions from the DFIC other than those described in step two are determined under section 959.
- (v) The amount under section 956 for the DFIC and the U.S. shareholder's inclusion under section 951(a)(1)(B) is determined.⁶¹

(c) Application of Section 961

Pursuant to authority under section 965(o), Notice 2018-07 indicates the intent of Treasury and the Service to issue regulations providing appropriate basis adjustments to reflect the impact of section 965. Specifically, Treasury and the Service intended to issue regulations providing for the reduction of section 961(b)(2) gain in the case of distributions from income that is described in section 959(c)(2) because of section 965(a).⁶²

(d) Treatment of Affiliated Groups

Notice 2018-07 indicates the intent of Treasury and the Service to issue regulations providing that, for the purpose of calculating a section 965(a) inclusion for a consolidated group, all of the members of the consolidated group that are U.S. shareholders of SFCs will be considered a single U.S. shareholder. Regulations will also

⁶⁰ Notice 2018-7, § 3.02(c).

⁶¹ Notice 2018-7, § 3.02(d).

⁶² Notice 2018-7, § 3.03.

provide for appropriate adjustments to basis, the consolidated group impact of attributes such as ownership of E&P deficit corporations and cash positions of SFCs, and non-consolidated member minority ownership interests.⁶³

(e) Foreign Currency Gain or Loss

Notice 2018-07 indicates the intent of Treasury and the Service to issue regulations providing that any gain or loss recognized pursuant to section 986(c) as a result of distributions of income previously taxed under section 965(a) is reduced proportionately by reason of the section 965(c) deduction.⁶⁴

(2) Notice 2018-13

The second Notice published by Treasury and the Service with respect to section 965 is Notice 2018-13.⁶⁵ Notice 2018-13 addresses additional section 965 computational questions.

(a) Determination of SFC as a DFIC or E&P Deficit Foreign Corporation

Notice 2018-13 indicates the intent of Treasury and the Service to issue regulations providing that in determining whether an SFC is a DFIC or an E&P deficit foreign corporation, it must first be determined whether the SFC is a DFIC.⁶⁶ If it meets the definition of a DFIC, it is treated only as a DFIC and not also as an E&P deficit foreign corporation. However, if the SFC is not a DFIC, it must be determined whether it is an E&P deficit foreign corporation.

A company may be classified as neither a DFIC nor an E&P deficit corporation. Notice 2018-13 includes an example in which a foreign corporation has 100u of section 959(c)(2) PTI and a deficit of 90u of section 959(c)(3) income as of November 2, 2017 and December 31, 2017. The foreign company is neither a DFIC nor an E&P deficit corporation. Under section 965(d)(2)(B), the foreign corporation's accumulated post-1986 deferred income does not include PTI. Disregarding the foreign corporation's PTI, the foreign corporation has a deficit in accumulated post-1986 deferred foreign income. Therefore, the foreign corporation is not a DFIC. It is not, however, an E&P deficit corporation because it has 10u of post-1986 accumulated E&P as of November 2, 2017.⁶⁷

⁶³ Notice 2018-7, § 3.04.

⁶⁴ Notice 2018-7, § 3.05.

⁶⁵ Notice 2018-13, 2018-6 I.R.B. 341.

⁶⁶ Notice 2018-13, 2018-6 I.R.B. 341, § 3.01.

⁶⁷ Notice 2018-13, § 3.01.

(b) Alternative Method for Calculating Post-1986 E&P

Treasury and the Service recognized the practical difficulties of determining the post-1986 E&P and specified E&P deficit of an SFC as of November 2, 2017, a Measurement Date that does not fall on the last day of a month. In response, Notice 2018-13 indicates the intent of Treasury and the Service to issue regulations, forms, publications and other guidance providing that an election can be made to use an alternative method for the calculation of post-1986 E&P (including a deficit).⁶⁸

Under the alternative method, an SFC's post-1986 E&P as of November 2, 2017 will equal the sum of:

- (i) the corporation's post-1986 E&P as of October 31, 2017; and
- (ii) the corporation's annualized E&P amount.

The annualized E&P amount is the product of two multiplied by the corporation's daily earnings amount. The daily earnings amount is the corporation's post-1986 E&P earned in the year which includes October 31, 2017 and as of the close of October 31, 2017, divided by the number of days that have elapsed in the taxable year as of October 31, 2017. Special rules are provided for SFCs with taxable years of 52 or 53 weeks.⁶⁹

(c) Treatment of Deficits

(i) Allocation of Deficits to Different Class of Stock

Notice 2018-13 indicates the intent of Treasury and the Service to issue regulations providing that where an SFC with multiple classes of stock outstanding has a specified E&P deficit, the deficit will be allocated first among common stock shareholders in proportion to the value of the common stock they own.⁷⁰

(ii) Treatment of Hovering Deficits

Following Congressional intent stated in the Conference Report, Notice 2018-13 indicates the intent of Treasury and the Service to issue regulations that all deficits, including hovering deficits,⁷¹ should be taken into account in determining post-1986 E&P, including deficits, of SFCs.⁷²

⁶⁸ Notice 2018-13, § 3.02.

⁶⁹ *Id.*

⁷⁰ Notice 2018-13, § 3.03(a).

⁷¹ A hovering deficit exists “[i]f immediately prior to the foreign section 381 transaction either the foreign acquiring corporation or the foreign target corporation has a deficit in one or more separate categories of post-1986 undistributed earnings or an aggregate deficit in pre-1987 accumulated profits.” Reg. § 1.367(b)-7(d)(2)(i).

⁷² Notice 2018-13, § 3.03(b).

(d) Determination of Aggregate Foreign Cash Position

(i) Definitions for Determining Net Accounts Receivable

Notice 2018-13 indicates the intent of Treasury and the Service to issue regulations stating that, for purposes of the definition of net accounts receivable under section 965(c)(3)(C), accounts receivable will mean receivables as defined in section 1221(a)(4). Accounts payable will mean payables arising from the procurement of property described in section 1221(a) or section 1221(a)(8) or services from vendors or suppliers. To prevent double-counting, such receivables should not also be treated as short-term obligations.⁷³

(ii) Treatment of Demand Obligations

Notice 2018-13 indicates the intent of Treasury and the Service to issue regulations providing that a loan that must be paid on demand of the lender or within a year of the demand will be treated as a short-term obligation, regardless of the loan's stated term.⁷⁴

(e) Translation Rules

(i) Comparison of Accumulated Post-1986 Deferred Foreign Income as of the Measurement Dates

Notice 2018-13 indicates the intent of Treasury and the Service to issue regulations providing that the accumulated post-1986 deferred foreign income of an SFC must be compared in functional currency as of the Measurement Dates.⁷⁵ Per Notice 2018-13, this follows the general principle that E&P of a foreign corporation is determined in the functional currency of the foreign corporation.⁷⁶ However, if the functional currency of an SFC changes between Measurement Dates, the analysis is made by comparing the E&P in the functional currency of the corporation as of December 31, 2017, with the E&P of the corporation as of November 2, 2017, translated into the new functional currency using the November 2, 2017, spot rate.

⁷³ Notice 2018-13, § 3.04(a).

⁷⁴ Notice 2018-13, § 3.04(b).

⁷⁵ Notice 2018-13, § 3.05(a).

⁷⁶ *See*, I.R.C. § 986(b)(1).

**(ii) Determination of the Amount of
Section 965 Inclusion under Section
951(a)(1)**

Notice 2018-13 indicates the intent of Treasury and the Service to issue regulations providing that the appropriate exchange rate for translating section 965(a) amounts will be the December 31, 2017, spot rate.⁷⁷ Notice 2018-13 states that December 31, 2017 is the appropriate exchange rate because that is both the day on which the post-1986 E&P becomes fixed and is immediately before the transition to the section 245A participation exemption regime. In addition, Notice 2018-13 indicates that a single spot rate is more administrable for the Service. It is also less burdensome for taxpayers as compared to the yearly average approach under section 989(b)(3). In some cases, amounts may not be determinable until the last closing of an inclusion year of an SFC.

The December 31, 2017 spot rate will also apply for the translation of other amounts necessary to apply section 965(b). For purposes of section 986(c), foreign currency gain or loss for distributions of PTI created under section 965 will be determined based on the movements in the exchange rate between December 31, 2017, and the date on which previously taxed earnings are actually distributed.⁷⁸

**(iii) Determination of Cash Positions as
of Cash Measurement Dates**

Notice 2018-13 indicates the intent of Treasury and the Service to issue regulations providing that the aggregate foreign cash position of an SFC on each cash measurement date must be compared in U.S. dollars.⁷⁹

For this purpose, accounts receivable and payable, as well as section 965(c)(3)(B)(iii) assets, must be translated at the spot rate on the applicable Measurement Date.⁸⁰

**(f) Modification of Rules Related to
Distributions Described in Notice 2018-07**

Notice 2018-13 indicates the intent of Treasury and the Service to expand the section 961(b)(2) reduction rule of Notice 2018-07⁸¹ and issue regulations providing that the rule also applies to distributions made through a chain of ownership and received

⁷⁷ Notice 2018-13, § 3.05(b).

⁷⁸ *Id.*

⁷⁹ Notice 2018-13, § 3.05(c).

⁸⁰ *Id.*

⁸¹ *See supra* note 72 and accompanying text.

from a DFIC.⁸² The concern was that Notice 2018-07 does not expressly apply to distributions made to a U.S. shareholder by a foreign corporation that is *not* a DFIC where such foreign corporation has received distributions from a DFIC attributable to PTI created under section 965. Even where the upper-tier foreign corporation is a DFIC, Notice 2018-07 could be interpreted to state that the gain reduction rule is limited to the section 965 amount included with respect to the upper-tier entity and not including the section 965 amount included with respect to the lower-tier entity.

Notice 2018-13 provides specifically that the section 961(b)(2) gain recognized by a U.S. shareholder with respect to any entity in the ownership chain will be reduced by the section 965 inclusion amount with respect to the DFIC. Furthermore, the gain reduction rule will apply to reduce the gain under section 961(c) by CFCs in the ownership chain and through which distributions are made to a U.S. shareholder.

**(g) Guidance in Connection with the Repeal
of Section 958(b)(4)**

(i) Application of Section 863

Notice 2018-13 provides that Treasury and the Service intend to study the impact of the repeal of section 958(b)(4) on certain sourcing rules of section 863 and regulations issued under section 863, some of which depend on whether the recipient is a CFC. Until further guidance (which will be prospective) is provided, taxpayers may determine whether an entity is a CFC for purposes of applying Regulation sections 1.863-8 and 1.863-9, without regard to the repeal of section 958(b)(4).⁸³

**(ii) Elimination of Form 5471 Filing
Obligations for Certain Constructive
Owners**

The instructions for Form 5471 provide that a category 5 filer must file a Form 5471. A category 5 filer is any U.S. shareholder who owns stock in a CFC on the last day of a CFC's taxable year. The repeal of section 958(b)(4) could cause U.S. persons to become category 5 filers solely as a result of downward attribution.⁸⁴

Notice 2018-13 provides relief from filing as a category 5 filer where that status is gained solely as a result of downward attribution. The Notice states that the Service intends to amend instructions to Form 5471 to provide an exception from category 5 filing:

[F]or a United States person that is a United States shareholder with respect to a CFC if no United States shareholder (including such United States person) owns, within the meaning of section 958(a), stock in such

⁸² Notice 2018-13, § 4.

⁸³ Notice 2018-13, § 5.02.

⁸⁴ Instructions for Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*.

CFC, and the foreign corporation is a CFC solely because such United States person is considered to own the stock of the CFC owned by a foreign person under section 318(a)(3).⁸⁵

(3) Notice 2018-26

Notice 2018-26 further expands on computational issues, but also addresses elections and issues related to filings.⁸⁶

**(a) Application of Section 318(a)(3)(A) to
Treat a Foreign Corporation as an SFC**

In their continuing study of the repeal of section 958(b)(4), Treasury and the Service recognized that pursuant to sections 958(b), 318(a)(3)(A) and 318(a)(3)(C), ownership attribution could result in the unintended treatment of an entity as an SFC which could result in additional section 965 inclusions.

Notice 2018-26 provides an example where a person, A, owns 100 percent of the stock of a domestic corporation, DC, and 1 percent of the interests in a partnership, PS.⁸⁷ A United States citizen, USI, owns 10 percent of the interests in PS and 10 percent by vote and value of the stock of a foreign corporation, FC. The remaining 90 percent by vote and value of the stock of FC is owned by non-U.S. persons that are unrelated to A, USI, DC, and PS.⁸⁸

Under the constructive ownership rules of sections 958 and 318, DC would be treated as a U.S. shareholder of FC, causing FC to be an SFC and causing USI to be a U.S. shareholder required to include section 965 amounts in gross income.⁸⁹

To alleviate compliance and administrative difficulties for taxpayers and the Service, Notice 2018-26 states the intent of Treasury and the Service to issue regulations, pursuant to authority under section 965(o), providing that for purposes of determining whether a foreign corporation is an SFC, stock owned directly or indirectly by or for a partner will not be considered to be owned by a partnership pursuant to sections 958(b) and 318(a)(3)(A) if the partner owns less than five percent of the partnership's capital and profit interests.⁹⁰

⁸⁵ Notice 2018-13, § 5(b).

⁸⁶ Notice 2018-26, 2018-16 I.R.B. 480.

⁸⁷ Notice 2018-26, § 3.01.

⁸⁸ *Id.*

⁸⁹ *Id.*

⁹⁰ Notice 2018-26, § 3.01.

**(b) Determination of Cash Measurement
Dates of an SFC with Respect to a U.S.
Shareholder**

Questions arose from taxpayers regarding whether a U.S. shareholder's cash position should include cash measurement dates on which the SFC was not owned by a U.S. shareholder either because, for example, the SFC went out of existence prior to the final cash measurement date or the entity was acquired or disposed of between cash measurement dates.

Notice 2018-26 states the intent of Treasury and the Service to issue regulations providing that a U.S. shareholder takes into account its pro rata share of the cash position of an SFC for any cash measurement date on which the shareholder was a U.S. shareholder of the SFC, regardless of whether it was a U.S. shareholder on any other cash measurement date.⁹¹ The Notice provides that the first cash measurement date, if any, is the close of the last tax year of the SFC that ends after November 1, 2015 and before November 2, 2016. The second cash measurement date, if any, is the close of the last tax year that ends after November 1, 2016 and before November 2, 2017. The final cash measurement date, if any, is the close of the last tax year of the SFC that begins before January 1, 2018 and ends on or after November 2, 2017.

**(c) Treatment of Certain Accrued Foreign
Income Taxes for Purposes of Determining Post-
1986 E&P**

In response to concerns regarding foreign taxes accruing between Measurement Dates, Notice 2018-26 indicates the intent of Treasury and the Service to issue regulations providing that for purposes of determining the post-1986 E&P of an SFC as of November 2, 2017, foreign taxes that accrue (i) within the tax year of an SFC that includes November 2, 2017, and (ii) after November 2, 2017, but on or before December 31, 2017, are allocated between the foreign tax base attributable to the U.S. tax year ending November 2, 2017 and the tax year beginning after November 2, 2017.⁹²

The Notice indicates that the exception applies only to taxes accrued on or before December 31, 2017, as the final measurement date for section 965(a) earnings. Furthermore, the exception is relevant only for determining post-1986 E&P and not for purposes of the foreign tax credit under section 902 or 960.⁹³

⁹¹ Notice 2018-26, § 3.02.

⁹² Notice 2018-26, § 3.03.

⁹³ *Id.*

(d) Anti-Avoidance Rules

(i) Transactions Undertaken with a Principal Purpose of Reducing Section 965 Tax Liability

Notice 2018-26 indicates the intent of Treasury and the Service to issue regulations providing that transactions will be disregarded for purposes of determining a U.S. shareholder's section 965 tax liability if:

- (i) The transaction occurs on or after November 2, 2017, whether in whole or in part;
- (ii) The transaction was undertaken with a principal purpose of reducing a U.S. shareholder's tax liability under section 965; and
- (iii) The transaction would reduce the section 965 tax liability (without application of the anti-avoidance rule).⁹⁴

Reduction of a section 965 tax liability includes reduction of section 965(a) inclusion, reduction of aggregate foreign cash position and increase of foreign income taxes deemed paid under section 960 as a result of a section 965 inclusion.⁹⁵

Cash reduction transactions, E&P reduction transactions and pro rata share transactions are presumed to be undertaken with the principal purpose of reducing section 965 tax liability.⁹⁶ The presumption can be rebutted only if it is clearly established by facts and circumstances that the transaction was not undertaken with such a principal purpose.⁹⁷ Moreover, certain transactions will be treated as "per se" undertaken with a principal purpose of reducing section 965 tax liability.

(ii) Disregard of Certain Changes in Method of Account and Entity Classification Elections

Notice 2018-26 indicates the intent of Treasury and the Service to issue regulations providing that any change in the method of accounting made for the tax year of an SFC that ends in 2017 or 2018 will be disregarded for purposes of determining a U.S. shareholder's section 965 tax liability if the change would reduce the shareholder's section 965 tax liability. The rule does not apply for changes filed prior to November 2, 2017.⁹⁸

⁹⁴ Notice 2018-26, § 3.04(a).

⁹⁵ *Id.*

⁹⁶ *Id.*

⁹⁷ *Id.*

⁹⁸ Notice 2018-26, § 3.04(b).

Similarly, entity classification elections filed on or after November 2, 2017 will be disregarded for purposes of determining section 965 tax liability if the change would reduce a U.S. shareholder's section 965 tax liability.⁹⁹

Both rules apply regardless of whether the change was made with the principal purpose of reducing a U.S. shareholder's section 965 tax liability.

(e) Rules Related to Elections Reporting and Payment

(i) Documentation of Cash Position

Notice 2018-26 indicates the intent of the Service to issue forms, publications, regulations or other guidance specifying the documentation which a U.S. shareholder must maintain and provide to show that cash assets were not taken into account by the U.S. shareholder for one SFC because they were taken into account for another SFC.¹⁰⁰

(ii) U.S. Persons Eligible to Make Elections under Section 965 in the Case of a U.S. Shareholder that is a Domestic Passthrough Entity

Notice 2018-26 responds to questions regarding the impact of section 965 for owners of SFCs through passthrough entities. Notice 2018-26 indicates the intent of Treasury and the Service to issue regulations providing that if a domestic passthrough entity is a U.S. shareholder of a DFIC and owns stock of the DFIC under section 958(a) ("section 958(a) stock"), each owner of the domestic passthrough entity will take into account its share of the section 965(a) inclusion amount and the section 965(c) deduction, regardless of whether the owner is itself a U.S. shareholder of the DFIC. The section 965(c) deduction and the section 965(a) inclusion amount are to be allocated in the same proportion.¹⁰¹

Since the domestic passthrough owner must include its share of the section 965(a) inclusion amount, the elections under sections 965(h), (m), and (n) are available regardless of whether the domestic passthrough owner is a U.S. shareholder of a DFIC.¹⁰²

If an S corporation is an owner or other beneficiary of a domestic passthrough and is thereby a U.S. shareholder of a DFIC, owners of the S corporation will be able to make an election under section 965(i) to defer net section 965 tax liability. However, if the S corporation is not a U.S. shareholder of the DFIC, a shareholder of the S corporation will

⁹⁹ Notice 2018-26, § 3.04(b).

¹⁰⁰ Notice 2018-26, § 3.05(a).

¹⁰¹ Notice 2018-26, § 3.05(b).

¹⁰² *Id.*

not include their share of the domestic passthrough entity's section 965(a) or section 965(c) amounts.¹⁰³

**(iii) Determination of Amount of Net
Tax Liability Under Section 965 for
Purposes of Section 965(h)**

Where the owner of a domestic passthrough entity is taxable on its share of the section 965(a) amount, Notice 2018-26 indicates the intent of Treasury and the Service to issue regulations providing that the domestic passthrough owner will be treated as a U.S. shareholder of purposes of determining the net tax liability under section 965.¹⁰⁴

**(iv) Application of Section 965(n) to
Loss Arising in the Year in Which the
Inclusion Year of a DFIC Ends**

In response to questions on the use of the term “deduction” under section 965(n)(1)(A), Notice 2018-26 indicates the conclusion of Treasury and the Service that section 965(n)(1)(A) and section 965(n)(1)(B) were intended to apply to different sets of losses. It is the intent of Treasury and the Service to issue regulations providing that if an election is made under section 965(n), the amount of an NOL for the tax year in which a section 965(a) amount is includable will be determined without taking into account the section 965(a) amount. Such an election will be treated as made with respect to both carryover or carryback NOLs and the NOL for the current year.¹⁰⁵

**(v) Filing and Payment Due Date for
Specified Individuals**

Notice 2018-26 indicates the intent of Treasury and the Service to issue regulations providing that if Regulation sections 1.6081-5(a)(5) or (6) provide a specified individual an extension of time to file and pay, the due date for an installment payment will also be the 15th day of the sixth month following the close of the taxable year.¹⁰⁶ For this purpose, specified individuals are: (1) U.S. citizens or residents whose tax homes and abodes are outside the U.S. and Puerto Rico in a real and substantial sense; and (2) U.S. citizens and residents on duty in military or naval service outside the U.S. and Puerto Rico.¹⁰⁷

¹⁰³ Notice 2018-26, § 3.05(b).

¹⁰⁴ Notice 2018-26, § 3.05(c).

¹⁰⁵ Notice 2018-26, § 3.05(d).

¹⁰⁶ Notice 2018-26, § 3.05(e).

¹⁰⁷ Notice 2018-26, § 2.18; Reg. § 1.6081-5(a)(5), (6).

**(f) Treatment of Section 965(c) Deduction
for Purposes of Section 62(a) and 63(d)**

Notice 2018-26 indicates the intent of Treasury and the Service to issue regulations providing that a section 965(c) deduction will not be treated as an itemized deduction, including under sections 56 and 67.¹⁰⁸

**(g) Modification of Rule Described in Section
3.04(a) of Notice 2018-13**

In clarification of the definition of accounts receivable and payable, Notice 2018-26 indicates the intent of Treasury and the Service to issue regulations providing that the definition of the terms will include only receivables or payables with a term of less than one year.¹⁰⁹

**(h) Regulations to be Issued Addressing
Elections under Section 962**

Notice 2018-26 indicates the intent of Treasury and the Service to issue regulations providing that, in order to make an election under section 962, a domestic passthrough owner that is an individual must be a U.S. shareholder with respect to a DFIC. If the election under section 962 is made, the tax imposed on amounts under section 951(a), including under section 965, is imposed under section 11 and not under section 1. The section 965(c) deduction may be taken into account in reducing income taxable under section 11 not under section 1.¹¹⁰

**(i) Penalty Relief Under Sections 6654 and
6655 in Connection with the Amendment of
Section 965 and Repeal of Section 958(b)(4)**

**(i) Penalty Waiver with Respect to
Section 965**

The Service will waive underpayment penalties under sections 6654 and 6655 with respect to a taxpayer's net tax liability under section 965 where the section 965(h) election is made. Additionally, underpayment penalties will be waived for those taxpayers who do not elect to pay the section 965 net tax liability in installments. Therefore, required installments of estimated taxes do not need to include section 965 amounts.

¹⁰⁸ Notice 2018-26, § 3.06.

¹⁰⁹ Notice 2018-26, § 4.

¹¹⁰ Notice 2018-26, § 5.

**(ii) Penalty Waiver for 2017 with
Respect to Amendments to Sections 965
and 958(b) by the Act**

The Service will not apply the estimated tax penalty under sections 6654 or 6655 to an estimated payment due on or before January 15, 2018 where the underpayment is attributable to amendments to section 958(b) or section 965 under the Act.

(4) Revenue Procedure 2018-17

To limit potential for deferral of a section 965 inclusion, Revenue Procedure 2018-17 limits the ability of an SFC to obtain an automatic approval to change its annual accounting periods by changing to a one-month deferral.

b) Other Guidance

**(1) Questions and Answers About Reporting
Related to Section 965 on 2017 Tax Returns**

In March, April and June of 2018, the Service released additional guidance related to returns, elections, statements and payment of taxes in the form of a list of questions and answers (the “FAQs”).¹¹¹

In regards to the payment of taxes, the Service will apply 2017 estimated tax payments first to a taxpayer’s net income tax liability determined without regard to section 965 and then to its section 965 tax liability.¹¹² Any overpayment of estimated tax existing after application to a taxpayer’s regular income tax liability and the first annual installment will not be refunded or credited to the taxpayer. Instead, it will be applied to subsequent section 965 installment payments.¹¹³

In addition, the Service will waive late-payment penalties arising from section 965 in certain circumstances.¹¹⁴ Specifically, the Service will waive estimated tax penalties for taxpayers who improperly attempted to apply 2017 overpayments to 2018 estimated taxes if required payments were made by June 15, 2018. The Service will also waive late payment penalties (but not interest) for individual taxpayers who missed the April 18, 2018 deadline for making the first installment payment if the installment is paid by April 15, 2019 and the total transition tax liability is less than \$1 million. If an individual filed a 2017 return without making an election under section 965(h), the individual may make the election on an amended Form 1040 filed by October 15, 2018.

¹¹¹ IR 2018-53.

¹¹² FAQs at 13.

¹¹³ FAQs at 14.

¹¹⁴ IR-2018-131, June 4, 2018.

(2) Publication 5259 – How to Calculate Section 965 Amounts and Elections Available to Taxpayers

On April 6, 2018, the Service issued Publication 5292, which provides workbooks and guidance for calculating cash positions, E&P, section 965(a) inclusion, section 965(c) deduction, deemed paid foreign taxes and disallowed foreign taxes. The publication also provides guidance in regards to who can make elections, when elections can be made and how elections can be made.

(3) PMTA 2018-016

After the FAQs was published, taxpayers raised concerns that refunds or credits would not be available for overpayments of a taxpayer's estimated taxes in respect of its regular tax liability (determined without regard to section 965(h)) until the entire section 965 tax liability is paid. In response, the Service issued PMTA 2018-16.¹¹⁵ In the PMTA, the Service outlines that it is authorized to apply overpayments as credits and refund balances pursuant to authority under section 6402. However, that section does not authorize the Service to provide credits or refunds in other situations, i.e., when no overpayment exists.¹¹⁶ Under cited case law,¹¹⁷ overpayments occur when payments exceed the amount due. They do not occur when a taxpayer pays in excess of an elected installment payment.¹¹⁸ Even though taxes may be paid in installments, a taxpayer's tax liability is the entire amount of the total tax liability for the period.

In the PMTA, the Service states that section 965(h) permits only a deferral of the payment of the liability, not a deferral of the recognition of the section 965 tax liability.¹¹⁹ Accordingly, until the entire amount of the liability under section 965 is paid, an overpayment does not exist and a refund or credit cannot be issued by the Service. The Service also states in the PMTA that a section 965(h) election to defer payments of section 965(h) net tax liability makes that liability a tax payable in installments subject to section 6403.¹²⁰ Under that section where tax is paid in installments, any payments made in excess of an installment is credited against future unpaid installments.

¹¹⁵ PMTA 2018-016 (Aug. 2, 2018)

¹¹⁶ In support, the Service cited *Minihan v. Commissioner*, 138 T.C. 1 (2012) (in the context of a party seeking a refund as an innocent spouse because tax had been collected from a joint account, the court cited section 6402 in support of the position that the taxpayer must have made an overpayment of tax in order to be entitled to a refund under section 6015(g)(1)), reconsideration granted in part and modified (Feb. 17, 2012).

¹¹⁷ *Jones v. Liberty Glass Co.*, 332 U.S. 524, 531 (1947); *Lewis v. Reynolds*, 284 U.S. 281 (1932).

¹¹⁸ *Estate of Bell v. Commissioner*, 928 F.2d 901, 903-04 (9th Cir. 1991).

¹¹⁹ *Id.*

¹²⁰ *Id.* In support, the Service cited *Estate of Bell v. Commissioner*, 928 F.2d 901 (9th Cir. 1991) (election to defer estate tax liability under section 6166 caused such tax liability to be one payable in installments governed by section 6403 and refund unavailable for payments in excess of installment then due).

Additionally, the offset refund bypass procedure¹²¹ will not apply if a taxpayer still has unpaid section 965 installments because no overpayment will exist under section 6402.

B. Proposed Regulations

1. Proposed Regulation Section 1.965-1 – Overview, General Rules, and Definitions

a) General Rules

Proposed Regulation section 1.965-1 provides the general rules and definitions under section 965. Generally, Proposed Regulation section 1.965-1 follows the rules set forth in the statute and is consistent with guidance provided in the Notices.

Proposed Regulation section 1.965-1(b)(1) provides the general rule of section 965(a) (i.e., a DFIC must increase its subpart F income for its inclusion year by the section 965(a) inclusion amount). Proposed Regulation section 1.965-1(b)(1) also clarifies that neither the section 965(a) earnings amount nor the section 965(a) inclusion is subject to the rules and limitations in section 952 or is otherwise limited by the accumulated E&P of the DFIC.

Proposed Regulation section 1.965-1(b)(2) provides the general rule of section 965(b) (i.e., a U.S. shareholder of a DFIC is able to reduce its section 965(a) inclusion amount by the U.S. shareholder's aggregate foreign E&P deficit). Proposed Regulation section 1.965-1(b)(2) also clarifies that all U.S. persons that are U.S. shareholders of a DFIC under section 958(a) ("section 958(a) U.S. shareholders") and that are members of a consolidated group are treated as a single section 958(a) U.S. shareholder.¹²²

Proposed Regulation section 1.965-1(c) provides rules relating to the section 965(c) deduction. In the definitions, the Proposed Regulations clarify that a section 958(a) U.S. shareholder's aggregate foreign cash position is allocated to the aggregate section 965 inclusion of that U.S. shareholder.¹²³ If the U.S. shareholder has more than one section 965 inclusion, its aggregate foreign cash position is allocated to each inclusion year, and the section 965(c) deduction is determined separately for each inclusion year.

The Proposed Regulations are consistent with section 965(e)(2)'s treatment of non-CFC SFCs, such that DFICs that are not CFCs are subject to the rules in sections 951 and 961 and under Regulations section 1.1411-10.¹²⁴ Proposed Regulation section 1.965-1(e)(1) expands the rules provided in Notice 2018-26¹²⁵ for identifying section 958(a) U.S. shareholders of SFCs owned through domestic partnerships. While the rules in

¹²¹ I.R.M. 21.4.6.5.11.1.

¹²² See also Prop. Reg. § 1.965-1(f)(33).

¹²³ Prop. Reg. § 1.965-1(f)(1)–(4), (8), (42).

¹²⁴ Prop. Reg. § 1.965-1(d).

¹²⁵ See Notice 2018-26, § 2.13 (referencing Notice 2010-41, 2012-22 I.R.B. 715).

Notice 2018-26 referred only to CFCs, the expanded rules in the Proposed Regulations provide that a “controlled domestic partnership” within the meaning of Proposed Regulation section 1.965-1(e)(2) is treated as a foreign partnership for purposes of determining the section 958(a) U.S. shareholder of an SFC and the “section 958(a) stock” within the meaning of Proposed Regulation section 1.965-1(f)(32) of such SFC if the following conditions are satisfied:

- (i) the CDP is a section 958(a) U.S. shareholder of the SFC and thus owns section 958(a) stock of such SFC (“tested stock”);
- (ii) if the CDP (and all other CDPs in the chain of ownership of the SFC) were treated as foreign--
 - a. the SFC would continue to be an SFC; and
 - b. at least one U.S. shareholder of the SFC--
 - i. would be treated as a section 958(a) U.S. shareholder of the SFC; and
 - ii. would be treated as owning under section 958(a) the tested stock of the SFC through another foreign corporation that is a direct or indirect partner of the CDP.¹²⁶

b) Definitions

Proposed Regulation section 1.965-1(f) sets forth an extensive list of definitions for terms that apply for purposes of the section 965 Proposed Regulations. Generally, the definitions in the Proposed Regulations conform to those used in section 965 and the Notices, but also provide certain clarifications.

Proposed Regulation section 1.965-1(f)(45)(ii) adopts the “downward” attribution rule of Notice 2018-26, section 3.01, that, for purposes of determining whether a foreign corporation is an SFC, limits the attribution of stock owned by or for a partner (the “tested partner”) to a partnership when the tested partner owns less than five percent of the interests in the partnership’s capital and profits.¹²⁷

Proposed Regulation section 1.965-1(f)(29) defines “post-1986 earnings and profits.” The definition is consistent with the “dividend reduction rule” discussed in Notice 2018-07 (i.e., the rule to prevent the double-counting of the E&P of a distributing foreign corporation), whereby a dividend from a distributing SFC to a distributee SFC made in a taxable year that begins before January 1, 2018, is not taken into account in determining the post-1986 E&P of the distributing SFC only to the extent the dividend increases the post-1986 E&P of the distributee SFC. That is, the rule, as described in Notice 2018-07 and promulgated in Proposed Regulation section 1.965-1(f)(29), limits

¹²⁶ Prop. Reg. § 1.965-1(e)(1). A “controlled domestic partnership” is a domestic partnership that is controlled by the U.S. shareholder and by persons related to the U.S. shareholder. Prop. Reg. § 1.965-1(e)(2). Control is determined under all facts and circumstances, but is deemed to exist if 50 percent of the interest in the partnership capital or profits are owned by the U.S. shareholder or persons related to the U.S. shareholder within the meaning of sections 267(b) and 707(b)(1). *Id.*

¹²⁷ For purposes of this rule, an interest in a partnership owned by another partner will be considered as being owned by the tested partner under the principles of sections 958(b) and 318, as modified by Proposed Regulation section 1.965-1(f)(45)(ii), as if the interest in the partnership were stock. Prop. Reg. § 1.965-1(f)(45)(ii).

the reduction in E&P of the distributing SFC to the amount by which the distributee SFC increases its E&P as a result of the distribution.

Consistent with the rules of Notice 2018-26, section 3.03, Proposed Regulation section 1.965-1(f)(29) also includes a rule allowing for a reduction in post-1986 E&P for foreign taxes that accrue (i) prior to November 2, 2017, and (ii) after November 2, 2017, but on or before December 31, 2017, and that are attributable to the portion of taxable income (determined under foreign law) that accrues on or before November 2, 2017.

Finally, Proposed Regulation section 1.965-1(f)(29)(iii) provides rules that allow all deficits, including hovering deficits, to be taken into account for purposes of determining post-1986 E&P and the section 965(a) inclusion amount. These rules are consistent with the Conference Report and Notice 2018-13, section 3.03(b), and apply solely for purposes of determining post-1986 E&P. Treasury and the Service request comments on whether additional rules are needed to address the treatment of hovering deficits, (e.g., for when a hovering creates a specified E&P deficit within the meaning of section 965(b)(3)(C) and Proposed Regulation section 1.965-1(f)(44)).¹²⁸

The preamble to the Proposed Regulations (the “Preamble”) notes that Treasury and the Service received taxpayer comments requesting the ability to use an alternative measurement date for determining post-1986 E&P and cash position, given that an SFC that is not a CFC does not generally track E&P under U.S. tax principles.¹²⁹ Although appreciative of the administrative challenges, Treasury and the Service have determined that similar situations already occur in the context of minority U.S. shareholders of CFCs that are passive foreign investment corporations, as defined in section 1298 (“PFICs”) and thus decline to include such a rule in the Proposed Regulations.¹³⁰

Proposed Regulation section 1.965-1(f)(17) is consistent with the rules provided by Notice 2018-13, section 3.01, for determining whether an SFC is a DFIC or an E&P deficit foreign corporation. Specifically, the rules provide that the DFIC status of an SFC is determined first; if the SFC is a DFIC, then it is classified solely as a DFIC and not as an E&P deficit foreign corporation, even if the SFC would also qualify as such under section 965(b)(3)(B) and Proposed Regulation section 1.965-1(f)(22). If the SFC is not a DFIC, then it must be determined whether it is an E&P deficit foreign corporation. An SFC may fail to qualify as a DFIC or an E&P deficit foreign corporation despite having positive post-1986 E&P or a deficit in accumulated post-1986 deferred foreign income.¹³¹

Comments received by Treasury and the Service requested that PTI be disregarded for purposes of determining the existence of a specified E&P deficit of an E&P deficit foreign corporation. Section 965(d)(2) excludes PTI for purposes of calculating post-1986 deferred foreign income, but no express exclusion of PTI is provided for in section 965(d)(3) for purposes of determining post-1986 E&P. Accordingly, the comment was not accepted, and Proposed Regulation section 1.965-

¹²⁸ Preamble, Proposed Regulations, 83 Fed. Reg. 39521 (2018).

¹²⁹ *Id.*

¹³⁰ *Id.*

¹³¹ *See* Prop. Reg. § 1.965-1(g).

1(f)(22)(ii) does not exclude PTI for purposes of determining a deficit in post-1986 E&P. Treasury and the Service, however, are considering other rules with respect to the definitions of post-1986 E&P, accumulated post-1986 deferred foreign income, and specified E&P deficit, and welcome comments on this subject.¹³²

Proposed Regulation section 1.965-1(f)(7)(i)(C) provides that, in the case of a CFC that has shareholders that are not U.S. shareholders on the E&P measurement date¹³³, the accumulated post-1986 deferred foreign income of the CFC is reduced by amounts that would have been included by such shareholders if they had been U.S. shareholders. In this regard, Proposed Regulation section 1.965-1(f)(i)(C) is consistent with Notice 2018-07, section 3.02(c), in applying the principles of Revenue Ruling 82-16 to determine the amounts by which accumulated post-1986 deferred foreign income is reduced.¹³⁴ The Proposed Regulations, however, clarify that accumulated post-1986 deferred foreign income is reduced only to the extent such income is accrued by the SFC as of the E&P measurement date.¹³⁵

The Proposed Regulations are also consistent with Notice 2018-26, section 3.02, in the definitions of the terms “cash measurement dates” and “pro rata share.”¹³⁶ However, the Proposed Regulations do not include rules for determining 52-53 week taxable years under Regulation section 1.441-2(c). Notice 2018-26, section 3.02, had announced forthcoming regulations would provide that a 52-53-week taxable year is deemed to begin on the first day of the calendar month closest to the first day of the 52-53-week taxable year and is deemed to end or close on the last day of the calendar month nearest to the last day of the 52-53-week taxable year, as the case may be. Instead, the Proposed Regulations use the actual dates on which such a year begins and ends.¹³⁷ Replying to taxpayer comments that requested guidance on measurement of cash when a section 381 transaction occurs during the last year of an SFC that begins before January 1, 2018, Treasury and the Service stated that the current rules provide appropriate guidance, and no additional rules are necessary.¹³⁸

Proposed Regulation sections 1.965-1(f)(13), (14), and (16) provide definitions addressing an SFC’s cash position and the treatment of derivative financial instruments. Generally, the cash position of an SFC includes the fair market value of the cash-equivalent assets held by the SFC, including derivative financial instruments that are not bona fide hedging transactions. These definitions are consistent with Notice 2018-07, section 3.01(c), with the following clarifications. First, the Proposed Regulations clarify that an SFC’s cash position does not include bona fide hedging transactions with respect

¹³² Preamble, Proposed Regulations, 83 Fed. Reg. 39522 (2018).

¹³³ The proposed regulations provide for two possible E&P measurement dates, November 2, 2017 and December 31, 2017, with the date dependent on the amount of accumulated post-1986 deferred foreign income. Preamble, Proposed Regulations, 83 Fed. Reg. 39514-15 (2018).

¹³⁴ Revenue Ruling 82-16, 1982-1 C.B. 106.

¹³⁵ See, Prop. Reg. § 1.965-1(f)(7)(ii).

¹³⁶ See, Prop. Reg. § 1.965-1(f)(24), (31), (25), (30)(iii).

¹³⁷ *Id.*

¹³⁸ Preamble, Proposed Regulations, 83 Fed. Reg. 39522 (2018).

to an asset that is not cash-equivalent assets or a liability within the meaning of Regulation section 1.1221-2(b)(2).¹³⁹ Thus, only the value of cash-equivalent assets and of hedging transactions with respect to a cash equivalent asset, subject to certain adjustments, are used to determine the SFC's cash position.¹⁴⁰ Second, Proposed Regulation section 1.965-1(f)(12) clarifies that, because the requirements to identify a bona fide hedging transaction described in Regulation section 1.954-2(a)(4)(ii) are generally relevant only to CFCs, such identification requirement will apply only to CFCs and not SFCs.

Proposed Regulation sections 1.965-1(f)(5), (6), and (43) provide definitions for the terms “account payable,” “account receivable,” and “short-term obligation,” respectively, that are consistent with the rules in Notices 2018-13, section 3.04(a) (clarified by Notice 2018-26, section 3.06) and 3.04(b)). Treasury and the Service declined to adopt regulations that define “accounts payable” to include payables related to the licensing of intellectual property, payables to employees in the ordinary course of business, and payables arising from property described in section 1221(a)(2).¹⁴¹ Treasury and the Service also declined to adopt a facts and circumstances test that would allow taxpayers to prove that a demand loan should not be treated as a short-term obligation.¹⁴²

Proposed Regulation section 1.965-1(f)(3) provides the definition for “pro rata share” consistent with the definition provided in Notice 2018-13, section 3.03(a), and clarifies 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 taxable year of the E&P deficit foreign corporation that begins before January 1, 2018. Treasury and the Service request comments regarding whether there are circumstances in which a specified E&P deficit should be allocated to the holders of an E&P deficit foreign corporation's preferred stock, and if so, how to allocate the specified E&P deficit between the common and preferred shareholders.¹⁴³

The definitions related to domestic passthrough entities, found in Proposed Regulation section 1.965-1(f)(19) (defining “domestic passthrough entity”), (20) (defining “domestic passthrough owner”) (21) (defining “domestic passthrough owner share”), (28) (defining “passthrough entity”), (37) (defining “section 965(a) inclusion”), and (41) (defining “section 965(c) deduction amount”) generally conform with Notice 2018-26, section 3.05(b). Proposed Regulation section 1.965-3(g), discussed below, provides rules regarding the allocation of the section 965(c) deduction in the context of domestic passthrough entities.

The definitions related to foreign currency translation are also consistent with those provided in Notice 2018-13, section 3.05(b), with Proposed Regulation section 1.965-1(f)(36) confirming that an SFCs accumulated post-1986 deferred foreign income

¹³⁹ See Prop. Reg. 1.965-1(f)(12)–(14), (16). Preamble, Proposed Regulations, 83 Fed. Reg. 39522 (2018).

¹⁴⁰ *Id.*

¹⁴¹ Preamble, Proposed Regulations, 83 Fed. Reg. 39523 (2018).

¹⁴² *Id.*

¹⁴³ *Id.*

as of each E&P measurement date must be compared in the SFC's functional currency, with any changes in functional currency between November 2, 2017, and December 31, 2017, translated into the new functional currency of the SFC using the spot rate on November 2, 2017. Proposed Regulation section 1.965-4, discussed below, may also apply to disregard certain changes in functional currency. Additionally, the Proposed Regulations use the spot rate on December 31, 2017, for translating the section 965(a) earnings amount of a DFIC into U.S. dollars for purposes of determining the section 965(a) inclusion amount of a U.S. shareholder of the DFIC, as well as for other purposes, including those described in Notice 2018-13, section 3.05(b).¹⁴⁴

2. Proposed Regulation Section 1.965-2 – Adjustments to Earnings and Profits and Basis

Generally, Proposed Regulation section 1.965-2 provides rules related to the adjustments to E&P and basis under sections 965(a), 965(b), Proposed Regulation section 1.965-1, and section 961(b). Proposed Regulation section 1.965-2 generally expands on the E&P and basis adjustments rules described in the Notices.

Proposed Regulation section 1.965-2(b) provides rules clarifying the interaction between sections 959 and 965. These rules are consistent with and follow the sequence of the rules laid out in Notice 2018-07, section 3.02(d).

Generally, Proposed Regulation section 1.965-2(c) provides that the E&P of a DFIC that is described under section 959(c)(2) with respect to a section 958(a) U.S. shareholder is increased by the amount equal to the section 965(a) inclusion of such U.S. shareholder. Because section 965(a) previously taxed E&P is tracked in functional currency but the section 965(a) inclusion amount is in U.S. dollars, such previously taxed E&P is translated, if necessary, into the foreign currency of the DFIC using the spot rate on December 31, 2017, provided the section 965(a) inclusion amount is included in income by the section 958(a) U.S. shareholder.¹⁴⁵ Proposed Regulation section 1.965-2(c) also provides that the E&P (including a deficit) of a DFIC described in section 959(c)(3) is reduced (or in the case of a deficit, increased) by an amount equal to the section 965(c) previously taxed E&P of the DFIC.

Proposed Regulation section 1.965-2(d) provides rules relating to the E&P of DFICs and E&P deficit foreign corporations by reason of a reduction under section 965(b)(1) or (5) (the "reduction rules"). Proposed Regulation section 1.965-2(d)(1) provides that a DFIC increases its E&P described in section 959(c)(2) by an amount equal to the reduction in the section 965(a) inclusion amount taken by a DFIC's section 958(a) U.S. shareholder under the reduction rules. Such increase in section 959(c)(2) is defined under Proposed Regulation section 1.965-2(d)(1) as "section 965(b) previously taxed E&P". Section 965(b) previously taxed E&P must be translated to the DFIC's functional currency, if necessary, using the spot rate of December 31, 2017, are included

¹⁴⁴ See Prop. Reg. §§ 1.965-1(b), (f)(9), (11); 1.965-2(c)-(d); 1.965-6(b) (regarding application of section 902 for purposes of the section 965(a) inclusion amount, discussed below).

¹⁴⁵ Prop. Reg. 1.965-1(c).

in the gross income of the section 958(a) U.S. shareholder under section 951(a)(1)(A), and reduce the DFIC's E&P (including a deficit) described in section 959(c)(3).¹⁴⁶

Proposed Regulation section 1.965-2(d)(2)(i)(A) provides that the section 959(c)(3) E&P of an E&P deficit foreign corporation is increased by an amount equal to the section 958(a) U.S. shareholder's pro rata share of the specified E&P deficit taken into account under the reduction rules.¹⁴⁷ For purposes of the above-mentioned rule, increased E&P is not treated as E&P of the taxable year described in section 316(a)(2). Proposed Regulation section 1.965-2(d)(2)(i)(B) provides that, for purposes of determining the reduction in a qualified deficit under section 952, a section 958(a) U.S. shareholder pro rata share of the E&P of an E&P deficit foreign corporation is increased by an amount equal to the portion of the U.S. shareholder's pro rata share of the specified E&P taken into account under the reduction rules, and such increase is attributable to the same activity to which the deficit so taken into account was attributable. Proposed Regulation section 1.965-2(d)(2)(ii) provides rules for determining the portion of a section 958(a) U.S. shareholder's pro rata share of a specified E&P deficit taken into account for purposes of the reduction rules. Such portion is 100 percent if (i) the section 958(a) U.S. shareholder (or the consolidated group of which such shareholder is a member) does not have an excess aggregate foreign E&P deficit, or (ii) for an affiliated group of which not all section 958(a) U.S. shareholders are members of the same consolidated group, the aggregate of the section 965(a) inclusion amounts of the group's E&P net surplus shareholders (to the extent of group ownership) is equal to or greater than the sum of the excess aggregate foreign E&P deficits of the group's E&P net deficit shareholders.¹⁴⁸ In any other case, the section 958(a) U.S. shareholder must designate the portion of the specified E&P deficit of each E&P deficit foreign corporation to be taken into account, including the portion attributable to a qualified deficit.¹⁴⁹

Proposed Regulation section 1.965-2(e)(1) provides that, pursuant to section 961(a), a section 958(a) U.S. shareholder must increase its basis in the stock of the DFIC by the U.S. shareholder's section 965(a) inclusion amount with respect to such DFIC. Proposed Regulation section 1.965-2(e)(2), relating to rules regarding basis adjustments in the case of section 962 election, is reserved; Treasury and the Service requested comments as to the appropriate amount of the basis adjustments in such situations.¹⁵⁰

Proposed Regulation section 1.965-2(f)(1) clarifies the general rule that, except as provided in Proposed Regulation section 1.965-2(f)(2), no adjustments to basis of stock or property are made under section 961 (or any other provision of the Code) to take into account the reduction in the section 965(a) earnings amount of a section 958(a) U.S. shareholder under section 965(b). Treasury and the Service believe an increase in the

¹⁴⁶ Prop. Reg. 1.965-2(d)(1).

¹⁴⁷ See also the discussion in ¶ II.F., *infra*, regarding the timing of the adjustment to the post-1986 undistributed earnings of an E&P deficit foreign corporation for purposes of determining a deemed paid credit allowed under §§ 902 and 960.

¹⁴⁸ See also. Prop. Reg. § 1.965-8(f)(1)(A), (B).

¹⁴⁹ Prop. Reg. § 1.965-2(d)(2)(ii)(B).

¹⁵⁰ Preamble, Proposed Regulations, 83 Fed. Reg. 39526 (2018).

basis of DFICs is appropriate only if there is a corollary reduction to the basis of the E&P deficit foreign corporations.¹⁵¹ Additionally, Treasury and the Service believe that such a reduction may give rise to gain in certain cases and prove to be overly burdensome for taxpayers.¹⁵²

Accordingly, Proposed Regulation section 1.965-2(f)(2) provides rules that allow section 958(a) U.S. shareholders to make an election to make basis adjustments to account for the application of section 965(b). Generally, these adjustments allow the section 958(a) U.S. shareholder to (i) increase the basis of the stock of the DFIC by an amount equal to the section 965(b) previously taxed E&P of the DFIC, and (ii) decrease the basis of the stock of an E&P deficit foreign corporation (or the U.S. shareholder's basis in applicable property with respect to an E&P deficit foreign corporation) by an amount equal to its pro rata share of the specified E&P deficit taken into account under section 965(b) and Proposed Regulation sections 1.965-2(b)(2) and 1.965-8(b) (discussed below), as the case may be.¹⁵³ The adjustments must be consistently made by the section 958(a) U.S. shareholder with respect to all section 958(a) stock of SFCs owned by such U.S. shareholder and related persons.¹⁵⁴ The basis adjustment election must be made no later than the due date (taking into account extensions) for the section 958(a) U.S. shareholder's return for the first taxable year that includes the last day of the last taxable year of the DFIC or E&P deficit foreign corporation that begins before January 1, 2018; relief is not available under Regulations sections 301.9100-2 or 301.9100-3.¹⁵⁵ As final regulations have not yet been issued, Treasury has stated that with respect to tax returns that are due (determined with regard to any extension) before the date that is 90 days after the date that the final regulations are published in the Federal Register (the "Federal Register Publication Date"), the basis election must be made no later than 90 days after the Federal Register Publication Date.¹⁵⁶ In addition, the final regulations will provide that if a basis election was made on or before the Federal Register Publication Date, the basis election may be revoked no later than 90 days after the Federal Register Publication Date.¹⁵⁷

Proposed Regulation section 1.965-2(g) provides a "gain-reduction" rule pursuant to which a section 958(a) U.S. shareholder would reduce the amount of gain that would otherwise be recognized under section 961(b)(2) as the result of a distribution of section 965 previously taxed E&P. The rules are consistent with those provided under Notice 2018-7, section 3.03, and Notice 2018-13, section 4. Furthermore, the rules would apply to distributions of section 965(b) previously taxed E&P where the taxpayer makes a basis

¹⁵¹ *Id.*

¹⁵² *Id.*

¹⁵³ Prop. Reg. § 1.965-2(f)(2)(ii).

¹⁵⁴ Prop. Reg. § 1.965-2(f)(2)(iii)(a). "Related person" means a person related to the section 958(a) U.S. shareholder under sections 267(b) or 707(b). *Id.*

¹⁵⁵ Prop. Reg. § 1.965-2(f)(iii)(B)(1). The section 958(a) U.S. shareholder must attach a statement to its tax return as described in Proposed Regulation section 1.965-2(f)(iii)(B)(2).

¹⁵⁶ Notice 2018-78, 2018, I.R.B. (Oct. 1, 2018).

¹⁵⁷ *Id.*

adjustment election under Proposed Regulation section 1.965-2(f). Proposed Regulation section 1.965-2(g)(2) requires the taxpayer to reduce the basis in section 958(a) stock or applicable property by the amount that would be recognized as gain but for the rule.

Proposed Regulation section 1.965-2(h) provides the rules of application for all basis adjustments under Proposed Regulation sections 1.965-2(e), (f)(2), and (g)(2). Generally, the rules require the adjustments to be made as of the close of the last day of the last taxable year of the SFC that begins before January 1, 2018, and are made to each share of section 958(a) stock (or in a manner consistent with such allocation to stock in the case of applicable property).¹⁵⁸ Additionally, the rules require netting of the specified basis adjustments and gain recognition to the extent that a net downward adjustment would exceed basis.¹⁵⁹ Finally, the specified basis adjustments are limited to property held by a section 958(a) U.S. shareholder, unless the section 958(a) stock or applicable property is owned through a foreign passthrough entity, in which case the adjustment is made to the section 958(a) stock or applicable property held by the foreign passthrough entity as if it was directly held by the section 958(a) U.S. shareholder.¹⁶⁰

Proposed Regulation section 1.965-2(i) provides definitions that apply for purposes of Proposed Regulation section 1.965-2(i). Proposed Regulation section 1.965-2(i)(1) defines “applicable property” to be, with respect to a section 958(a) U.S. shareholder and an SFC, property owned by such U.S. shareholder (including through foreign passthrough entities) by reason of which the section 958(a) U.S. shareholder is considered under section 958(a)(2) as owning section 958(a) stock of the SFC. Proposed Regulation section 1.965-2(i)(2) defines “foreign passthrough” entity to mean a foreign partnership, foreign estate, or foreign trust within the meaning of section 7701(a)(31). Proposed Regulation section 1.965-2(i)(3) defines “property” to mean property within the meaning of Regulation section 1.961-1(b)(1).

3. Proposed Regulation Section 1.965-3 – Section 965(c)

Deductions

Proposed Regulation section 1.965-3 provides rules regarding the section 965(c) deduction and the section 965(c) deduction amounts.

Proposed Regulation section 1.965-3(b)(1) provides rules regarding the aggregate foreign cash position of a section 958(a) U.S. shareholder that are generally consistent with the rules set forth in Notice 2018-07, section 3.01. Under these rules, any account payable, account receivable, short-term obligation, or derivative financial instrument between an SFC with respect to which a section 958(a) U.S. shareholder owns section 958(a) stock and a related SFC on a “cash measurement date” is disregarded to the extent of the smallest of the product of the amount of the item on such cash measurement date of each SFC and the U.S. shareholder's ownership percentage of section 958(a) stock of

¹⁵⁸ Prop. Reg. § 1.965-2(h)(1), (4).

¹⁵⁹ Prop. Reg. § 1.965-2(h)(2), (3).

¹⁶⁰ Prop. Reg. § 1.965-2(h)(5).

the SFC on such date.¹⁶¹ As noted below, this rule applies even in the context of a consolidated group (e.g., each member determines the items disregarded on a separate entity basis). Treasury has recognized, however, that separate entity treatment may overstate the aggregate foreign cash position of a consolidated group for purposes of applying Proposed Regulation section 1.965-3(b).¹⁶² Consequently, Treasury has stated that final regulations will provide that all members of a consolidated group that are section 958(a) U.S. shareholders of an SFC are also treated as a single section 968(a) U.S. shareholder for purposes of Proposed Regulation section 1.965-3(b).¹⁶³

Proposed Regulation section 1.965-3(b)(2) provides the relief announced in Notice 2018-26, section 3.05(a), to prevent the double-counting of assets of an SFC in determining a section 985(a) U.S. shareholder's aggregate cash position when those assets have been included in determining the U.S. shareholder's pro rata share of the cash position of another SFC. The U.S. shareholder must attach a statement to its timely-filed tax return for the inclusion year providing the following information: (i) a description of the asset that would be taken into account with respect to both SFCs; (ii) a statement of the amount by which its pro rata share of the cash position of SFC is reduced; (iii) a detailed explanation of why there would otherwise be double-counting, including the computation of the amount taken into account with respect to the other SFC; and (iv) an explanation of why Proposed Regulation section 1.965-3(b)(1) does not apply to disregard such amount.¹⁶⁴ Relief is not available under Regulations sections 301.9100-2 or 301.9100-3 to allow late filing of the statement.

Proposed Regulation section 1.965-3(c) provides rules for determining a section 958(a) U.S. shareholder's aggregate cash position for an inclusion year; the rules are consistent with those announced in Notice 2018-07, section 3.05(a). If a section 958(a) U.S. shareholder has a single inclusion year, the U.S. shareholder's aggregate foreign cash position for such single inclusion year is equal to its aggregate foreign cash position.¹⁶⁵ If a section 958(a) U.S. shareholder has multiple inclusion years, the U.S. shareholder's cash position is allocated to an inclusion year in the following manner:

- (i) For the first inclusion year, allocate a portion of the aggregate foreign cash position equal to the lesser of the section 958(a) U.S. shareholder's aggregate foreign cash position, or the section 958(a) U.S. shareholder's aggregate section 965(a) inclusion amount for the U.S. shareholder's inclusion year.¹⁶⁶
- (ii) For any succeeding inclusion year, allocate a portion of the aggregate foreign cash position equal to the lesser of the excess, if any, of the section 958(a) U.S.

¹⁶¹ Prop. Reg. § 1.965-3(b)(1). An SFC is related to another SFC if the requirements of section 954(d)(3) are met, substituting the term SFC for CFC in each place it appears. *Id.*

¹⁶² Notice 2018-78, § 3, 2018 I.R.B. (Oct. 1, 2018).

¹⁶³ *Id.*

¹⁶⁴ *Id.*

¹⁶⁵ Prop. Reg. § 1.965-3(c)(1).

¹⁶⁶ Prop. Reg. § 1.965-3(c)(2)(i).

shareholder's aggregate foreign cash position over the aggregate amount of its aggregate foreign cash position allocated to prior inclusion years.¹⁶⁷

Proposed Regulation section 1.965-3(c)(3) allows a section 958(a) U.S. shareholder to assume that its pro rata share of the cash position of any SFC is zero if the SFC has a taxable year beginning before January 1, 2018, and ending after the date the return for such U.S. shareholder inclusion year is timely filed. If the pro rata share is assumed to be zero but the section 958(a) U.S. shareholder's pro rata share of the SFC's cash position on the final cash measurement date exceeds one half the sum of the SFC's cash position on the first and second cash measurement dates, then the U.S. shareholder may avoid interest and penalties by filing an amended return the year after the section 958(a) U.S. shareholder's inclusion year with the correct aggregate foreign cash position.¹⁶⁸

Proposed Regulation section 1.965-3(d) provides rules coordinating the section 965(c) deduction with the section 965(l) expatriated provisions, requiring recapture of all section 965(c) deductions taken by an expatriated entity without regard to whether the expatriated entity was itself a section 958(a) U.S. shareholder.

Proposed Regulation section 1.965-3(e) provides that, in the case of an individual making a section 962 election, any section 965(c) deduction taken into account under Proposed Regulation section 1.962-1(b)(1)(i)(B) in determining taxable income is used in section 11 and is not taken into account for purposes of determining the individual's taxable income under section 1.

Consistent with Notice 2018-26, section 3.06, Proposed Regulation section 1.965-3(f)(1) provides that the section 965(c) deduction is not treated as an itemized deduction for any purpose of the Code. Proposed Regulation sections 1.965-3(f)(3) and (f)(4) clarify, respectively, that, a section 965(c) deduction is not treated as (i) being properly allocable to any section 965(a) inclusion for purposes of section 1411 and section 1.1411-4(f)(6), nor as (ii) an ordinary and necessary expense paid or incurred for the production or collection of gross investment income for purposes of section 4940(c)(3)(A).

Proposed Regulation section 1.965-3(f)(2)(i) provides that, in the case of a domestic partnership or S corporation, the net section 965(a) inclusion (i.e., the section 965(a) inclusion less the section 965(c) deductions) is treated as a separately stated item of net income for purposes of calculating basis under sections 705 and 1367(a)(1) and Regulations sections 1.705-1(a) and 1.367-1(f), as the case may be. Treasury and the Service believe that this rule will allow shareholders of S corporations and partners of domestic partnerships to take into account their share of a section 965(c) deduction amount that may otherwise not be allocated to them with the corresponding amount of the section 965(a) inclusion under the rules of subchapters S or K.¹⁶⁹ Additionally, Proposed Regulation section 1.965-3(f)(2)(ii) provides that, in the case of an S corporation, the aggregate amount of its section 965(a) inclusions equal to the aggregate amount of its section 965(c) deductions is treated as income not exempt from tax solely for purposes of

¹⁶⁷ Prop. Reg. § 1.965-3(c)(2)(ii).

¹⁶⁸ Prop. Reg. § 1.965-3(c)(3).

¹⁶⁹ Preamble, Proposed Regulations, 83 Fed. Reg. 3957-28 (2018).

determining whether an adjustment is made to its AAA under Regulations sections 1368(e)(1)(A) and 1.1368-2(a)(2).

Proposed Regulation section 1.965-3(g), applicable for purposes of determining a domestic passthrough owner's share of the section 965(c) deduction, provides that a section 965(c) deduction amount must be allocated to the domestic passthrough owner in the same proportion as an aggregate section 965(a) inclusion amount of the domestic passthrough entity for the inclusion year is allocated to such owner.

4. Proposed Regulation Section 1.965-4 – Disregard of Certain Transactions

Proposed Regulation section 1.965-4 provides rules to disregard certain transactions for purposes of applying 965.

Proposed Regulation section 1.965-4(b) provides an anti-avoidance rule that disregards transactions taken with a principal purpose of changing the amount of a “section 965 element.” The rule is generally consistent with the rule announced in Notice 2018, section 3.04, except that the rule is based on a change in a “section 965 element” instead of a change in the “section 965 liability.” The term “section 965 element” means, with respect to any section 958(a) U.S. shareholder, any of the following amounts: (i) the U.S. shareholder's section 965(a) inclusion; (ii) the U.S. shareholder's aggregate foreign cash position; or (iii) the amount of foreign income taxes of an SFC deemed paid by the U.S. shareholder under section 960 as a result of a section 965(a) inclusion.¹⁷⁰

Treasury and the Service did not adopt a taxpayer-proposed suggestion that the anti-avoidance rule not apply when a reduction in the section 965(a) liability is offset by an equal amount of tax under a different Code provision.¹⁷¹ Treasury and the Service noted that, because the anti-avoidance rule includes a “principal purpose” test, transactions that do not reduce overall tax liability may not, under certain facts and circumstances, implicate Proposed Regulation section 1.965-4(b).¹⁷² Treasury and the Service also did not adopt a de minimis rule for purposes of the anti-avoidance rule.¹⁷³

Proposed Regulation section 1.965-4(c) makes clear that accounting method changes and entity classification changes are disregarded solely for purposes of section 965. In this regard, Treasury and the Service issued regulations applying the anti-avoidance rule when the change is from an impermissible to a permissible accounting method.¹⁷⁴

Proposed Regulation section 1.965-4(f) provides rules regarding the double-counting of “specified payments” between SFCs occurring between E&P Measurement Dates. These rules are consistent with those announced in Notice 2018-07, section

¹⁷⁰ Prop. Reg. § 1.965-4(d).

¹⁷¹ Preamble, Proposed Regulations, 83 Fed. Reg. 39528 (2018).

¹⁷² *Id.*

¹⁷³ *Id.*

¹⁷⁴ Preamble, Proposed Regulations, 83 Fed. Reg. 39529 (2018).

3.02(a), and provide that amounts paid or incurred between related SFCs of a section 958(a) U.S. shareholder between E&P Measurement Dates that would otherwise reduce the post-1986 earnings of the payor SFC are disregarded for purposes of both the payor and payee SFC as of the December 31, 2017, E&P Measurement Date. Treasury and the Service received comments asking to expand these rules to include (i) deductible payments by an SFC to a U.S. shareholder or partnership owned by a U.S. shareholder and (ii) distribution by an SFC to a U.S. shareholder.¹⁷⁵ In the Preamble, Treasury and the Service explained that possible double-counting of post-1986 E&P arises only in the context of payments between related SFCs, not from payments by an SFC to its U.S. shareholder, and disregarding SFC-to-U.S. shareholder payments could have other consequences (e.g., the availability of section 902 credits to the U.S. shareholder and the impact they would have on the section 965(g)(1) limitation) that would need to be considered if such payments were disregarded.¹⁷⁶ Thus, Treasury and the Service declined to expand the rule to cover the proposed transactions.

**5. Proposed Regulations Sections 1.965-5 and 1.965-6 –
Allowance of Credit or Deduction for Foreign Tax Credits;
Computation of Foreign Tax Credits Deemed Paid, and Allocation
and Apportionment of Deductions**

Proposed Regulation sections 1.965-5 and 1.965-6 provide rules related to the allowance and calculation of deductions or credits for foreign income taxes paid or accrued.

Consistent with section 965(g), no deduction or credit will be allowed for the applicable percentage¹⁷⁷ of foreign income taxes paid or accrued (or treated as paid or accrued) and attributable to the section 965(c) deduction applicable to a section 965(a) inclusion amount.¹⁷⁸ Similarly, Proposed Regulation section 1.965-5(b) further clarifies no deduction or credit will be allowed for the applicable percentage of foreign income taxes paid or accrued (or treated as paid or accrued) with respect to distributions of

¹⁷⁵ *Id.*

¹⁷⁶ *Id.*

¹⁷⁷ As determined under section 965(g)(2). Prop. Reg. § 1.965-5(d). For a domestic corporation that is attributed foreign income taxes through a domestic pass-through entity, the applicable percentage will be based on the domestic corporation's share of the domestic pass-through entity's applicable percentage. Prop. Reg. § 1.965-5(d)(2).

¹⁷⁸ Prop. Reg. § 1.965-5(b), (c)(1)(i). Foreign taxes paid or accrued are taxes paid or accrued directly by the domestic corporation under section 901. Preamble, Proposed Regulations, 83 Fed. Reg. 39529 (2018). Foreign income taxes treated as paid or accrued with respect to a section 965(a) inclusion are those deemed paid under section 960(a)(1). Taxes treated as paid or accrued also include foreign income taxes allocated under Regulation section 1.901-2(f)(4) and a taxpayer's distributive share of foreign income taxes paid or accrued by a partnership.

In regards to the limit, the amount of the section 78 gross-up is similarly reduced. Prop. Reg. § 1.965-5(c)(3). For a domestic corporation which is attributed foreign income taxes through a domestic pass-through entity, for purposes of the section 78 gross-up under section 965(g)(4), the section 965(a) inclusion will be based on the domestic pass-through entity's section 965(a) inclusion. Prop. Reg. § 1.965-5(c)(3)(ii).

section 965(a) or (b) previously taxed E&P.¹⁷⁹ This rule applies to withholding taxes and certain other taxes.¹⁸⁰

With respect to a distribution of section 965(a) or 965(b) PTI, only the foreign income taxes paid or accrued (including withholding taxes) by an upper-tier foreign corporation in regards to a distribution of section 958(a) or (b) PTI from a lower-tier foreign subsidiary will be considered foreign income taxes deemed paid by a domestic corporation under section 960(a)(3).¹⁸¹ Furthermore, a credit under section 960(a)(3) is not allowed for any foreign income taxes that would be deemed paid under section 960(a)(1) for the portion of the section 965(a) earnings reduced by allocable E&P deficit since no taxes were paid on that amount.¹⁸²

Treasury and the Service have reserved on foreign income taxes deemed paid under new section 960(b) as applicable to tax years beginning after December 31, 2017.¹⁸³

Section 902, as in effect in 2017, applies as if the section 965(a) inclusion is a dividend paid by the DFIC.¹⁸⁴ Consistent with current law, the Proposed Regulations provide that the section 902 fraction for either a DFIC or an E&P deficit foreign corporation is the amount of a dividend paid by or a section 951(a)(1) inclusion (including a section 965(a) inclusion) (the “numerator”) with respect to the foreign corporation divided by the foreign corporation’s post-1986 undistributed earnings (the “denominator”).¹⁸⁵ If the denominator is positive but less than the numerator for a section 902 fraction, the fraction is treated as being one.¹⁸⁶ If the denominator is zero or less than zero, the section 902 fraction is treated as being zero. No foreign income taxes are deemed paid.¹⁸⁷

The E&P of an E&P deficit corporation is increased under section 965(b)(4)(B) and Proposed Regulation section 1.965-2(d)(2)(i)(A) for purposes of section 902(c)(1) as of the first day of an E&P deficit foreign corporation’s first tax year following the

¹⁷⁹ Prop. Reg. § 1.965-5(b), -5(c)(1)(i). Foreign income treated as paid or accrued with respect to section 965(a), (b) PTI distributions are deemed paid under section 960(a)(3).

¹⁸⁰ Prop. Reg. § 1.965-5(b). It also includes net basis taxes imposed by a foreign jurisdiction on a US citizen residing in that foreign jurisdiction on distribution of a section 958(a) or (b) previously tax amount.

¹⁸¹ Prop. Reg. § 1.965-5(c)(1)(ii). The Preamble states that this follows section 960(a)(3), which provides that a distribution of PTI is treated as a dividend by the recipient domestic corporation for purposes of calculating the section 902 dividend in regards to accumulated profits of the distributing foreign corporation. Preamble, Proposed Regulations, 83 Fed. Reg. 39530 (2018).

¹⁸² Prop. Reg. § 1.965-5(c)(1)(ii).

¹⁸³ Prop. Reg. § 1.965-5(c)(1)(iii).

¹⁸⁴ Prop. Reg. § 1.965-6(b). The section 965(a) inclusion is translated at the spot rate on December 31, 2017, consistent with Notice 2018-13, Section 3.05(b).

¹⁸⁵ Prop. Reg. § 1.965-6(c)(1).

¹⁸⁶ Prop. Reg. § 1.965-6(c)(2).

¹⁸⁷ *Id.*

inclusion year.¹⁸⁸ Section 965(c) deductions do not cause any part of the section 965(a) inclusion or related assets or stock to be treated as exempt, excluded or eliminated for purposes of apportioning interest and other expenses under section 864(e)(3) or Temporary Regulation section 1.861-8(d).¹⁸⁹ Similarly, sections 965(a) and (b) PTI is not treated as exempt under section 864(e)(3).¹⁹⁰

Treasury and the Service have requested comments regarding to additional rules that may be necessary to take into account basis adjustments similar to those required under section 864(e)(4) as a result of section 965(b)(4)(A) and (B), as well as application of section 904 basketing rules.¹⁹¹

6. Proposed Regulation Section 1.965-7 – Elections and Payment Rules

a) Section 965(h) Election

Proposed Regulation section 1.965-7(b) deals with the election under section 965(h) allowing taxpayers to pay their section 965(h) net tax liability in eight installments. The section 965(h) election may be revoked only by paying the outstanding amount of the section 965(h) net tax liability.¹⁹²

In response to concerns regarding the underpayment of the first installment payment, the Proposed Regulations provide that if a deficiency is assessed with respect to a section 965(h) net tax liability or a return or an amended return is filed increasing the taxpayer's section 965(h) net tax liability, the additional amount or deficiency is prorated among the installments.¹⁹³ Further, if the amount of the first installment must be increased, the remaining installments will not be accelerated.¹⁹⁴

The Proposed Regulations expand on the acceleration events identified in section 965(h)(3). The acceleration events would include an exchange or other disposition of substantially all of the assets of a taxpayer in addition to their liquidation or sale. An acceleration event would also include an event that causes a person to no longer be a U.S. person, such as a resident becoming a non-resident. Finally, with respect to a consolidated group, a non-member becoming a member or a group ceasing to exist will constitute an acceleration event.¹⁹⁵

¹⁸⁸ Prop. Reg. § 1.965-6(c)(3). The Preamble states Treasury and the Service declined to adopt comments regarding taxes related to hovering deficits because existing rules under Regulation section 1.367(b)-7 adequately address such taxes. Preamble, Proposed Regulations, 83 Fed. Reg. 39529 (2018).

¹⁸⁹ Prop. Reg. § 1.965-6(d).

¹⁹⁰ *Id.*

¹⁹¹ Preamble, Proposed Regulations, 83 Fed. Reg. 39531 (2018).

¹⁹² Prop. Reg. § 1.965-7(b)(1).

¹⁹³ Prop. Reg. § 1.965-7(b)(1)(ii).

¹⁹⁴ *Id.*; Preamble, Proposed Regulations, 83 Fed. Reg. 39533 (2018).

¹⁹⁵ Prop. Reg. § 1.965-7(b)(3)(ii). In response to comments, the Preamble confirms that because all members of a consolidated group will be considered a single person under Proposed Regulation section 1.965-8(e)(1),

A liquidation, sale, exchange or other disposition of a taxpayer's assets, a non-member becoming a member of a consolidated group, or a consolidated group ceasing to exist will not result in acceleration of the remaining installments if the relevant parties (referred in the Proposed Regulations as the transferor and transferee) enter into a transfer agreement.¹⁹⁶ The Proposed Regulations outline the requirements and procedural rules for the transfer agreement. These include a representation that the section 965(h) eligible transferee is able to make the outstanding payments and the acknowledgement that the transferor and any successor to the transferor will remain jointly and severally liable for any unpaid installments.¹⁹⁷

Treasury and the Service declined to accept comments requesting that the section 965(h) election be made by default.¹⁹⁸ Elections must be made by the due date of the relevant return (including extensions).¹⁹⁹ The Proposed Regulations provide that late election relief under Regulation sections 301.9100-2 or 301.9100-3 is not available. Treasury and the Service also declined to apply section 965(h) to tax due under other chapters such as section 1411.²⁰⁰

b) Section 965(i) Election

Proposed Regulation section 1.965-7(c) provides additional guidance for S corporation owners to make an election under section 965(i) to defer payment of the section 965 net tax liability.

Consistent with Notice 2018-26, section 3.05(b), any shareholder of an S corporation that is a U.S. shareholder of a DFIC may make the election.²⁰¹ The election must be made by filing a statement with the shareholder's return for the relevant year. The Proposed Regulations outline the information that must be included in the statement.²⁰²

The Proposed Regulations also outline events which will trigger the section 965 net tax liability, as provided in section 965(i). However, a transfer of any share of stock of the S corporation by the shareholder (including by reason of death or otherwise) may

the liquidation of a single member will not be an acceleration event. Preamble, Proposed Regulations, 83 Fed. Reg. 39531 (2018).

¹⁹⁶ Prop. Reg. § 1.965-7(b)(3)(iii)(A). For this purpose, the transferee must be an eligible section 965(h) transferee which is a single U.S. person that is not a domestic pass-through entity and satisfies certain additional requirements. Prop. Reg. § 1.965-7(b)(3)(iii)(B)(1).

¹⁹⁷ Prop. Reg. § 1.965-7(b)(3)(iii)(B)(4)(vii), (viii).

¹⁹⁸ Preamble, Proposed Regulations, 83 Fed. Reg. 39533-34 (2018).

¹⁹⁹ Prop. Reg. § 1.965-7(b)(2)(ii).

²⁰⁰ Preamble, Proposed Regulations, 83 Fed. Reg. 39534 (2018).

²⁰¹ Prop. Reg. § 1.965-7(c).

²⁰² *Id.*

be exempted as a triggering event if a transfer agreement is entered into pursuant to the Proposed Regulation.²⁰³

Treasury and the Service confirmed that, by its terms, section 965(i) affects only the timing of the payment of the section 965 net tax liability, but does not affect timing of the section 965(a) inclusion.²⁰⁴

Elections must be made by the due date of the relevant return (including extensions).²⁰⁵ No relief is available under Regulation sections 301.9100-2 or 301.9100-3.

c) Section 965(m) Election

The Proposed Regulations provide the procedural rules regarding how a REIT can make an election under section 965(m) to defer its section 965(a) inclusion. Treasury and the Service did not adopt comments requesting that RICs be allowed to make a similar election.²⁰⁶

Elections must be made by the due date of the relevant return (including extensions).²⁰⁷ No relief is available under Regulation sections 301.9100-2 or 301.9100-3.

d) Section 965(n) Election

The Proposed Regulations also provide procedural rules for making an election under section 965(n) to not take the section 965(a) inclusions and corresponding section 78 gross-ups into account for determining a taxpayer's NOL or taxable income that may be reduced by NOL carryovers or carrybacks.²⁰⁸ In other words, the election allows a taxpayer not to use its NOLs to reduce its section 965(a) inclusion.

Consistent with Notice 2018-26 section 3.05(d), Treasury and the Service have determined that the election should apply to both NOLs for the tax year for which the election is made, as well as NOL carryovers and carrybacks to the tax year.²⁰⁹ Furthermore, in response to comments, the section 965(n) election applies to the taxpayer's NOL amount in its entirety (i.e., no partial elections are permitted) and applies to all NOLs of a consolidated group.

²⁰³ Prop. Reg. § 1.965-7(c)(3). On October 8, 2018, the Service issued a special update for the FAQs notifying taxpayers of upcoming guidance for transfer agreements entered pursuant to Proposed Regulations section 1.965-7(c). The special updated provides that that transfer agreements filed in accordance with such future guidance will be considered timely filed, notwithstanding that the Proposed Regulations have an October 9, 2018, due date for transfer agreements.

²⁰⁴ Preamble, Proposed Regulations, 83 Fed. Reg. 39534 (2018).

²⁰⁵ Prop. Reg. § 1.965-7(c)(2)(ii).

²⁰⁶ Prop. Reg. § 1.965-7(d).

²⁰⁷ Prop. Reg. § 1.965-7(d)(3)(ii).

²⁰⁸ Prop. Reg. § 1.965-7(e).

²⁰⁹ Preamble, Proposed Regulations, 83 Fed. Reg. 39535 (2018).

Elections must be made by the due date of the relevant return (including extensions).²¹⁰ No relief is available under Regulation sections 301.9100-2 or 301.9100-3.

e) Election to use Alternative Method for Calculation of Post-1986 E&P

Generally, the Proposed Regulations follow section 3.02 of Notice 2018-13. However, a comment requested that individuals be allowed to pro-rate year-end numbers in order to determine post-1986 E&P as of November 2, 2017. Treasury and the Service declined to adopt this comment because it would allow taxpayers to determine their E&P as of a single date rather than two measurement dates as intended under section 965.²¹¹

7. Proposed Regulation Section 1.965-8 – Affiliated Groups, including Consolidated Groups

Proposed Regulation section 1.965-8 generally expands on Notice 2013-07 and provides rules for treatment of affiliated and consolidated groups.

Generally, a consolidated group is treated as a single section 958(a) shareholder for purposes of the section 965(b) E&P deficit calculation, as well as section 965(k) and the elections under section 965(h) and (n).²¹² However, each member must calculate its own section 965(a) inclusion, foreign income taxes deemed paid, and any other purpose other than one specifically listed in the regulations.²¹³ A section 965(c) deduction must also be calculated on a separate entity basis. For consolidated group purposes, aggregate foreign cash position is determined by multiplying the separate entity's section 965(a) inclusion by the group cash ratio of the consolidated group; however, as noted previously, each member that is a section 958(a) U.S. shareholder determines on a separate entity basis which accounts payable, accounts receivable, short-term obligations and derivative financial instruments are to be disregarded in determining its aggregate foreign cash position.²¹⁴

Proposed Regulation section 1.965-8(b) provides computational rules under section 965(b)(5). Section 965(b)(5) allows an affiliated but non-consolidated member

²¹⁰ Prop. Reg. § 1.965-7(b)(2)(ii).

²¹¹ Preamble, Proposed Regulations, 83 Fed. Reg. 39535-36 (2018).

²¹² Prop. Reg. § 1.965-8(e)(1). Accordingly, an agent of the group must make one election on behalf of all members of the consolidated group. An agent for this purpose is defined under Regulation section 1.1502-77. Furthermore, in determining whether an asset transfer to a non-member has created an accelerating event, all assets of the consolidated group and each member are considered and appropriate adjustments should be made to prevent duplication of value or assets.

²¹³ Prop. Reg. § 1.965-8(e)(2).

²¹⁴ Prop. Reg. § 1.965-8(e)(3). The group cash ratio is the ratio of the consolidated group aggregate foreign cash position to the total sum section 965(a) inclusion of all consolidated group members. Prop. Reg. § 1.965-8(f)(8).

that has a net section 965(a) inclusion amount to reduce its section 965(a) inclusion amount by its applicable share of the unused E&P deficit of an affiliated group.²¹⁵

Proposed Regulation section 1.965-8(c) provides record-keeping requirements for those affiliated members with net E&P deficits. The Proposed Regulations require such members to maintain in books and records a statement indicating the portion of E&P deficit used under section 965(b)(5).²¹⁶

In general, a “two-step” process applies for determining whether unused aggregate foreign E&P deficits of affiliated group members can be used to offset section 965(a) inclusion amounts of other members.²¹⁷ First, each section 958(a) U.S. shareholder determines its section 965(a) inclusion amount under the general rules, taking into account any aggregate foreign E&P deficits in its ownership chain.²¹⁸ Following this first step, certain affiliated group members may have positive section 965(a) inclusion amounts (an “E&P net surplus shareholder”)²¹⁹ and certain other members may have no section 965(a) inclusion amount because the aggregate foreign E&P deficits in its section 958(a) ownership chain exceed the accumulated post-1986 deferred foreign income of its DFICs (an “E&P net deficit shareholder”).²²⁰ Second, each E&P net surplus shareholder reduces its section 965(a) inclusion amount by its applicable share of the affiliated group’s aggregate unused E&P deficit, which is the sum of the excess deficits of all E&P net deficit shareholders of the affiliated group.²²¹ If a section 958(a) U.S. shareholder is a member of a consolidated group, all section 958(a) U.S. shareholders that are members of that group are treated as a single section 958(a) shareholder for purpose of allocating the group’s aggregate foreign E&P deficit.²²²

8. Proposed Regulation Section 1.965-9 – Applicability Dates

The Proposed Regulations are generally effective for the last tax year of a foreign corporation beginning before January 1, 2018, and to the tax years of U.S. persons in

²¹⁵ A consolidated group is treated as a single shareholder where it is part of a larger affiliated group. Prop. Reg. § 1.965-8(c)(2).

²¹⁶ Prop. Reg. § 1.965-8(c)(1).

²¹⁷ I.R.C. § 965(b)(5); Prop. Reg. § 1.965-8(b).

²¹⁸ I.R.C. § 965(b)(1), (2); Prop. Reg. § 1.965-1(b)(2).

²¹⁹ I.R.C. § 965(b)(5)(B); Prop. Reg. § 1.965-8(f)(6).

²²⁰ I.R.C. § 965(b)(5)(C); Prop. Reg. § 1.965-8(f)(5).

²²¹ I.R.C. § 965(b)(5)(D); Prop. Reg. § 1.965-8(f)(1). To the extent the aggregate unused E&P deficit exceeds the aggregate of the section 965(a) inclusion amounts of all of the affiliated group’s E&P net surplus shareholders, each affiliated group member that is an E&P net deficit shareholder must designate the portion of its deficit taken into account in the allocation of the group’s excess aggregate unused E&P deficit. *See also* Prop. Reg. § 1.965-8(c) (describing designation procedure).

²²² Prop. Reg. § 1.965-1(b)(2), (DFIC earnings amount reduced by allocable share of the section 958(a) U.S. shareholder’s aggregate foreign E&P deficit); Prop. Reg. § 1.965-8(e)(1) (treating all section 958(a) shareholders that are members of a consolidated group as a single section 958(a) shareholder for purposes of § 1.965-1(b)(2)). It is our understanding that, before the issuance of the Proposed Regulations, many taxpayers had assumed that the aggregate unused E&P deficit scheme of section 965(b)(5) would apply equally to consolidated groups.

which or with which the tax year of the foreign corporation ends. However, Proposed Regulation section 1.965-4 applies regardless of whether a transaction, effective date of method of accounting change or entity classification election, or specified payment as described in Proposed Regulation section 1.965-4, occurred earlier.

9. Other Proposed Regulations

a) Proposed Regulation section 1.986(c)-1 – Coordination with Section 965

Proposed Regulation section 1.986(c)-1 provides that foreign currency gain or loss on distributions of section 965(a) previously taxed amounts will be determined based on the movements in the exchange rate between December 31, 2017, and the date on the which the previously taxed earnings are actually distributed, consistent with Notice 2018-13, Section 3.05(b). This rule does not apply to distributions of section 965(b) previously taxed amounts.²²³ Any gain or loss is reduced in proportion by the applicable section 965(c) deduction.²²⁴

b) Proposed Regulations Sections 1.962-1(b) and 1.962-2(a) – Coordination with Section 965

Proposed Regulations sections 1.962-1(b) and 1.962-2(a) provide rules consistent with Notice 2018-26, section 5, regarding elections under section 962. Proposed Regulations section 1.962-1(b)(1)(i)(A) defines the term “taxable income” to allow the section 965(c) deduction to be taken against the tax imposed on the electing individual shareholder under section 11; the electing individual’s section 11 liability cannot be reduced by any other amounts or deductions. The section 965(c) deduction cannot then be deducted again at the individual level for purposes of determining the individual’s actual taxable income.²²⁵

Proposed Regulations section 1.962-2(a) clarifies that the section 962 election may be made by an individual who is a U.S. shareholder and who by reason of section 958(b) owns stock in a DFIC through a domestic passthrough entity within the meaning of Proposed Regulations section 1.965-1(f)(19). This means that a U.S. person who is a partner in a domestic partnership and owns ten percent or more of a CFC through the partnership may make the section 962 election; the partnership does not make the election.

²²³ Prop. Reg. § 1.986(c)-1(c).

²²⁴ Prop. Reg. § 1.986(c)-1(b).

²²⁵ Prop. Reg. § 1.965-3(e)(1).

C. Comments Regarding the Treatment of Certain Passthrough Entities and Individuals

1. Impact on Partnerships and Partners

a) Controlled Partnerships

The Proposed Regulations provide a special rule that expands upon the reference in Notice 2018-26²²⁶ to Notice 2010-41²²⁷ and, if certain conditions are satisfied, treats a CDP described in Proposed Regulation section 1.965-1(e)(2) as a foreign partnership for purposes of the Proposed Regulations. In general, if a CDP is treated as a foreign partnership, it is not a U.S. shareholder of any SFC and its (direct and indirect) U.S. partners may be section 958(a) U.S. shareholders with respect to an SFC held by the partnership.

Included in the conditions that must be satisfied to treat a CDP as a foreign partnership is a requirement that “[i]f the controlled domestic partnership (and all other controlled domestic partnerships in the chain of ownership of the specified foreign corporation) were treated as foreign—”

(B) At least one United States shareholder of the specified foreign corporation—

(1) Would be treated as a section 958(a) U.S. shareholder of the specified foreign corporation; and

(2) Would be treated as owning (within the meaning of section 958(a)) tested section 958(a) stock of the specified foreign corporation through another foreign corporation that is a direct or indirect partner in the CDP.²²⁸

The definition of CDP provides, in part:

For purposes of paragraph (e)(1) of this section, the term CDP means, with respect to a United States shareholder described in paragraph (e)(1)(ii)(B) of this section, a domestic partnership that is controlled by the United States shareholder and persons related to the United States shareholder.²²⁹

Defining the term CDP “with respect to a United States shareholder described in... Proposed Regulation section 1.965-1(e)(1)(ii)(B)...” raises the question as to whether a domestic partnership is treated as a CDP with respect to all of its partners or solely with respect to the U.S. shareholder described in Proposed Regulation section 1.965-1(e)(1)(ii)(B). It appears the intent of the rule is to treat a CDP that satisfies all of the conditions in Proposed Regulation section 1.965-1(e)(1)(i) and (ii) as a foreign partnership with respect to all partners of the partnership “for purposes of determining the section 958(a) U.S. shareholder of a specified foreign corporation and the section 958(a) stock of the specified foreign corporation owned by the section 958(a) U.S. shareholder.” Treating a CDP as a foreign partnership with respect to all of its partners (i.e., on an

²²⁶ 2018-16 I.R.B. 480.

²²⁷ 2010-1 C.B. 715.

²²⁸ Prop. Reg. § 1.965-1(e)(1)(ii).

²²⁹ Prop. Reg. § 1.965-1(e)(2).

entity basis) is also consistent with Notice 2010-41 and the announcement in Notice 2018-26 that Treasury and the Service intended to issue Regulations “treating certain domestic partnerships as foreign partnerships for purposes of identifying which United States shareholders are required to include amounts in gross income under section 951(a).”

If a CDP is treated as a foreign partnership with respect to only certain partners (i.e., the U.S. shareholder described in Proposed Regulation section 1.965-1(e)(1)(ii)(B) and related persons) but is respected as a domestic partnership as to other partners, there could be various complexities associated with capital accounts, tax basis, and allocations because the partnership could be a section 958(a) U.S. shareholder with respect to some but not all of its partners. For example, although the capital account and basis consequences are not clear, the partners with respect to whom the partnership is respected as a domestic partnership may increase their capital accounts and their bases in the partnership for their distributive shares of the partnership’s section 965(a) inclusion, while the partners with respect to whom the partnership is treated as foreign may have no corresponding increase to their capital accounts because a foreign partnership may not have a section 965(a) inclusion. These adjustments could cause capital account and basis results that are not consistent with the economic arrangement of the partners and the partnership.

Accordingly, we recommend that the Regulations, when finalized, clarify that a CDP that is treated as a foreign partnership for purposes of the Regulations under section 965 is treated as a foreign partnership with respect to all partners of the partnership (and not solely with respect to the U.S. shareholder described in Proposed Regulation section 1.965-1(e)(1)(ii)(B)).

**b) Specified Basis Adjustments under Proposed
Regulation section 1.965-2(h)(5)**

**(1) Application of Section 743(b) Rules to Specified
Basis Adjustments for Foreign Passthrough Entities**

(a) Section 961 Basis Adjustments

As discussed above, section 961 provides that a U.S. shareholder makes appropriate adjustments to the basis of the stock of a CFC and certain other property to account for the amount required to be included in the U.S. shareholder’s gross income under section 951(a) (i.e., section 956 and subpart F income). In general, the purpose of these basis adjustments is “to avoid double taxation of the income of a later disposition of the stock of [a CFC]” where the U.S. shareholder previously included subpart F income with respect to the CFC.²³⁰

Sections 961(a) and (b) prescribe basis adjustments that are made to a U.S. shareholder’s stock of a CFC and property of a U.S. shareholder by reason of which the U.S. shareholder is considered under section 958(a)(2) as owning stock of a CFC. In

²³⁰ H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 1997 (July 30, 1997), at 620.

addition, section 961(c) generally provides for basis adjustments similar to the adjustments provided by section 961(a) and (b) to stock of a CFC that is owned by another CFC in a chain of ownership described in section 958(a)(2) with respect to the U.S. shareholder. There is no provision in section 961 for adjusting the basis of stock or other property held by a foreign partnership, and practitioners disagree as to whether a foreign partnership, the outside basis of which is adjusted under section 961(a) and (b), may adjust the basis in stock of a CFC in which the partnership holds stock, although there is widespread agreement that it would, as a tax policy matter, be appropriate to make such adjustments.

(b) Specified Basis Adjustments

The Proposed Regulations provide a general rule for basis adjustments described in Proposed Regulation section 1.965-2(e), (f)(2), or (g)(2) (each a “specified basis adjustment”) with respect to a section 965 inclusion.²³¹ Proposed Regulation section 1.965-2(h)(5)(i) provides that, in general, “a specified basis adjustment is made solely with respect to section 958(a) stock owned by the section 958(a) U.S. shareholder within the meaning of section 958(a)(1)(A) or applicable property²³² owned directly by the section 958(a) U.S. shareholder.”

The Proposed Regulations also provide a special rule that applies specified basis adjustments to section 958(a) stock or applicable property held by a foreign passthrough entity for purposes of determining the foreign passthrough entity’s basis in such property with respect to the section 958(a) U.S. shareholder.²³³

If the applicable property of the section 958(a) U.S. shareholder described in paragraph (h)(5)(i) of this section is an interest in a foreign pass-through entity, then, for purposes of determining the foreign pass-through entity’s basis in section 958(a) stock or applicable property, as applicable, with respect to the section 958(a) U.S. shareholder, a specified basis adjustment is made with respect to section 958(a) stock or applicable property of the section 958(a) U.S. shareholder owned through the foreign pass-through entity in the same manner as if the section 958(a) stock or applicable property were owned directly by the section 958(a) U.S. shareholder. In the case of tiered foreign pass-through entities, this paragraph (h)(5)(ii) applies with respect to each foreign pass-through entity.²³⁴

We believe the purpose and function of the specified basis adjustment rules, similar to section 961, is to avoid double taxation of income when section 958(a) stock or applicable property is disposed or when an SFC makes a distribution. The language

²³¹ Prop. Reg. § 1.965-2(h)(5)(i).

²³² Pursuant to Prop. Reg. § 1.965-2(i)(1), “[t]he term applicable property means, with respect to a section 958(a) U.S. shareholder and a specified foreign corporation, property owned by the section 958(a) U.S. shareholder (including through one or more foreign pass-through entities) by reason of which the section 958(a) U.S. shareholder is considered under section 958(a)(2) as owning section 958(a) stock of the specified foreign corporation.”

²³³ Prop. Reg. § 1.965-2(h)(5)(ii).

²³⁴ *Id.*

“with respect to the section 958(a) U.S. shareholder” seems to give effect to the policy that this basis adjustment should be made solely for the benefit of the section 958(a) U.S. shareholder that has a section 965(a) inclusion by reason of its ownership of the foreign passthrough entity. In light of the purposes of the specified basis adjustment rules, we agree with this policy result.

If the specified basis adjustment of a foreign passthrough entity is not made solely for the benefit of the section 958(a) U.S. shareholder (or an intermediate foreign passthrough entity between the foreign passthrough entity and the section 958(a) U.S. shareholder, as the case may be), there could be double taxation of the income of an SFC that is already included in the income of a section 958(a) U.S. shareholder under section 965 and inappropriate deferral for others.

Example 1 A domestic corporation (USCo) and an unrelated foreign corporation (ForCo) each own 50 percent of the capital and profits of a foreign partnership (FP). FP owns all of the outstanding stock of a foreign corporation (FC). All of the entities have taxable years ending on December 31. Before any basis adjustments are made pursuant to the Proposed Regulations, FP has zero basis in its FC stock. On both Measurement Dates, FC has \$100 of post-1986 deferred foreign income. USCo’s pro rata share of FC’s section 965(a) earnings amount is \$50. On September 1, 2018, FP sells all of its FC stock for \$100.

Analysis On December 31, 2017, USCo makes a specified basis adjustment to its partnership interest in FP in the amount of \$50.²³⁵ In addition, on December 31, 2017, for purposes of determining FP’s basis in the section 958(a) stock of FC with respect to USCo, a specified basis adjustment is made with respect to section 958(a) stock of USCo owned through FP in the amount of \$50 (because USCo would have made a \$50 specified basis adjustment to the FC stock if USCO owned such stock directly).²³⁶

FP recognizes gain on the sale of its FC stock in the amount of \$50 (\$100 amount realized less \$50 basis²³⁷). We believe that, under the Proposed Regulations, FP allocates all \$50 of the gain to FC and none to USCo. This is the same result that would have been reached if USCo had owned the stock of FC directly, the basis adjustments under section 961(a) and Proposed Regulation section 1.965-2(e)(1) would have eliminated all of USCo’s gain on the sale of FC stock. If, on the other hand, FP treats the specified basis adjustment as basis that is common to all partners of the

²³⁵ Prop. Reg. § 1.965-2(e)(1), (h)(1), (h)(5)(i).

²³⁶ Prop. Reg. § 1.965-2(h)(5)(ii).

²³⁷ FP’s stock basis in the FC stock is \$50 as a result of the specified basis adjustment made under Prop. Reg. § 1.965-2(h)(5)(ii).

partnership and allocates \$25 of gain to each of USCo and ForCo, USCo will temporarily suffer double taxation.²³⁸

For these reasons, we recommend that the Regulations, when finalized, clarify that a specified basis adjustment made by a foreign passthrough entity to section 958(a) stock or applicable property is made solely for the benefit of the section 958(a) U.S. shareholder described in Proposed Regulation section 1.965-2(h)(5)(i).²³⁹

(c) Section 743(b) Basis Adjustments

If Treasury and the Service agree with our prior recommendation, we also recommend that the specified basis adjustments made by a foreign partnership be made using the framework of section 743(b). Section 743(b) has an established and well-understood framework for computing and managing basis adjustments that are allocated to property owned by a partnership and that are only with respect to a certain partner. Furthermore, the language in section 743(b) providing that a basis adjustment under section 743(b) “shall constitute an adjustment to the basis of partnership property with respect to the transferee partner only” is similar to language used in Proposed Regulation section 1.965-2(h)(5)(ii), which provides, in part, that a specified basis adjustment is made “with respect to the section 958(a) U.S. shareholder.”

Basis adjustments under section 743(b) are generally made only if there is a sale or exchange of an interest in a partnership.²⁴⁰ Nevertheless, Temporary Regulations under section 367(a) (the “367(a) Temporary Regulations”) adopted section 743(b) as a mechanism to associate basis adjustments with a partner who recognizes gain under section 367(a) (as a result of a partnership’s transfer of property to a foreign corporation) even though there is no actual sale or exchange of an interest in the partnership.²⁴¹

In order to provide a section 743(b) adjustment with respect to a partner that is treated as transferring a proportionate share of the property of a partnership to a foreign corporation, the 367(a) Temporary Regulations provide that (i) the partner’s basis in the partnership is increased by the amount of gain recognized by the partner under section 367(a) and (ii) solely for purposes of determining the basis of the partnership in the stock of the transferee foreign corporation, the partner is treated as having a newly acquired interest in the partnership for an amount equal to the gain recognized.²⁴² Thus, the 367(a)

²³⁸ USCo’s double taxation is temporary because USCo would have the opportunity to recognize an offsetting loss on the liquidation of its interest in FP.

²³⁹ In the case of tiered foreign pass-through entities, the specified basis adjustment made by a lower-tier foreign pass-through entity would be made solely for the benefit of the upper-tier foreign pass-through entity through which the § 958(a) U.S. shareholder owns an indirect interest in the lower-tier foreign pass-through entity.

²⁴⁰ Section 743(b) adjustments may also be made upon the death of a partner.

²⁴¹ T.D. 8087, 1986-1 C.B. 175.

²⁴² Temp. Reg. § 1.367(a)-1T(c)(3)(i)(B) (“If a U.S. person is treated under the rule of this paragraph (c)(3)(i) as having transferred a proportionate share of the property of a partnership in an exchange described in section 367(a), and is therefore required to recognize gain upon the transfer, then (1) [t]he U.S. person's basis in the partnership shall be increased by the amount of gain recognized by him; (2) [s]olely for purposes of determining the basis of the partnership in the stock of the transferee foreign corporation, the U.S. person

Temporary Regulations make an adjustment to the basis of the partner's partnership interest and then allow an adjustment to be made to the basis of partnership property under section 743(b) to account for the difference between the partner's basis in the (newly acquired) partnership interest and the partner's share of the partnership's basis in the stock of the foreign corporation.

(d) Application and Recommendation

The long-standing basis adjustment rules under section 743(b) have provided an administrable method of computing and managing basis adjustments necessitated by section 367(a) in a manner consistent with the purposes of section 367(a) and Subchapter K of the Code. We recommend that the Regulations, when finalized, apply the rules of section 743(b) for purposes of associating a specified basis adjustment made by a foreign passthrough entity with the section 958(a) U.S. shareholder with respect to whom the specified basis adjustment is made.²⁴³ We further recommend that the rules of the Regulations, when finalized, applying section 743(b) for this purpose follow the framework established by Temporary Regulation section 1.367(a)-1T(c)(3)(i)(B).

(2) Reduction of a Foreign Passthrough Entity's Specified Basis Adjustment for Distributions

As discussed above, the specified basis adjustment rules generally prescribe special rules for the application of section 961 for purposes of section 965. By providing for specified basis adjustments to be made by foreign passthrough entities "in the same manner as if the section 958(a) stock or applicable property were owned directly by the section 958(a) U.S. shareholder," the Proposed Regulations effectively apply the rules of section 961(a), for purposes of section 965, to adjust the basis of property held by a foreign passthrough entity.

Any increase in basis made by section 961(a) is generally subject to a decrease in basis under section 961(b)(1). However, the only specified basis adjustment that reduces the basis of section 958(a) stock and applicable property with respect to a distribution by an SFC in the Proposed Regulations is the decrease to basis that occurs as a result of a distribution, during the inclusion year, to which the gain reduction rule applies.²⁴⁴ In order to maintain the alignment between basis adjustments made under section 961(a) and the specified basis adjustments under Proposed Regulation section 1.965-2(h)(5), we recommend that the Regulations, when finalized, clarify that specified basis adjustments

shall be treated as having newly acquired an interest in the partnership (for an amount equal to the gain recognized), permitting the partnership to make an optional adjustment to basis pursuant to sections 743 and 754; and (3) [t]he transferee foreign corporation's basis in the property acquired from the partnership shall be increased by the amount of gain recognized by U.S. persons under this paragraph (c)(3)(i).").

²⁴³ If the section 958(a) U.S. shareholder owns the foreign pass-through entity indirectly through another foreign pass-through entity (an "upper-tier foreign pass-through entity"), section 743(b) and the principles of Temp. Reg. § 1.367(a)-1T(c)(3)(i)(B) should apply to associate the specified basis adjustment of a foreign pass-through entity with the upper-tier foreign pass-through entity that owns an interest in the foreign pass-through entity.

²⁴⁴ Prop. Reg. § 1.965-2(g)(2).

made by a foreign passthrough entity are subject to reduction for distributions made by an SFC under the rules of section 961(b)(1) in the same manner as if the section 958(a) stock or applicable property were owned directly by the section 958(a) U.S. shareholder.²⁴⁵

(3) Basis Adjustments for Domestic Partnerships

A domestic partnership (other than a CDP that is treated as a foreign partnership for purposes of the Proposed Regulations) that owns ten percent or more of the voting stock of the CFC is a section 958(a) U.S. shareholder that recognizes a section 965(a) inclusion and a section 965(c) deduction and allocates that inclusion and deduction among its partners in accordance with section 704(b) (i.e., without regard to whether such partners are domestic or foreign).²⁴⁶ In the case of a domestic partnership, the Proposed Regulations prescribe certain basis adjustments that are made to (1) the partners' interests in the partnership²⁴⁷ and (2) property held by the partnership.²⁴⁸

Specifically, Proposed Regulation section 1.965-3(f)(2) provides rules for adjusting the basis of a partner's interest in a domestic partnership under section 705(a) with respect to the partner's share of the partnership's section 965(a) inclusion and section 965(c) deduction. We believe the basis adjustment rules in Proposed Regulation section 1.965-3(f)(2) appropriately provide for basis adjustments under section 705(a) with respect to each partner of a domestic partnership that receives an allocation of a section 965(a) inclusion and a section 965(c) deduction from the domestic partnership.

The Proposed Regulations also provide rules for adjusting the basis of (1) a domestic partnership's basis in section 958(a) stock or applicable property owned directly by the domestic partnership²⁴⁹ and (2) a foreign partnership's basis in section 958(a) stock or applicable property owned directly by the foreign partnership.²⁵⁰

Thus, the Proposed Regulations provide for both inside and outside basis adjustments for both foreign and domestic partnerships. It is not entirely clear, however, whether the Proposed Regulations provide for both adjustments for CDPs. As noted earlier, the Proposed Regulations provide that certain domestic partnerships (i.e., CDPs) are treated as foreign partnerships for certain purposes:

For purposes of the section 965 regulations, a controlled domestic partnership is treated as a foreign partnership for purposes of determining the section 958(a) U.S. shareholder of a specified foreign corporation and the section 958(a) stock

²⁴⁵ Notwithstanding the recommendation to apply section 961(b)(1) to specified basis adjustments made by foreign pass-through entities, we believe it is appropriate that section 961(b)(2) does not apply to distributions made to foreign pass-through entities because (1) Prop. Reg. § 1.961-2(h)(3) already provides an appropriate gain recognition rule with respect to specified basis adjustments, and (2) a foreign pass-through entity is not a U.S. shareholder with respect to whom a distribution is excluded from gross income pursuant to section 959(a).

²⁴⁶ See e.g., I.R.C. §§ 951(b), 7701(a)(30); See Prop. Reg. § 1.965-1(f)(33).

²⁴⁷ Prop. Reg. § 1.965-3(f)(2).

²⁴⁸ Prop. Reg. § 1.965-2(h)(5)(i).

²⁴⁹ Id.

²⁵⁰ Prop. Reg. § 1.965-2(h)(5)(ii).

of the specified foreign corporation owned by the section 958(a) U.S. shareholder if [certain] conditions are satisfied.²⁵¹

Further, with respect to a CDP that is treated as a foreign partnership, a person that is treated as a section 958(a) U.S. shareholder is subject to the specified basis adjustment rules under Proposed Regulation section 1.965-2(h)(5)(i) (with respect to section 958(a) stock or applicable property held by such shareholder).²⁵²

Nevertheless, while the CDP rule applies for “purposes of the section 965 regulations” and for “purposes of determining the section 958(a) U.S. shareholder...the section 958(a) stock,” it is not clear that a domestic partnership that is treated as a foreign partnership for such purposes is treated as a foreign partnership within the meaning of Proposed Regulation section 1.965-2(i)(2) (which defines the term “foreign passthrough entity” for purposes of the specified basis adjustment rules). If a CDP that is treated as a foreign partnership is not subject to the specified basis adjustment rules for a foreign passthrough entity under Proposed Regulation section 1.965-2(h)(5)(ii), then there exists the potential for double taxation of foreign earnings because the section 958(a) U.S. shareholder’s basis in the partnership interest of the CDP will be increased pursuant to Proposed Regulation section 1.965-2(h)(5)(i) but there will be no corresponding increase to the basis of the section 958(a) stock (or applicable property) held by the CDP (as may be the case with foreign partnerships today with respect to subpart F inclusions). We believe a purpose of the special specified basis adjustment rules for foreign passthrough entities is to prevent the potential for such double taxation. Consistent with that purpose, we recommend that the Regulations, when finalized, clarify that a CDP that is treated as a foreign partnership pursuant to Proposed Regulation section 1.965-1(e)(1) is also treated as a foreign passthrough entity for purposes of the specified basis adjustment rules under Proposed Regulation section 1.965-2(h)(5)(ii).

**c) Downward Attribution in the Case of Small Partners
and Modification of Examples to Avoid Sideways Attribution**

The term SFC includes any foreign corporation in which a U.S. corporation is a U.S. shareholder.²⁵³ Section 318(a)(3)(A) provides for downward attribution of stock owned by a partner to its partnership and section 318(a)(2)(A), in conjunction with section 318(a)(5)(C), provides for attribution of that stock to other partners in that partnership. These attribution rules are taken into account in determining whether a foreign corporation is an SFC under section 965(e)(1)(B). However, Proposed Regulation section 1.965-1(f)(45)(ii) provides that solely for purposes of determining whether a foreign corporation is an SFC within the meaning of section 965(e)(1)(B) and

²⁵¹ Prop. Reg. § 1.965-1(e)(1) (emphasis added).

²⁵² See Prop. Reg. § 1.965-1(e)(1) (“a controlled domestic partnership is treated as a foreign partnership for purposes of determining the section 958(a) U.S. shareholder of a specified foreign corporation and the section 958(a) stock of the specified foreign corporation owned by the section 958(a) U.S. shareholder”); See Prop. Reg. § 1.965-2(h)(5)(i) (“a specified basis adjustment is made solely with respect to section 958(a) stock owned by the section 958(a) U.S. shareholder within the meaning of section 958(a)(1)(A) or applicable property owned directly by the section 958(a) U.S. shareholder”).

²⁵³ I.R.C. § 965(e)(1); Prop. Reg. § 1.965-1(f)(45).

Proposed Regulation section 1.965-1(f)(45)(i)(B), stock owned, directly or indirectly, by or for a partner will not be considered as being owned by a partnership under sections 958(b) and 318(a)(3)(A) and Regulation section 1.958-2(d)(1)(i) if the partner owns less than five percent of the interests in the partnership's capital and profits.

We commend Treasury and the Service for recognizing the administrative difficulties of applying downward attribution in the case of partners with small interests for this purpose. We recommend, however, that a distinction be made regarding partners that are capable of controlling or managing a partnership and those who are not. Partners who cannot manage or control the partnership may have difficulty accessing the information necessary to comply with the attribution rules. More importantly, partnerships may have difficulty collecting the information from those partners necessary for the partnership to comply with the attribution rules. Thus, we recommend that the five percent threshold apply in the case of general partners, partners active in the management of the partnership, or partners with control and information rights that would give them access to the information required to analyze constructive ownership under sections 318 and 958(b), but that in the case of other partners, a fifteen percent threshold would be appropriate. Such a threshold would increase the likelihood of there being a sufficient relationship between the partner and the partnership that the requisite information sharing necessary for compliance with these rules occurs.

We also recommend that Treasury modify examples 1 and 2 of Proposed Regulation section 1.965-1(g) so that while downward attribution of stock from a partner to a partnership is “turned off” when the partner owns less than the requisite interest in the partnership (the “special attribution rule of Proposed Regulation section 1.965-1(f)(45)(ii)”), it is done in a manner that is not contrary to the statutory prohibition on “sideways” attribution set forth in section 318(a)(5)(C). Currently, those examples apply the special attribution rule in a manner that is inconsistent with the anti-retribution rule in section 318(a)(5)(C) and existing IRS guidance.²⁵⁴

In example 1, A, an individual, owns 100 percent of the stock of a domestic corporation, DC, and one percent of the interests in a partnership, PS. A United States citizen, USI, owns 10 percent of the interests in PS and 10 percent by vote and value of the stock of a foreign corporation, FC. The remaining 90 percent by vote and value of the stock of FC is owned by non-United States persons that are unrelated to A, USI, DC, and PS.

The analysis in example 1 of Proposed Regulation section 1.965-1(g) provides, in part, that “absent the special attribution rule in [Proposed Regulation section 1.965-1(f)(45)(ii)], PS would be treated as owning 100 percent of the stock of DC and 10 percent of the stock of FC” and, “under sections 958(b), 318(a)(5)(A), and 318(a)(3)(C), and section 1.958-2(f)(1)(i) and (d)(1)(iii), DC would be treated as owning the stock of FC treated as owned by PS.”

Section 318(a)(5)(C) provides that “[s]tock constructively owned by a partnership, estate, trust, or corporation by reason of the application of paragraph (3) shall not be considered as owned by it for purposes of applying paragraph (2) in order to make

²⁵⁴ LTR 200637022 (Sept. 15, 2006).

another the constructive owner of such stock".²⁵⁵ This provision and the IRS guidance interpreting it allow for reattribution of stock deemed owned through downward attribution, but do not permit such stock to be reattributed through upward reattribution or through other means that result in sideways attribution or overlapping ownership attribution. Thus, PS may not attribute the shares of DC or FC upstream.²⁵⁶ Consequently, we recommend that Treasury modify examples 1 and 2 of Proposed Regulation section 1.965-1(g) by having PS own directly, and not through attribution, the shares of DC or to otherwise modify the example to eliminate the impermissible attribution to avoid a conflict between the examples and section 318(a)(5)(C).

We recommend that the facts and analysis of example 1, as modified, generally provide:

- PS, a partnership, owns 100 percent of the stock of a domestic corporation, DC. A United States citizen, USI, owns four percent of the capital and profits interests in PS and 10 percent by vote and value of the stock of a foreign corporation FC. The remaining 90 percent by vote and value of the stock of FC is owned by non-United States persons that are unrelated to USI, DC, and PS.
- Absent the special attribution rule under Proposed Regulation section 1.965-1(f)(45)(ii), PS would be treated as owning 10 percent of the stock of FC under sections 958(b) and 318(a)(3)(A) and Regulation section 1.958-2(d)(1)(i). As a result, under sections 958(b), 318(a)(5)(A), and 318(a)(3)(C), and Regulation section 1.958-2(f)(1)(i) and (d)(1)(iii), DC would be treated as owning the stock of FC treated as owned by PS, and thus DC would be a U.S. shareholder with respect to FC within the meaning of section 951(b), causing FC to be an SFC within the meaning of Proposed Regulation section 1.965-1(f)(45).
- However, under the special attribution rule, solely for purposes of determining whether a foreign corporation is an SFC, the stock of FC owned by USI is not treated as owned by PS because USI owns less than five percent of the interests in PS's capital and profits. Accordingly, FC is not an SPC within the meaning of Proposed Regulation section 1.965-1(f)(45).

d) Foreign Cash Position Through Partnerships

The conference report for the Act²⁵⁷ (the "Conference Report") indicates that special rules should be applied to determine a U.S. shareholder's cash position

²⁵⁵ Emphasis added.

²⁵⁶ If PS attributes the shares of DC or FC upstream, it appears the effect would be to cause attribution when "there is no basis either in family relationship or in common economic interest for the application of" the reattribution rule. See H.R. Conf. Rep. No. 1844, 88th Cong., 2d Sess., 1964-2 C.B. 706.

²⁵⁷ H.R. Rep. No. 115-466 (Dec. 15, 2017).

attributable to cash of a partnership. Specifically, the conference report noted the following:

The conference agreement also provides that the cash position of a U.S. shareholder does not generally include the cash attributable to a direct ownership interest in a partnership, but preserves the rule that cash positions of certain noncorporate foreign entities owned by a specified foreign corporation are taken into account if such entities would be specified foreign corporations with respect to the U.S. shareholder if the entity were a foreign corporation. For example, if a U.S. shareholder owns a five-percent interest in a partnership, the balance of which is held by a specified foreign corporation with respect to which such shareholder is a U.S. shareholder, the partnership is treated as a specified foreign corporation with respect to the U.S. shareholder, and the cash or cash equivalents held by the partnership are includible in the aggregate cash position of the U.S. shareholder on a look-through basis. The conferees anticipate that the Secretary will provide guidance for taking into account only the specified foreign corporation's share of the partnership's cash position, and not the five-percent interest directly owned by the U.S. shareholder.²⁵⁸

Consistent with the Conference Report, we recommend that the final regulations provide that that the SFC must (1) take into account an SFC's share of the cash position of a partnership in which the SFC is partner, and (2) not take into account the cash position of a partnership to the extent the partnership is held directly by a U.S. shareholder or another person that is not an SFC.

e) Coordination with the Section 965 Q&A on IRS.gov

The Preamble to the Proposed Regulations helpfully directs taxpayers to the Questions and Answers about Reporting Related to Section 965 on 2017 Tax Returns available on the Service's website (the "Section 965 Q&A") for instructions on "how and when to properly report section 965-related amounts and file returns reporting such amounts" for the 2017 tax year.²⁵⁹ There are, however, a few provisions of the Proposed Regulations that we believe could be better coordinated with the contents of the Section 965 Q&A.

As noted earlier, the Proposed Regulations provide that relief is not available under Regulation section 301.9100-2 or 301.9100-3 to make a late election under section 965(h), (i), (m), and (n) (each a "Section 965 Election").

Given the approaching tax return deadlines for many taxpayers with respect to the inclusion year and the denial of late election relief by the Proposed Regulations, we recommend that Treasury and the Service clarify the requirements for statements that must be attached to a taxpayer's return for the inclusion year by:

²⁵⁸ *Id.* at 621.

²⁵⁹ Preamble, Proposed Regulations 83 Fed. Ref. 39537 (2018)

1. Providing in the final regulations or the preamble to the final regulations that the Section 965 Q&A constitutes “other guidance” within the meaning of Proposed Regulation section 1.965-7(b)(2)(iii), (c)(2)(iii), (d)(3)(iii), and (e)(2)(iii) (such that good faith completion of the templates for the Section 965 Election statements provided by the Section 965 Q&A represents full compliance with the requirements of the Regulations);
2. Updating the Section 965 Election statement templates on the Section 965 Q&A to include a section for the taxpayer to sign the statement under penalties of perjury; or
3. Removing from the final regulations the requirement that each statement on which a taxpayer makes a Section 965 Election must be signed under penalties of perjury.

f) Interaction with Section 1411

Proposed Regulation section 1.965-1(d) provides that an SFC described in section 965(e)(1)(B) and Proposed Regulation section 1.965-1(f)(45)(i)(B) that is not otherwise a CFC is treated as a CFC for, among other things, purposes of Regulation section 1.1411-10. Regulation section 1.1411-10 addresses the application of the net investment income tax (the “NIIT”) to shareholders of CFCs, by providing that gross income inclusions for subpart F income and CFC earnings invested in U.S. property “are not treated as dividends” under the income tax rules.²⁶⁰

As such, amounts includible pursuant to section 951(a) (either as subpart F income, investments in U.S. property, or GILTI) are not subject to the NIIT imposed under section 1411 until those amounts are actually distributed.²⁶¹ Proposed Regulation section 1.965-3(f)(3) provides that an SFC that is not otherwise a CFC is treated as a CFC for purposes of sections 965(b), 951, 961 and Regulation section 1.1411-10.

On the one hand, Proposed Regulation section 1.965-7(b)(3)(ii)(D) states that any event that results in a person no longer being a U.S. person (which includes a resident alien becoming a nonresident alien) is an acceleration event triggering any payments otherwise deferred under a properly executed section 965(h) election. On the other hand, however, Regulation section 1.1411-2(a)(1) explicitly excludes nonresident aliens from the purview of the section 1411 NIIT.

The regulations under section 1411 could be interpreted as implying that no NIIT is due under section 1411 with respect to section 965(a) income even when an acceleration of the section 965(h) net tax liability arises from a resident alien becoming a nonresident alien. In light of this possible interpretation, we suggest that Treasury and the Service clarify the interaction of the NIIT rules with those under section 965, as they apply to persons that cease to be U.S. tax residents after incurring the section 965 tax liability.

²⁶⁰ Reg. § 1.1411-10.

²⁶¹ See Reg. § 1.1411-10(c).

2. Impact on Individual U.S. Shareholders

a) Changes in Method of Accounting

The Proposed Regulations provide that any change in the method of accounting by U.S. shareholders with respect to an SFC will be disregarded if the change results in reduction of a section 965 element.²⁶² The Proposed Regulations go further than announced in Notice 2018-26, as they apply to any reduction of a section 965 element.²⁶³

We agree it is appropriate for the Proposed Regulations to disregard changes from calendar year end SFCs to fiscal year end SFCs, because those changes would defer the payment of section 965 liability. Changing the SFC's method of accounting from fiscal year-end to a calendar year-end, however, would accelerate the section 965 liability; and, while possibly reducing a section 965 element, should not be treated as an abusive transaction, even if the change of method of accounting has been requested by the SFC after November 2, 2017.

The change from being a fiscal year end SFC to a calendar year end SFC may be primarily requested for reducing administrative burden on taxpayers whose exercise in calculating the section 965 liability may be challenging and burdensome. This may be especially true for those individual U.S. shareholders who are required to calculate the section 965 liability because of the existence of a domestic corporate U.S. shareholder. We, therefore, recommend allowing the changes of method of accounting from fiscal year end SFC to a calendar year end SFC.

b) Section 962 Election Revocation

The Proposed Regulations, consistent with the Code, provide that amounts included in gross income under section 951(a) by an individual who makes a section 962 election are treated as if they were received by a domestic corporation for purposes of section 960.²⁶⁴

The section 962 election cannot be revoked for the year without the Commissioner's consent.²⁶⁵ The Service will not consent unless a "material and substantial change in circumstances occurs which could not have been anticipated when the election was made."²⁶⁶ The Proposed Regulations do not provide any guidance on whether individual U.S. shareholders would be allowed to revoke their section 962 election immediately after the year of section 965 inclusion. This may present significant burdens for the individual U.S. shareholders, even if the section 962 election might otherwise be beneficial for other purposes of the Act (for example, GILTI provisions).

²⁶² Prop. Reg. §1.965-4(c)(1).

²⁶³ Cf. Notice 2018-26, Section III.04(b).

²⁶⁴ Preamble, Proposed Regulations, 83 Fed. Reg. 39521 (2018).

²⁶⁵ I.R.C. §962(b). *See also* Reg. §1.962-2(b), (c) on the manner for making the election and circumstances under which it can be revoked.

²⁶⁶ Reg. §1.962-2(c)(2).

The Conference Report provides that “individual U.S. shareholders, and the investors in U.S. shareholders that are pass-through entities, generally can elect application of corporate rates for the year of inclusion.”²⁶⁷ This language seems to suggest that Congress saw this election as a one-time election to address, among other potential areas of concern, the rates at which individual taxpayers paid tax on section 965 inclusions. Accordingly, we believe that granting individual U.S. shareholders who make the section 962 election the ability to revoke the election after the year of the section 965 inclusion is consistent with Congressional intent.

D. Comments Regarding Deficits, Basis Adjustments, and Gain

Reduction Rule

1. Deficits

a) Reduction of Section 959(c)(3) Deficit by PTI in Defining E&P Deficit Foreign Corporation

Like section 3.01 of Notice 2018-13, the Proposed Regulations provide that a deficit in post-1986 E&P exists only if the deficit exceeds the aggregate of the SFC’s post-1986 E&P described in section 959(c)(1) and (c)(2), or, in other words, its PTI.²⁶⁸ As discussed in the Preamble, under the statute, post-1986 E&P is not reduced by PTI whereas accumulated post-1986 deferred foreign income is reduced by PTI.²⁶⁹ If these rules were applied literally, taxpayers would be able to use a deficit in one company to offset the deferred foreign income in another company if the deficit company has PTI. For example, assume that SFC1 has a deficit in post-1986 E&P of 50 and it has a section 959(c)(2) account of 50. Further assume that SFC2 has post-1986 deferred foreign income of 100. Under a literal reading of the definitions, the 50 of deficit in SFC1 is effectively absorbed by the 50 in PTI and is not available to offset the income in SFC2.²⁷⁰

A literal application of these rules would increase the likelihood of a CFC having both PTI and a deficit in section 959(c)(3) E&P,²⁷¹ which raises the question of whether PTI can be distributed from a CFC having such a deficit.²⁷² Most importantly, offsetting a “taxable deficit” against PTI essentially eliminates the benefit of section 965(b), which we believe was intended to permit deficits to offset otherwise deferred earnings subject to

²⁶⁷ H.R. Rep. No. 115-466, at 620 (2017).

²⁶⁸ Prop. Reg. § 1.965-1(f)(22)(ii).

²⁶⁹ Compare I.R.C. § 965(d)(2) (defining accumulated post-1986 deferred foreign income) with § 965(d)(3) (defining post-1986 E&P).

²⁷⁰ See Prop. Reg. § 1.965-1(g), example 5, for another illustration of the rule.

²⁷¹ Cf. Prop. Reg. § 1.959-3(e)(5) (deficits in section 959(c)(3) E&P do not reduce or otherwise affect PTI).

²⁷² In addition, for those U.S. shareholders that take the position that PTI can be distributed from an SFC having a deficit in section 959(c)(3) E&P, a literal application of the rules would lead to an increase in the available deficits if such shareholders had the foresight to make distributions of PTI prior to November 2, 2017.

the transition tax.²⁷³ Consequently, there appears to be a conflict between the congressionally-provided benefit of section 965(b) and a strict technical reading of the definition of E&P. We recommend that Treasury reconsider this portion of the Proposed Regulations and provide a rule in the final regulations that permits the full amount of the deficit to be available to reduce a section 965(a) inclusion as Congress intended. We recognize that Treasury and the Service may feel that a technical correction is required to adopt such a position, and, if so, would recommend that the issue be addressed in the preamble to the final regulations.

2. Basis Adjustment Rules

a) Basis Adjustment May Provide No Actual Benefit

The Proposed Regulations generally provide that no adjustments to the basis of stock or other applicable property with respect to a DFIC are made under section 961 or otherwise to take into account the reduction in a section 958(a) U.S. shareholder's pro rata share of a DFIC's section 965(a) earnings amount by an allocable share of the shareholder's aggregate foreign E&P deficit.²⁷⁴ A section 958(a) U.S. shareholder, however, may elect to adjust the basis of each DFIC and each E&P deficit foreign corporation in accordance with the Proposed Regulations.²⁷⁵ The basis adjustment rules, however, may actually provide no appreciable benefit when the DFIC and E&P deficit foreign corporations are located in the same ownership chain.²⁷⁶ Although this situation may not pose any concern if the relevant deficits were equity funded at the top of the chain (as sufficient basis would then exist apart from the section 965 allocation scheme), a distribution of section 965(b) PTI could result in fully taxable income (taxable at the 21% rate for C corporations) if the offsetting deficits were not fully equity funded at the first-tier level (e.g., they were debt funded).²⁷⁷ In such a case, section 965(b) PTI may be taxed immediately if the section 958(a) U.S. shareholder has made a basis adjustment election pursuant to Proposed Regulation 1.965-2(f)(2) because there may be insufficient basis in the deficit chain to absorb the downward basis adjustment to the stock or other applicable property in respect of an E&P deficit foreign corporation.²⁷⁸ Further, if no

²⁷³ See H.R. Rep. No. 115-466, at 618 (2017) (indicating that deferred earnings subject to the transition tax are reduced by the shareholder's share of deficits from an SFC).

²⁷⁴ Prop. Reg. § 1.965-2(f)(1). In contrast, basis adjustments are made to reflect the applicable section 965 inclusion amount in respect of the DFIC. Prop. Reg. § 1.965-2(e).

²⁷⁵ Prop. Reg. § 1.965-2(f)(2)(i) (election), (ii) (basis adjustments).

²⁷⁶ As Treasury recognized in the preamble to the proposed regulations on global intangible low-taxed income, when adjustments are made in the same ownership chain, no net benefit arises because the basis increase is offset by an equal amount of basis decrease. Notice of Proposed Rulemaking, *Guidance Relating to Section 951A (Global Intangible Low-Taxed Income)*, 83 Fed. Reg. 51072, 51081 (2018) (No basis adjustments required when tested loss offsets tested income in the same section 958(a)(2) ownership chain because there is no duplicative loss to the extent the shares of both the tested loss CFC and tested income CFC are directly or indirectly disposed of.).

²⁷⁷ The possibility of trading the use of the deficit against transition tax rates and a recapture at ordinary tax rates is not entirely clear in light of the interaction of sections 959(a) and 1248(d)(1), (j).

²⁷⁸ Prop. Reg. § 1.965-2(h)(3) (gain recognition resulting from downward basis adjustment).

basis election is made, section 965(b) PTI may be subject to full taxation (currently at 21 percent) when distributed (assuming there is an absence of other, unrelated, tax basis to absorb the required section 961(b) basis reduction).

b) Address Basis Adjustment for Section 965(b) PTI

The conference report states that “[t]he conferees recognize that basis adjustments (increases or decreases) may be necessary with respect to both the stock of the deferred foreign income corporation and the E&P deficit foreign corporation and authorizes the Secretary to provide for such basis adjustments or other adjustments, as may be appropriate.”²⁷⁹ For example, with respect to the stock of the deferred foreign income corporation, the Secretary may determine that *a basis increase is appropriate* in the taxable year of the section 951A inclusion or, alternatively, the Secretary may *modify the application of section 961(b)(1) with respect to such stock*.²⁸⁰ Thus, Congress contemplated that adjustments to the section 961 basis rules may be necessary in respect of section 965 PTI. To avoid the potential of taxing section 965(b) PTI upon distribution at current tax rates, while the original benefit arising from the deficit giving rise to such PTI was used to offset income taxed at the lower rates of tax under section 965, we recommend that the final regulations not require a downward basis adjustment under section 961(b) from the distribution of section 965(b) PTI. If this suggestion is not adopted, we recommend that the final regulations adopt an ordering rule such that section 965(b) PTI is treated as the last PTI to be distributed (see also the discussion below in respect of the gain reduction rule).

3. Gain Reduction Rule

A U.S. shareholder having insufficient basis in the stock or other applicable property in respect of an E&P deficit foreign corporation to absorb the required basis reduction may be required to recognize gain immediately if the election to adjust basis is made.²⁸¹ Even if the U.S. shareholder does not make the basis election, the gain reduction rule would subject to immediate tax the U.S. shareholder’s receipt of section 965 PTI (assuming no other basis exists to absorb that PTI).²⁸² As a result, in the absence of an ordering rule governing PTI, taxpayers are uncertain as to the tax consequences of a distribution of PTI (e.g., whether what they are distributing is section 965(a) PTI or section 965(b) PTI),²⁸³ which may inhibit repatriations of cash, one of the primary benefits of section 965.

To avoid this result, we recommend that the final regulations provide a special ordering rule in respect of the gain reduction rule that would apply it first to available

²⁷⁹ H.R. Rep. No. 466, 115 Cong., 1st Sess. 620 (Dec. 15, 2017)

²⁸⁰ *Id.* at 620-621 (emphasis added).

²⁸¹ Prop. Reg. § 1.965-2(f)(2)(i), (h)(3).

²⁸² Prop. Reg. § 1.965-2(g)(1)(ii) (permitting gain reduction rule for section 965(b) PTI only to the extent that the basis election has been made).

²⁸³ Note that a U.S. shareholder subject to section 951A, GILTI, also would have to take into account GILTI PTI in determining the nature of the PTI distributed.

section 965(a) PTI. We recommend that the gain reduction rule should be applicable to section 965(b) PTI only after available section 965(a) PTI has been fully distributed. In other words, section 965(b) PTI should be last-in-line in terms of distributed PTI.

E. Comments Regarding Estimated Tax Payments

As mentioned previously, in March, April and June of 2018, the Service published and updated the FAQs relating to the application of section 965 for the 2017 taxable year. Q&A 14 addresses whether taxpayers that make an election under section 965(h) to pay the section 965(h) net tax liability²⁸⁴ in eight installments could receive refunds of any 2017 payments or estimated tax payments that exceeded the sum of their (i) 2017 net income tax liability determined without regard to section 965 and (ii) the first annual installment of section 965(h) net tax liability due in 2018. Answer 14 states that taxpayers are not eligible for a refund of this amount unless and until the amount of payments exceeds the entire unpaid 2017 income tax liability, including all amounts to be paid in installments under section 965(h) in subsequent years. It further provides that any excess amounts paid are applied to the “next successive annual installment (due in 2019), and to the extent such excess exceeds the amount of that installment due, then to the next such successive annual installment (due in 2020), etc.” In response to taxpayers’ concerns with the legal basis for the statement in Q&A 14, the Service issued PMTA 2018-016 (August 2, 2018) (the “PMTA”) explaining that the Service has no authority under section 6402 to provide a refund or credit of any amount paid exceeding the amount currently due because no overpayment of tax exists in respect of 2017.

1. Ordinary Course Tax Overpayments is a Common Practice

To avoid penalties for underpayment of taxes, taxpayers frequently overpay estimated taxes. In 2017, as the Service noted, many taxpayers followed their usual practice and paid amounts in excess of their 2017 net income tax liability (determined without regard to section 965) and the applicable 2018 estimated tax liability. In accordance with Q&A 10, originally issued on March 13, 2018, taxpayers were required to make a separate payment in respect of their first installment payment of section 965(h) net tax liability. It was only after the FAQs were updated on April 13, 2018, however, that taxpayers were alerted to the Service’s position that overpayments would not be refunded or credited against 2018 estimated tax liability.

2. Precluding Refunds and Credits Inconsistent with Congressional Intent

Congress intended to provide taxpayers with flexibility to pay the section 965(h) net tax liability over time in light of the significant tax liability arising from the transition tax. The conference agreement follows the Senate amendment in this regard and backloads the installment payments over the eight-year period.²⁸⁵ There is no indication that Congress expected taxpayers who elected to pay the transition tax in installments

²⁸⁴ See Prop. Reg. § 1.965-7(g)(4) (defining section 965(h) net tax liability), (10) (defining total net tax liability under section 965).

²⁸⁵ I.R.C. § 965(h)(1); Prop. Reg. § 1.965-7(b)(1)(i).

would have ordinary course overpayments of tax (including estimated tax) used to pay the transition tax liability before the installment payments are otherwise due.²⁸⁶ Stated differently, Congress provided for the ability to defer payments and provided for certain acceleration of those required payments. There is no evidence that Congress expected prepayments or overpayments of other taxes to result in the effective prepayment of the section 965 tax liability.

3. National Taxpayer Advocate Position Identified

In a recent blog posting, the National Taxpayer Advocate, Nina Olson, identified the inconsistency of the Service’s approach to section 965(h) with Congressional intent to mitigate the burden of the transition tax on taxpayers.²⁸⁷ She noted that “[a]s a practical matter, this interpretation sharply limits the value of [s]ection 965(h), and in some cases, it may even render it meaningless.”²⁸⁸ In addition to two suggested alternatives, noted below, the Taxpayer Advocate stated that if the Service does not adopt either of the approaches, the Service should consider other possible interpretations of the relevant statutes that would enable it to implement the law consistent with Congressional intent or “corporations will not receive any of the benefits Congress provided by enacting Section 965(h).”²⁸⁹

²⁸⁶ Section 965(h)(3); Prop. Reg. § 1.965-7(b)(3).

²⁸⁷ Nina Olson, National Taxpayer Advocate, *NTA’s Blog: IRS Administration of the Section 965 Transition Tax Contravenes Congressional Intent and Imposes Unintended Burdens on Taxpayers* (April 16, 2018), available at <https://taxpayeradvocate.irs.gov/news/nta-blog-irs-administration-of-the-section-965-transition-tax-contravenes-congressional-intent-and-imposes-unintended-burden-on-taxpayers?category=Tax> (hereinafter “*Taxpayer Advocate Blog*”).

²⁸⁸ *Id.*

²⁸⁹ Taxpayers and organizations have made arguments similar to those set forth in the Taxpayer Advocate Blog. See, e.g., Letter of Caroline L. Harris, Chamber of Commerce of the United States, to Steven T. Mnuchin, Secretary of Treasury, and David J. Kautter, Assistant Secretary for Tax Policy, *Overpayments and §965(h)* (Aug. 21, 2018), Doc 2018-34017, 2018 TNT 163-33; Letter of Kevin C. Hardman, Huntsman, to Thomas West, Tax Legislative Counsel, *IRS Application of 2017 Estimated Tax Overpayments to Future IRC § 965(h) Installments* (Aug. 14, 2018) (noting that contrary to the analysis in the PMTA, the Service has as a matter of law and equity the authority to refund or credit the portion of a taxpayer’s 2017 estimated tax payments in excess of the amount of the taxpayer’s regular tax liability plus its first section 965(h) installment), Doc 2018-34048, 2018 TNT 163-41; Letter of Annette Nellen, Chair, AICPA Tax Executive Committee, to Steven T. Mnuchin, Secretary of Treasury, and David J. Kautter, Assistant Secretary for Tax Policy, *Application of 2017 Estimated Tax Payments to Section 965(h) Installment Obligations* (Sept. 17, 2018) (urging for the reversal of the conclusion reached in Q&A 13 and 14 of the FAQs), available at <https://www.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/20180917-aicpa-comments-on-965-overpayments.pdf>. Although acknowledging that the Service’s interpretation may be correct in its view that Congressional tax writers failed to consider the interaction of section 965(h) with existing provisions governing refunds and credits, some practitioners have argued that the Service may not pay refunds after a return is filed and the tax has been assessed, but they have suggested that – before the liability is assessed – the Service may at least pay the estimated tax refunds requested on Form 4466. See e.g., AICPA, *Questions and Answers about Reporting Related to Section 965 on 2018 Tax Returns – IRS Update of April 13, 2018* (April 19, 2018) (hereinafter “AICPA Letter”), available at <https://www.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/20180419-aicpa-comments-on-965-overpayment-faqs.pdf>

The Taxpayer Advocate Blog notes that, in addition to other potential approaches, the Service should consider alternatives such as analogizing the transition tax to a recapture of tax eligible for exclusion from the computation of estimated tax liability.²⁹⁰ Such treatment would allow a taxpayer to compute estimated tax liability without regard to transition tax liability and then seek a refund of estimated tax overpayments as so computed,²⁹¹ even if, including its transition tax liability, the corporate taxpayer's actual tax liability exceeds its estimated tax overpayment. Treating the transition tax liability separate from the taxpayer's regular tax liability, for which it has made estimated tax payments, would allow the refund of overpayments of estimated tax, consistent with Congressional intent as well as arguably the intent of the estimated tax overpayment section and the relevant tax form.²⁹²

The Taxpayer Advocate Blog also notes that Treasury has the authority, pursuant to section 965(o)(2), to "prescribe" guidance "to prevent the avoidance of the purposes of this section." Given that the purpose of section 965(h) is to allow taxpayers to pay the transition tax over an eight-year period, the Taxpayer Advocate asks why the Service believes it does not have the authority to issue guidance enabling taxpayers to elect credits or refunds of extra installments under section 965(h), as requested on Form 4466 before assessment (or even after assessment).

4. Reconsideration of the Restrictions on Refunds or Credits in Respect of Tax Liabilities Unrelated to Section 965(h) Net Tax Liability

Consistent with the approach in the FAQs, which requires separate accounting and separate payment of the section 965(h) net tax liability, and for the reasons noted above and as described by other taxpayers and organizations, we recommend that the position in the PTMA and the FAQs be reconsidered. Leaving the FAQs as they are, would, in effect, result in a significant restriction on the Congressionally-designed installment payment regime. Moreover, taxpayers would, on the one hand, be penalized if they underpay, but, on the other hand, would have no access to a refund or credit if they overpay installments on the other. Consequently, we recommend that the Service consider, for example, treating each section 965(h) installment payment as a separate tax liability such that each installment payment would stand on its own in terms of whether an overpayment has arisen for a particular taxable year. If our recommendation is not accepted, we respectfully request that the Service consider permitting a refund or credit for an overpayment in 2017 because many taxpayers conservatively overpaid estimated taxes as a precautionary measure to preclude the imposition of estimated tax penalties in light of the timing of the enactment of the Act and the timing of the available guidance,

²⁹⁰ Reg. § 1.6655-1(g)(2)(iii).

²⁹¹ I.R.C. § 6425 (governing overpayments of corporate estimated tax liability).

²⁹² For further support of the view that estimated tax overpayments should be determined without regard to the transition tax, the Taxpayer Advocate Blog cites the relevant titles to section 6425, Adjustments of Overpayment of Estimated Income Tax by Corporations, and IRS Form 4466, Corporate Application for Quick Refund of Overpayment of Estimated Tax. The title of both the relevant Code section and the form focus on whether there has been an overpayment of estimated tax, not total actual tax liability.

as many taxpayers were unaware of the Service's view of the law as described in the FAQs and PMTA.²⁹³

F. Comments Regarding Foreign Tax Credits

1. Allocation of Foreign Taxes to Taxable Year of SFC

Under Proposed Regulation section 1.965-1(f)(29)(ii), a taxpayer is permitted to reduce the post-1986 E&P of certain SFCs by a portion of the foreign income taxes that are deemed to accrue as of November 2, 2017. We commend Treasury and the Service for proposing this rule, as it responds directly to taxpayer concerns that foreign corporations typically do not accrue earnings or foreign income taxes, on a consistent, month-to-month basis. Indeed, the opposite is true. In most circumstances, foreign income taxes accrue as of the end of the tax year of the foreign corporation. Without the rule in the Proposed Regulations, there could be a significant distortion in the measurement of post-1986 E&P.

As currently proposed, the rule provides that the SFC's post-1986 E&P as of November 2, 2017, is reduced by the "applicable portion" of such foreign income taxes.²⁹⁴ The applicable portion is "the amount of the taxes that are attributable to the portion of the taxable income (as determined under foreign law) that accrued on or before November 2, 2017."²⁹⁵ While the intent of the Proposed Regulations is clear, namely, that the foreign income taxes can be treated as accruing during the year, and not only at the close of the taxable year, the clause itself is, as drafted, could leave room for different interpretations. For example, the parenthetical could be read to modify only the noun "taxable income," such that the principles of foreign law would be used to determine when and how taxable income accrues, and how much of it had accrued as of November 2, 2017. In that case, only after understanding and applying the principles of foreign law to determine the accrual of taxable income would the taxpayer determine the ratio of accrued taxable income as of November 2, 2017 to December 31, 2017. This ratio would then be applied against the foreign income taxes accrued as of December 31, 2017, to determine a hypothetical amount of foreign income taxes deemed accrued as of November 2, 2017.

Another possible interpretation could be that foreign income taxes are "attributable to" the portion of taxable income accrued at the time when estimated payments are required to be made under foreign law. For example, where a foreign corporation is obligated to make monthly or quarterly estimated tax payments, such obligation might be treated as being fixed at the time of payment, making the accrual at least traceable to actual payments recorded on the financial statements of the foreign corporation.

²⁹³ See AICPA Letter, *supra* note 294; Taxpayer Advocate Blog, *supra* note 291 (recommending that the Service at least pay the quick refund claims of those corporate taxpayers that filed Form 4466, Corporation Application for Quick Refund of Overpayment of Estimated Tax, on or before April 17, 2018).

²⁹⁴ Prop. Reg. § 1.965-1(f)(29)(ii).

²⁹⁵ *Id.*

In order to reduce uncertainty, we recommend the final regulations modify the rule in Proposed Regulation 1.965-1(f)(29)(ii) to provide that foreign income taxes are treated as paid or accrued by a foreign corporation in an amount equal to a ratio comparing the E&P as of November 2, 2017 to that as of December 31, 2017. Adopting this method of calculation would be easier to implement as taxpayers could point directly to a ratio easily verifiable (and consistent with) the post-1986 E&P as of each measurement date, rather than determining the incidence of foreign income accrual under foreign tax law.

2. Disallowance of Foreign Tax Credits under Section 965(g)

Similar to inclusions under Subpart F, the U.S. corporate shareholder inclusion under section 965(a) is eligible to “pull” foreign tax credits to the extent the credits are with respect to the amount of the inclusion. Generally, this requires a measurement to determine the ratio of the amount of the current inclusion as compared to the pool of post-1986 E&P. This ratio is applied to determine the pro-rata share of foreign income taxes that the U.S. shareholder is eligible to claim (subject to all other requirements under section 901 and, importantly, also still subject to the limitations under section 904).

Section 965(g) provides for a reduction in certain foreign income taxes treated as eligible for a credit under section 960. More specifically, the statute limits the creditable foreign income taxes by disallowing a credit for the “applicable percentage” of any taxes paid or accrued, or treated as paid or accrued, with respect to any amount for which a deduction was provided for under section 965(c). The statute is intended to allow a credit only for the ratable portion of the foreign income that is subject to US taxation. Because the tax rate applicable to the section 965(a) inclusion amount which is attributable to the cash position of the U.S. shareholder is 15.5 percent, the “applicable percentage” of disallowed foreign income taxes is 55.7 percent²⁹⁶. The gross-up under section 78 is subject to a similar reduction.²⁹⁷

The Proposed Regulations take the section 965(g) limitation a step further by applying the same calculation to any foreign withholding taxes and similar foreign taxes imposed on the distribution of PTI. For example, Proposed Regulation section 1.965-5(b) provides that “neither a deduction nor a credit under section 901” is allowed for the applicable percentage of any foreign income taxes attributable to distributions of PTI generated under either section 965(a) or section 965(b). By example, the Proposed Regulations then state that “accordingly, no deduction or credit is allowed for the applicable percentage of any withholding taxes imposed on a United States shareholder.”

While the extension of the applicable percentage disallowance of section 965(g) to foreign distribution taxes furthers the policy of limiting foreign tax credits in the same proportion as the underlying deferred foreign earnings were so limited, we believe that the extension of the rule adds unneeded complexity to the calculation of creditable foreign income taxes by requiring taxpayers to track multiple E&P and PTI pools, potentially for decades, even though section 965 is a one-time inclusion event.

²⁹⁶ This percentage is rounded; the mathematical equivalent is: applicable percentage = $(0.35 - 0.155) / 0.35 = 0.557143$.

²⁹⁷ I.R.C. § 965(g)(4).

Moreover, we are not aware of anything in the statute or legislative history that mandates that foreign distribution taxes be subject to the section 965(g) reduction. This limitation is especially harsh on individual U.S. shareholders and those U.S. shareholders who reside outside the U.S. If indeed the FTC were to be limited by the applicable percentage amount, in some cases the section 965 liability would be significantly higher (double) of what it otherwise might be without such a “haircut.” Note that the section 965 liability of individual U.S. shareholders is already higher due to graduated income tax rates that apply for purposes of calculating the tax rate of section 965 liability, and that the individuals do not claim the tax credit pursuant to section 960, unless they have made the section 962 election.

We do not see any reason to apply the “haircut” to actual distributions to individual U.S. shareholders who do not get a benefit of the 100 percent dividend received deduction in the future, or a reason to apply the “haircut” to any excess foreign tax credit that individual U.S. shareholders may choose to carryforward or carryback, if available. We recommend that the final regulations limit availability of the FTC in those instances to, for example, instances in which the foreign tax in question is in the same basket as the section 965 inclusion amount.

Given the burden on taxpayers that this rule will create, as well as realistic double taxation potential (especially for those individual U.S. shareholders who reside outside the U.S.), and the fact that it imposes an incremental limitation on FTCs on top of that already imposed under section 904, we recommend removing the limitation on withholding taxes from Proposed Regulation section 1.965-5(b).

3. Coordination with IRS Form 1118

In order to provide urgently needed guidance relating to the filing of returns and reporting of the section 965(a) inclusions, Treasury and the Service have published the Section 965 Q&A.²⁹⁸ We commend the IRS and Treasury for their speed in addressing these issues and providing clarity with respect to many unresolved issues as the compliance season comes to bear.

Presumably in an effort to streamline the compliance process for Section 965 inclusions, the Section 965 Q&A effectively separates a taxpayer’s pre-existing US tax returns and the reporting required for section 965. This separation creates some unusual complexities with respect to foreign tax credit calculations under section 965 and IRS Form 1118.

The guidance in the Section 965 Q&A states as follows:

“Do not enter the relevant section 965(a) amount, the relevant section 965(c) deduction, the deemed paid foreign taxes with respect to the relevant section 965(a) amount, and the foreign taxes disallowed under section 965(g) on Form 1118. Report the deemed paid foreign taxes with respect to the section 965(a) amount and the foreign taxes disallowed

²⁹⁸ Available at: <https://www.irs.gov/newsroom/questions-and-answers-about-reporting-related-to-section-965-on-2017-tax-returns>

under section 965(g) on IRC 965 Transition Tax Statement, Lines 4a and 4b.”

This makes the determination and presentation of the section 904 limitation uncertain. The guidance could be interpreted to mean that none of the section 965 inclusions, including the foreign tax credits, should be included as part of the taxpayer’s overall foreign tax credit limitation calculation. However, there is nothing in the statute or the legislative history indicating that the foreign tax credits attributable to mandatory repatriation are somehow exempt from, or outside of, the ordinary section 904 requirements. Indeed, it seems clear that taxpayers may utilize foreign tax credit carryforwards (generated outside of mandatory repatriation) against their section 965 liability. That is, we believe that there is a single section 904 limitation applicable to the foreign tax credits claimed by a given taxpayers – regardless of whether those foreign tax credits are generated by section 965 or another provision of the Code.

In order to eliminate the uncertainty resulting from this issue, it is recommended that Treasury and the Service modify the Section 965 Q&A to provide that taxpayers may “pull” the section 965 amounts on to the respective IRS Form 1118, with proper documentation identifying the source of each category of foreign income and the foreign taxes attributable to such income. This could be accomplished by adding a category of inclusions reportable under Schedule A, column 1, identified simply as 965 rather than utilizing a country abbreviation. This would provide a more accurate section 904 limitation calculation and facilitate compliance. Future amendments to IRS Form 1118 could similarly create a separate category of inclusion for section 965 so that taxpayers have a single place to track PTI balances and foreign tax credit pools going forward.

4. Eligibility of Foreign Taxes on Distributions from DREs and Partnerships for a Foreign Tax Credit.

We recommend that Treasury and the Service consider clarifying that references in Proposed Regulation section 1.965-5(c)(1)(ii) to “upper-tier foreign corporation,” “distribution,” and “lower-tier foreign corporation” are to principles of foreign law and not U.S. tax classification. If those terms were applied by reference to U.S. tax classification, it appears that the Proposed Regulations would be limited to distributions between two recognized CFCs such that foreign withholding, distribution and recipient taxes imposed in respect of a distribution from a lower-tier partnership or lower-tier disregarded entity would not be eligible for a foreign tax credit under section 960(a)(3). When a disregarded entity distributes cash to its owner, or a partnership distributes cash to its partners after the imposition of U.S. tax on those earnings, the distribution may not be recognized for U.S. tax purposes as a distribution of PTI, but it would be recognized as a distribution for foreign tax purposes and, consequently, subject to foreign withholding, distribution or recipient taxes that should be eligible for a foreign tax credit pursuant to section 960(a)(3) because the underlying earnings to which the foreign tax relates was taxed under section 965(a).

Section 960(a)(3) provides that any portion of a distribution to a domestic corporation that is PTI is treated by the domestic corporation as a dividend solely for purposes of taking into account under section 902 any income, war profits or excess profits taxes paid to any foreign country on or with respect to the accumulated profits of such

foreign corporation from which such distribution is made so long as such taxes were previously deemed paid. Nothing in section 960(a)(3) suggests that it is limited to taxes imposed on distributions between corporations recognized as such for U.S. tax purposes.

5. Increase Foreign Tax Credits of E&P Deficit Foreign Corporation for Foreign Tax Credits Related to a Hovering Deficit

We respectfully recommend that Treasury and the Service reconsider their position that suspended foreign income taxes related to a hovering deficit that has reduced the post-1986 E&P of a DFIC cannot be taken into account for any other purpose, including in calculating the amount of post-1986 foreign income taxes deemed paid with respect to an inclusion under section 965. Treasury and the Service declined to adopt comments seeking to increase the post-1986 foreign income taxes of a DFIC in the inclusion year for foreign income taxes related to a hovering deficit that reduced the post-1986 E&P of the DFIC because the existing rules, set forth in Treasury Regulation section 1.367(b)-7, adequately address this issue. As the existing rules generally offset hovering deficits with post-transaction earnings in the same separate category of post-1986 undistributed earnings as of the first day of the foreign surviving corporation's first taxable year following the year in which the post-transaction earnings accumulated,²⁹⁹ foreign income taxes related to a hovering deficit likely will never be creditable due to the changes in the foreign tax credit system as a result of the Act.³⁰⁰ In promulgating the existing rules set forth in Treasury Regulation section 1.367(b)-7, Treasury recognized that the hovering deficit rule is a legislative mechanism designed to deter the trafficking of favorable tax attributes.³⁰¹ As the Act has changed the foreign tax credit system in a manner that likely precludes foreign income taxes related to a hovering deficit from ever being creditable in a post-2017 taxable year, no trafficking in such foreign income taxes will be possible, and the rationale for the hovering deficit rule does not exist in respect of these taxes. Thus, the last possible taxable year in which such taxes may be eligible to be claimed is in respect of an inclusion year under section 965. Consequently, we recommend that Treasury and the Service reconsider permitting taxpayers to access foreign income taxes related to a hovering deficit in the section 965 inclusion year. It could do so through either (i) increasing the post-1986 foreign income taxes of the DFICs to which the associated hovering deficit is allocated under section 965(b), or (ii) increasing the post-1986 foreign income taxes of the E&P deficit foreign corporation to which the hovering deficit relates for the inclusion year.³⁰²

²⁹⁹ See, e.g., Treas. Reg. § 1.367(b)-7(d)(2)(ii). See also Treas. Reg. § 1.367(b)-7(d)(2)(iii) (adding post-1986 foreign income taxes related to a hovering deficit to the foreign surviving corporation's post-1986 foreign income taxes on a pro rata basis as the hovering deficit is absorbed).

³⁰⁰ The Act repealed the pooling regime for post-1986 foreign income taxes of section 902. Treasury guidance on the application of the foreign tax credit system for taxable years after the Act has not yet been released.

³⁰¹ T.D. 9273, 71 Fed. Reg. 44887, 44888 (Aug. 8, 2006).

³⁰² Although an E&P foreign deficit corporation has a deficit, by definition, on November 2, 2017, it may not have a deficit that would otherwise preclude access to its post-1986 foreign income taxes in its inclusion year.

G. Comments on Miscellaneous Issues

1. Section 9100 Relief

Section 965(h)(5) states that the election to pay the section 965(h) tax liability over the 8-year period specified in section 965(h)(1) must be made “not later than the due date for the return of tax.” On March 13, 2018, the Service posted the FAQs. Q&A number 12 stated that if a person already filed a 2017 tax return and failed to submit the appropriate repatriation tax information and elections, then the –

person should consider filing an amended return based on the information provided in these FAQs and Appendices. Failure to submit a return in this manner may result in processing difficulties and erroneous notices being issued. Failure to accurately reflect the net tax liability under section 965 of the Code in total tax could result in interest and penalties.

The Proposed Regulations note that relief under Regulations sections 301.9100-2 and 301.9100-3 (i.e., regulatory relief allowing the Service to grant additional time to file for late filings of missed regulatory or specified statutory elections) is not available with respect to Section 965 elections. Notably, because the time for election is statutory, not regulatory, and not specified by proposed amendment to Regulation section 301.9100-2, a procedure to request additional time to elect, by default, is not available.³⁰³

In light of the language in Q&A 12, as opposed to the relief under Regulations sections 301.9100-2 and 301.9100-3 and the limiting language in the Proposed Regulations, greater clarification of the time to file and/or amend missed filings would be helpful because both taxpayers and certain practitioners may be more likely to access the FAQs than the final regulations and, consequently, erroneously believe they have a three-year period to elect. Specifically, we recommended that Q&A 12 be amended to conform to the language in Proposed Regulation Section 1.965-(f)(iii)(B), which states explicitly that relief is not available beyond the due date for a timely filed return for the first taxable year that includes the last day of the last taxable year of a deferred foreign income corporation of the shareholder that begins before January 1, 2018.

2. Eligible Section 965(h) Transferee

The unpaid portion of any remaining installment payments under section 965(h) are generally due on the date of an acceleration event.³⁰⁴ There is an exception to the acceleration of installments if the person with respect to whom the acceleration event occurs is an eligible section 965(h) transferor and the requirements of Proposed Regulation section 1.965-7(b)(3)(iii)(A) are satisfied.³⁰⁵ One of the requirements is that the eligible section 965(h) transferor and an eligible section 965(h) transferee enter into a transfer agreement pursuant to Proposed Regulation section 1.965-7(b)(3)(iii)(B). “For this purpose, the term eligible section 965(h) transferee refers to a single United States

³⁰³ See Reg. §§ 301.9100-1, 301.9100-2, 301.9100-3; Prop. Reg. § 1.965-7(b)(2)(iii)(B); I.R.C. § 965(h)(2).

³⁰⁴ Prop. Reg. § 1.965-7(b)(3).

³⁰⁵ *Id.*

person that is not a domestic passthrough entity.”³⁰⁶ Although we understand Treasury and the Service may be worried about collecting the section 965 tax liability, we do not understand why a domestic passthrough entity is the only person excluded from the definition of the term “eligible section 965(h) transferee.”

Fundamentally, an eligible section 965(h) transferee is a person who steps into the shoes of the eligible section 965(h) transferor with respect to the liability to make all remaining installment payments under the transferor’s section 965(h) election. We recommend that the Regulations, when finalized, provide that the term “eligible section 965(h) transferee” does not exclude a domestic passthrough entity.

3. Disregarded Transactions – Proposed Regulation section 1.965-4

While we recognize that anti-avoidance rules are necessary to prevent transactions entered into with a principal purpose of changing a section 965 element, Proposed Regulation section 1.965-4 imposes certain prohibitions that may be inflexible or inappropriate. The primary test is based on a “principal purpose” of changing a section 965 element and also delineates certain transactions that create presumptions that are rebuttable if the of facts and circumstances “clearly” established the lack of such a principal purpose and require disclosure of same.

Other transactions are automatically, or “per se,” deemed to be undertaken with a principal purpose of changing the section 965 element. These include transactions involving cash reduction by means of: a specified distribution to a U.S. shareholder to the extent there is a plan or intent for the distributee to transfer certain amounts to an SFC of the shareholder or the distribution is a non pro rata distribution to a related foreign person; E&P reduction transactions (i.e., distributions that reduce E&P made either to owners or related parties); and complete liquidations (regardless of purpose).

Treasury and the Service declined to adopt a de minimis exception to these per se avoidance transactions. In addition, by eliminating any ability to rebut a presumption based on facts and circumstances even by means of a clear and convincing standard, this proposed rule casts too wide of a net. The rule goes beyond its stated intention covering certain transactions perceived to be abusive as it encompasses transactions that are not abusive, e.g., transactions that may have been planned prior to or merely coincidental to the time frame of the passage of section 965. It is recommended therefore that the “per se” provisions be removed and replaced by a rebuttable presumption standard, perhaps having a higher evidentiary standard such as “clear and convincing.”

³⁰⁶ *Id.*