

## Client Alert

August 24, 2018

### Proposed Regulations Under Section 965

#### Introduction

On August 9, 2018, the Treasury Department (“Treasury”) and the Internal Revenue Service (the “IRS” or the “Service”) published in the Federal Register proposed Treasury Regulations interpreting new Section 965 (the “Proposed Regulations”). Enacted as part of the Tax Cuts and Jobs Act (the “TCJA”), Section 965 addresses the previously untaxed earnings of foreign subsidiaries by mandating the deemed repatriation of those earnings.

The Proposed Regulations provide welcome guidance on matters that have weighed on taxpayers mindful of the extraordinary compliance burden that Section 965 presents for the 2017 taxable year. The topics covered in the Proposed Regulations include: the mechanics of the deemed repatriation; the calculation of deemed-paid foreign taxes; the treatment of earnings and profits (“E&P”), previously taxed income (“PTI”) and basis following the deemed repatriation; special rules for anti-avoidance transactions and double counting of E&P; the treatment of passthroughs, consolidated groups, and individuals; and the mechanics for filing and installment payment election, among others.

The Proposed Regulations incorporate most of the prior guidance issued by the Treasury Department and the Service.<sup>1</sup> The Proposed Regulations apply beginning the last taxable year of a foreign corporation that begins before January 1, 2018, and with respect to a U.S. person, beginning the taxable year in which or with which such taxable year of the foreign corporation ends. Any written or electronic comments on the Proposed Regulations and requests for a public hearing must be received by Treasury and the Service before October 9, 2018.

This client alert describes the contents of the Proposed Regulations and provides preliminary observations as to its immediate impact on a broad array of U.S. taxpayers.

#### Inclusion Basics Under the Proposed Regulations

##### Definitional Matters

Generally speaking, Prop. Reg. § 1.965-1 clarifies the statutory language surrounding the general inclusion rule under Section 965(a). This section of the

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<sup>1</sup> See Notice 2018-7, 2018-4 I.R.B. 317 (Dec. 29, 2017); Notice 2018-13, 2018-6 I.R.B. 341 (Jan. 19, 2018); Revenue Procedure 2018-17, 2018-9 I.R.B. 384 (Feb. 13, 2018); Notice 2018-26, 2018-16 I.R.B. 480 (Apr. 2, 2018). In addition, there was more informal guidance - FAQs, an IRS publication, and a Program Manager Technical Advice, PMTA 2018-016 (Aug. 8, 2018).





Proposed Regulations employs many of the same terms that appear in the statute, including: “deferred foreign income corporation” (“DFIC”); SFC (“SFC”); post-1986 earnings and profits (“post-1986 E&P”); accumulated post-1986 deferred foreign income (“accumulated post-1986 DFI”); specified E&P deficit; and the last taxable year of an SFC beginning before January 1, 2018 (the SFC’s “inclusion year”).

This alert assumes a basic understanding of these fundamental terms that first appeared in Section 965, but we mention here a few definitional items of note. First, a foreign corporation that qualifies as a “passive foreign investment company” (or “PFIC,” as defined in Section 1297) with respect to a U.S. shareholder, but does not qualify as a CFC, is not an SFC with respect to such shareholder. Second, post-1986 E&P includes the E&P (importantly, including PTI) of the SFC. Post-1986 E&P is computed in accordance with Sections 964(a) and 986, subject to the anti-avoidance rules discussed in Part 3 below, and without diminution by reason of dividends distributed during the last taxable year of the foreign corporation that begins before January 1, 2018, other than dividends distributed to another SFC to the extent the dividends increase the post-1986 E&P of the distributee SFC.

Additionally, any deficit related to post-1986 E&P, including a hovering deficit, of an SFC is taken into account for purposes of determining the post-1986 E&P (including a deficit) of the SFC. This clarification regarding hovering deficits stems from the legislative history to Section 965. However, the preamble to the Proposed Regulations confirms that hovering deficits are not taken into account for any other purpose, such as for purposes of determining post-1986 undistributed earnings or pre-1987 accumulated profits in computing the taxes deemed paid under Section 902 for the foreign tax credit.

While an SFC that has a deficit in E&P as of November 2, 2017 is generally considered an E&P deficit foreign corporation (an “E&P DFC”), the Proposed Regulations provide that an SFC is nevertheless a DFIC if it has a positive amount of post-1986 E&P on one of the E&P measurement dates, notwithstanding the SFC’s post-1986 E&P deficit on November 2, 2017. This approach is consistent with Notice 2018-13. In some cases, an SFC may be neither a DFIC nor an E&P DFC if, for example, it is not an E&P DFC because its PTI causes its post-1986 E&P to be positive. Put differently, an SFC’s E&P deficit may be “soaked up” by any PTI balance that the SFC has, thereby preventing some or all of the E&P deficit from being used to offset positive untaxed earnings of other SFCs. This situation is illustrated in Example 5 in Prop. Reg. § 1.965-1(g).

## Computing the Section 965(a) Inclusion

Under the general inclusion rule of Section 965(a), in the case of an SFC’s inclusion year, the Subpart F income of a DFIC is increased by the greater of two amounts: the accumulated post-1986 DFI of such DFIC determined as of November 2, 2017 or as of December 31, 2017 (each date an “E&P measurement date,” and the greater amount the “Section 965(a) earnings amount”). Accumulated post-1986 DFI means post-1986 E&P except to the extent such E&P are attributable to effectively connected income (“ECI”) or PTI.



For this purpose, PTI includes amounts that would have been PTI if the shareholder was a U.S. shareholder under the principles of Rev. Rul. 82-16. Also, to determine the amount of PTI that would reduce the accumulated post-1986 DFI, only Subpart F income that has been accrued by the SFC as of the E&P measurement date is considered. In other words, Subpart F income earned *after* the E&P measurement date is *not* treated as PTI that reduces accumulated post-1986 DFI as of such E&P measurement date.

To calculate accumulated post-1986 DFI, a taxpayer must first determine post-1986 E&P. Consistent with Notice 2018-26, in computing post-1986 E&P as of November 2, 2017, the Proposed Regulations allow a reduction for the “applicable portion” of foreign income taxes that accrued after November 2, 2017, and on or before December 31, 2017. 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.

**Observation:** This rule provides some relief for SFCs whose foreign income taxes accrue as of the last day of an SFC’s fiscal year—typically, December 31. Instead of allowing a reduction for foreign income *taxes* accrued as of the November 2, 2017 E&P measurement date, this rule provides a reduction with respect to the actual foreign *taxable income* accrued as of that date. This prevents the inflation of the SFC’s E&P on the November 2, 2017 E&P measurement date by permitting, in a way, a deduction for imminent but not-yet-accrued foreign taxes. However, it is onerous, to say the least, to require that the “applicable portion” of foreign taxes relating to a November 2, 2017 E&P measurement date be determined by tracing each dollar of foreign tax to the underlying items of taxable income accrued as of November 2, 2017. For ease of administration, the final regulations would ideally allow a reduction to post-1986 E&P in an amount equal to the prorated amount of foreign taxable income that accrued as of the November 2, 2017 E&P measurement date.

Additionally, for purposes of determining post-1986 E&P, commentators had requested that an alternative measurement method be provided for SFCs that are not CFCs and, therefore, would have no reason to otherwise track E&P under U.S. federal income tax principles. In declining to adopt this comment, Treasury cited the challenges in obtaining information from such companies as “not unique” to the Section 965 context, as the same difficulty already arises in other contexts (*e.g.*, PFICs). Treasury’s response is somewhat unsatisfying, considering that minority shareholders in foreign corporations that are neither PFICs nor CFCs had no warning that they would ever need to obtain the information required by the Proposed Regulations.

In the event that the functional currency of an SFC changes between the two E&P measurement dates, a comparison must be made in the functional currency of the SFC as of December 31, 2017, by translating the DFIC’s accumulated post-1986 DFI as of November 2, 2017, into the new functional currency using the spot rate on November 2, 2017.



If a U.S. shareholder owns at least one DFIC and at least one E&P DFC, the pro rata share of the Section 965(a) earnings amount of a DFIC that otherwise would be included in the gross income of its U.S. shareholder under Section 951(a)(1) is generally reduced by the amount of such U.S. shareholder's "aggregate foreign E&P deficit" that is allocated to such DFIC (such reduced amount, the "Section 965(a) inclusion amount," which cannot be less than zero). In general, the aggregate foreign E&P deficit with respect to any U.S. shareholder is the aggregate of such shareholder's pro rata shares of the relevant E&P deficits (as of November 2, 2017) of the E&P DFCs of such shareholder.

Once the Section 965(a) earnings amount is determined, the mechanics by which a U.S. shareholder that owns stock of a DFIC directly or indirectly, within the meaning of Section 958(a) (a "Section 958(a) U.S. shareholder"), includes such amount in gross income generally follows the existing Subpart F mechanics provided under Section 951. Specifically, for the Section 958(a) U.S. shareholder's taxable year in which or with which the inclusion year of a DFIC ends, the shareholder includes its "pro rata share" of the Section 965(a) earnings amount of the DFIC, translated (if necessary) into U.S. dollars using the spot rate on December 31, 2017, and reduced by deficits to arrive at the Section 965(a) inclusion amount. For this purpose, "pro rata share" is defined as the portion of the Section 965(a) earnings amount that would be treated as distributed to the Section 958(a) U.S. shareholder under Section 951(a)(2)(A) and Treas. Reg. § 1.951-1(e), determined as of the last day of the inclusion year of the DFIC.

Although Section 965 piggybacks off of Subpart F to impose the transition tax, it is not subject to certain of Subpart F's limitations. Specifically, neither the Section 965(a) earnings amount nor the Section 965(a) inclusion amount is subject to the rules or limitations in Section 952 or limited by the accumulated E&P of the DFIC on the date of the inclusion. The preamble to the Proposed Regulations explains that this is because an increase in Subpart F income by reason of Section 965(a) is generally determined after the Subpart F income is otherwise determined under Section 952 for the taxable year, making the rule's application to the Proposed Regulation's general inclusion rule impractical.

## Determining the Participation Exemption Deduction and Applicable Transition Tax Rate

The Proposed Regulations reiterate the rule described in Section 965(c)(3) that sets forth the manner in which a U.S. shareholder computes its aggregate foreign tax position. This rule provides that a U.S. shareholder's aggregate foreign cash position is the greater of (i) the sum of the U.S. shareholder's pro rata share of the cash position of each of its SFCs on each SFC's "final measurement date" or (ii) the average of: (a) the sum of the U.S. shareholder's pro rata share of the cash position of each of its SFCs on each SFC's "second measurement date" and (b) the sum of the U.S. shareholder's pro rata share of the cash position of each of its SFCs on each SFC's "first measurement date." For a U.S. shareholder with only calendar year SFCs, its aggregate foreign cash position with respect to all of its SFCs would be the sum of their cash positions as of December 31, 2018 or the average of the sum of their cash positions as of the end of 2016 and 2017. When SFCs do not have a calendar year, and when all of a U.S. shareholder's SFCs do not have conforming taxable years, the



computation becomes a lot more challenging and problematic, as the Proposed Regulations attempt to address.

The rules involved in computing the aggregate foreign cash position of a U.S. shareholder are pivotal given that the 15.5 percent cash and cash equivalent rate and 8 percent non-cash equivalent rate are keyed to a U.S. shareholder's aggregate foreign cash position. To that end, the Proposed Regulations provide rules with respect to the Section 965(c) deduction and, in building off of prior Notices, provide taxpayers guidance on how to compute each SFC's cash position as of each measurement date, prevent the double counting of certain assets at the SFC level, and navigate the scenario where a U.S. shareholder has multiple inclusion years, among other items.

### SFC's Cash Position

The rules for determining an SFC's cash position as of each cash measurement date generally restate the statutory language and the few additional clarifications that the IRS set forth in the Notices. An SFC's cash position is the sum of its cash, net accounts receivable, and the fair market value of assets referred to by the Proposed Regulations as "cash-equivalent assets." The last of these categories includes actively traded personal property, commercial paper, foreign currency, and short-term obligations. As the IRS indicated in Notice 2018-13, short-term obligations include any loan payable on demand (excluding receivables). Derivative financial instruments, which include financial instruments that are notional principal contracts, options, forwards, futures, short positions in securities or commodities, or any similar financial instruments, are treated as cash-equivalent assets, as announced in Notice 2018-7. The inclusion of derivative financial instruments appears to be the limit of Treasury's exercise of its authority to add categories of assets that are considered "economically equivalent" to cash, receivables, and the cash-equivalent assets enumerated in the statute.

**Observation:** Treasury rejected appeals to make the cash and cash-equivalent categories more administrable and declined to provide a liquidity-based exception for certain cash and cash-equivalent assets. For example, even cash of foreign subsidiaries that is blocked and inaccessible is still considered "cash" for purposes of determining an SFC's cash position.

### Elimination of Certain Double Counting of Assets

For purposes of calculating the aggregate foreign cash position, Prop. Reg. § 1.965-3(b)(1) generally disregards accounts receivable, accounts payable, short-term obligations, and derivative financial instruments held between SFCs that are related and commonly owned by a U.S. shareholder. A Section 954(d)(3) control test is applied to determine whether SFCs are related for this purpose. The Proposed Regulations address double counting of such assets by disregarding them to the extent of the U.S. shareholder's "smallest ownership percentage" of each of the relevant SFCs on the cash measurement date.

Example 1 in Prop. Reg. § 1.965-3(b)(3) helps illustrate this rule. The simplified facts of the example are as follows: (i) USP, a U.S. shareholder and domestic corporation, owns 100 percent of the stock of CFC1, which in turn owns 95



percent of the stock of CFC2 (the remainder of the CFC2 stock is owned by a person unrelated to USP and CFC1); (ii) USP and CFC1 are calendar year taxpayers and CFC2 is an 11/30 taxpayer; and (iii) CFC1 makes a short-term loan to CFC2 worth \$100x on November 15, 2015. Under the anti-double counting rule, for purposes of determining USP's cash position on the first cash measurement date of each of these SFCs 95 percent of the amount of the loan is disregarded when measuring CFC1's cash position because (i) CFC1 and CFC2 are related SFCs of USP and (ii) USP owns 100 percent of CFC1 and, indirectly, 95 percent of CFC2 such that, as between the two entities, USP's smallest ownership percentage is its 95 percent interest in CFC2. Thus, in determining CFC1's aggregate foreign cash position, USP is treated as only taking into account \$5 of the loan, which is equal to 5 percent of the short-term obligation.

**Observation:** Although the anti-double counting rule provides relief for SFCs that are commonly owned by a single U.S. shareholder, the Proposed Regulations do not extend this same treatment to SFCs held by different members of a consolidated group. The Proposed Regulations treat members of a U.S. consolidated group as a single U.S. shareholder for some purposes of applying Section 965 but not for purposes of the anti-double counting rules. As a result, loans between SFCs that are owned by different U.S. shareholders may not be eligible for relief, even if the U.S. shareholders are corporations that are members of the same consolidated group.

Although the Proposed Regulations preclude the double counting of certain assets of related SFCs, Treasury recognized the need to provide additional safeguards with respect to the double counting of other assets of a U.S. shareholder. Under Prop. Reg. § 1.965-3(b)(2), a U.S. shareholder is allowed to disregard the net accounts receivable, actively traded property, and short-term obligations of an SFC to the extent such assets are attributable to amounts taken into account with respect to another SFC. In order to avoid double counting under Prop. Reg. § 1.965-3(b)(2), a taxpayer must file a statement with its timely filed return providing (i) a description of the relevant asset, (ii) the pro rata share of the cash position of the specific SFC that will be reduced, (iii) a detailed explanation as to why double counting would occur, and (iv) an explanation as to why Prop. Regs. § 1.965-3(b)(1) does not apply to disregard such amount.

### Ordering Rules for U.S. Shareholders with Multiple Inclusion Years and Cash Position Estimates

Prop. Reg. § 1.965-3(c) provides guidelines for U.S. shareholders with multiple inclusion years. In such a case, the rules provide that a portion of the aggregate foreign cash position is allocated to the first inclusion year in an amount equal to the lesser of (i) the U.S. shareholder's aggregate foreign cash position or (ii) the U.S. shareholder's aggregate Section 965(a) inclusion amount for such inclusion year. As a result, the application of the higher 15.5 percent rate is front-loaded, allocating as much of the U.S. shareholder's aggregate foreign cash position as possible to the first inclusion year.

For a succeeding inclusion year, the amount of the U.S. shareholder's aggregate foreign cash position that is allocated is equal to the lesser of the excess, if any, of the U.S. shareholder's foreign cash position over the aggregate amount of its



aggregate foreign cash position allocated in the first inclusion year (or, where there are more than two inclusion years, any inclusion year subsequent to the first inclusion year—and the U.S. shareholder's aggregate Section 965(a) inclusion amount for each relevant inclusion year). In other words, only the portion of the aggregate cash position left over (if any) from the first inclusion year is allocated to the next.

When an SFC's final measurement date occurs after its U.S. shareholder must have already filed its tax return, the U.S. shareholder may initially assume the cash amount for such SFC is zero. The U.S. shareholder, however, must go back and recalculate its aggregate foreign cash position after the SFC's final measurement date passes and, if its tax liability is increased as a result, must file an amended return (without application of interest and penalties).

## Resulting E&P and Basis Adjustments

Certain E&P and basis adjustments accompany the application of the inclusion and deficit-offset rules of Sections 965(a) and (b). The Proposed Regulations contain many important operative rules for U.S. taxpayers figuring out how “life after tax reform” is going to work in their foreign structures. The Proposed Regulations seem to solve many of the mysteries that left taxpayers wondering what happens with respect to PTI arising as the result of the application of Section 965, especially PTI arising because of deficit allocation under Section 965(b)(4). These rules also provide a gain reduction rule for distributions of Section 965(a) PTI during an SFC's inclusion year.

## Ordering Rules for E&P Adjustments for Purposes of Sections 959 and 965

First, Prop. Reg. § 1.965-2(b) provides the ordering rules for the adjustments to be made to E&P for the SFC's inclusion year, and for the taxable year of a Section 958(a) U.S. shareholder of such SFC in which or with which such year ends. Taxpayers will likely find themselves frequently referring back to this deceptively simple priority list as they track the journey of an SFC's E&P.

The ordering rules generally follow those set forth in Notice 2018-7 and require E&P adjustments for each SFC in the following sequence: (1) determine “regular” Subpart F income of the SFC (*i.e.*, without regard to Section 965); (2) account for SFC-to-SFC distributions made before January 1, 2018, but only for purposes of Section 959; (3) calculate the Section 958(a) U.S. shareholder's Section 965(a) inclusion amount, which calculation should include the participation exemption and deficit allocation, as well as ignore any Subpart F income earned after the relevant measurement date for purposes of determining Section 959(c)(2) PTI that is kicked out of accumulated post-1986 DFI; (4) give effect to any other distributions from the SFC; and (5) determine the Section 956 amount of the SFC, including any PTI that should accordingly be reclassified as Section 959(c)(1) PTI.

**Observation:** Adjustments for SFC-to-SFC distributions are given effect second in the order—prior to determining the SFC's Section 965(a) earnings amount—but only for purposes of Section 959. Thus, where an SFC would otherwise have a November 2 measurement date, a distribution by that SFC to another SFC *after* November 2 would not reduce its post-1986 E&P for purposes of determining the accumulated



post-1986 DFI amount measured as of November 2. Rather, the payor SFC would still include that distributed E&P for purposes of its Section 965(a) earnings amount, but, for purposes of Section 959, the untaxed earnings described in Section 959(c)(3) would move to the distributee SFC. This creates an odd momentary “double life” for a lower-tier SFC’s E&P, whereby such E&P can appear to be counted both for Section 965(a) inclusion purposes and for purposes of moving its untaxed earnings under Section 959(c)(3) to its SFC parent. Taxpayers should also note that SFC-to-SFC distributions may create a deficit in the payor’s Section 959(c)(3) E&P, as the result of the peculiar E&P adjustment rules that we describe below.

The -2(j) examples do not include an SFC-to-SFC distribution that occurs *after* a November 2 measurement date, presumably because this topic was reserved for application of the -4(f) rules that disregard certain SFC-to-SFC payments that occur between November 2 and December 31 (discussed below). Thus, in applying the E&P adjustment rules of -2(b), taxpayers must be careful to keep in mind further adjustments that could result from application of -4(f).

### Adjustments to E&P Resulting from Section 965(a) Inclusions and Section 965(b) Deficit Offsets

Under Prop. Reg. § 1.965-2(c), a U.S. shareholder increases its Section 959(c)(2) PTI with respect to a DFIC by its Section 965(a) inclusion amount with respect to that DFIC, translated using the spot rate on December 31, 2017, provided the Section 965(a) inclusion amount is included in income by the U.S. shareholder. This PTI is referred to as Section 965(a) previously taxed earnings and profits (“Section 965(a) PTI”). Similarly, if a DFIC’s post-1986 E&P are reduced by the allocation of a deficit amount, Prop. Reg. § 1.965-2(d)(1) requires the DFIC to increase its Section 965(b) previously taxed earnings and profits (“Section 965(b) PTI”) in the amount of that reduction, *provided that* the Section 958(a) U.S. shareholder includes the Section 965(a) inclusion amount with respect to the DFIC in income.

**Observation:** At first blush, this rule for creating Section 965(b) PTI seems to require that the Section 958(a) U.S. shareholder actually have an inclusion under Section 965(a). Thus, it is unclear what happens if, after the allocation of deficits, a Section 958(a) U.S. shareholder’s Section 965(a) inclusion amount happens to be zero. The phrasing of this proviso, however, suggests that it is “stock language” that has been tacked onto similar provisions (*e.g.*, the rule for Section 965(a) PTI, which contains an identical proviso). Considering the outcome provided in Example 5 of -2(j), the final regulations will likely clarify that this rule only means that the Section 958(a) U.S. shareholder must include *any* remaining Section 965(a) inclusion amount following deficit allocation, and that Section 965(b) PTI still arises with respect to the amount of deficits allocated.

Interestingly, the Proposed Regulations add a downward adjustment to the untaxed Section 959(c)(3) E&P of the DFIC in an amount equal to the increase to the DFIC’s Section 965(a) and Section 965(b) PTI. This reduction to Section 959(c)(3) E&P (or an increase to the deficit in Section 959(c)(3), as the case may





be) seems to “make up” for the fact that the DFIC’s Section 965(a) inclusion amount is determined without regard to income earned or losses incurred after November 2. The preamble confirms that it is possible for the increase to Section 965(a) PTI to exceed the ultimate untaxed E&P of the DFIC for the year: “For example, this will be the case when a DFIC incurs a loss after the E&P measurement date on which it determines its section 965(a) earnings amount and before the end of its inclusion year.”

**Observation:** It is unclear from the rule itself when, precisely, this reduction to Section 959(c)(3) untaxed E&P occurs. The ordering rules provided under -2(b) suggest that *all* E&P adjustments must occur prior to the end of the SFC’s inclusion year (as application of Section 956 is determined last). If the adjustment is effective as of the close of the inclusion year, this provision may lead to unexpected results, especially for an SFC with a November 30 taxable year end.

The E&P of the E&P DFCs whose deficits were allocated must also be dealt with. Under Prop. Reg. § 1.965-2(d)(2), an E&P DFC’s Section 959(c)(3) E&P are increased by an amount equal to the portion of the Section 958(a) U.S. shareholder’s pro rata share of the specified E&P deficit of that E&P DFC. The rules clarify that, “for purposes of section 316, the earnings and profits of the E&P DFC attributable to the increase . . . are not treated as earnings and profits of the taxable year described in section 316(a)(2).”

**Observation:** The clarification that any increase to an E&P DFC’s E&P is not current year E&P for Section 316(a)(2) purposes is especially helpful for U.S. shareholders of CFCs that had Subpart F recapture accounts under Section 952(c). Thus, the E&P increase to an E&P DFC resulting from the allocation of its deficits to DFICs should not trigger recapture of that E&P DFC’s Subpart F income that had been subject to the current year E&P limitation in prior years.

If the E&P increase applies to a qualified deficit, “such increase is attributable to the same activity to which the deficit so taken into account was attributable.” In other words, consistent with the statutory provision in Section 965(b)(4)(B), any qualified deficit is reduced by the increase in E&P, and thus the reduced portion will not constitute a qualified deficit eligible for future use under Section 952(c).

Finally, some Section 958(a) U.S. shareholders may have aggregate deficits with respect to E&P DFCs that exceed their aggregate Section 965(a) inclusion amount. In such a circumstance, a portion of the deficit from each E&P DFC will not have been used to offset the Section 965(a) earnings amount, and that unused portion of each deficit will not be affected by the requirement to increase an E&P DFC’s E&P and/or reduce its qualified deficit. A Section 958(a) U.S. shareholder in this situation is required to: (i) designate the amount of the deficit of each E&P DFC that was used to offset a Section 965(a) earnings amount; and (ii) maintain in its books and records a statement setting forth this amount with respect to each E&P DFC. With respect to E&P DFCs with qualified deficits, the statement must also specify the portion of the offsetting deficit that is attributable to the E&P DFC’s qualified deficit and the qualified activities to which the attributable portion of the qualified deficit relates.



## Adjustments to Basis Resulting from Section 965(a) Inclusions and Section 965(b) Deficit Offsets

A basis increase to a DFIC's stock arises in an amount equal to the Section 958(a) U.S. shareholder's Section 965(a) inclusion amount and corresponding Section 965(a) PTI. This is, as the language in Prop. Reg. § 1.965-2(e) confirms, similar to the basis increase provided under Section 961, which is consistent with the general treatment of Section 965(a) inclusions as Subpart F inclusions.

With respect to deficit allocations and corresponding increases to Section 965(b) PTI, however, as a general matter, Prop. Reg. § 1.965-2(f) provides that no adjustment to basis arises by reason of allocated deficits.

Since the enactment of the TCJA, taxpayers have suspected that Section 965(b)(4)(A), which states only that a DFIC increases its PTI with respect to allocated deficits "for purposes of section 959," may not provide any basis increase under Section 961. This provision in the Proposed Regulations confirms Treasury's position that there is no automatic Section 961-type basis increase. In Prop. Reg. § 1.965-2(f)(2), apparent dispensation appears in the form of an election to apply basis adjustments to the stock of both DFICs and E&P DFCs (a "-2(f)(2) election").

If a U.S. shareholder elects to apply these basis adjustments, generally, a DFIC's stock basis is *increased* to the extent of its Section 965(b) PTI, and an E&P DFC's stock basis is *reduced* in an amount equal to the Section 958(a) U.S. shareholder's pro rata share of the specified E&P deficit of the E&P DFC taken into account under Section 965(b). Whether this election is actually beneficial, however, depends entirely on a given U.S. shareholder's particular situation, as there are several notably unfavorable potential results, many of which result from the election's interaction with the mechanical rules provided in Prop. Reg. § 1.965-2(h).

First, the adjustments to basis resulting from the election are made with respect to each DFIC and each E&P DFC in which the U.S. shareholder owns stock directly or indirectly. The adjustments are therefore "all or nothing," with no ability to selectively apply which DFICs receive basis increases and which E&P DFCs are subject to basis reductions.

Second, the adjustments are not limited to existing basis in the Section 958(a) U.S. shareholder's stock of E&P DFCs. This is another aspect of the "all or nothing" character of these rules: if the U.S. shareholder had specified E&P deficits that were allocated to reduce positive E&P, the entire amount of that offset will result in basis adjustments. Because of the basis adjustment mechanics that require the recognition of gain if a basis reduction from a -2(f)(2) election exceeds a given entity's available basis, it is crucial, then, that taxpayers fully appreciate how any elective basis adjustments size up in comparison to available basis.

Third, the adjustment is made at the level of the U.S. shareholder's direct ownership of the relevant DFIC or E&P DFC, or in the shares of the "applicable property" through which the U.S. shareholder indirectly owns the DFIC or E&P DFC (if the DFIC, E&P DFC, or applicable property is owned through one or more passthrough entities, then the adjustment is made at the first such DFIC,



E&P DFC, or applicable property in the chain). The provision in Prop. Reg. § 1.965-2(h)(5) that basis adjustments resulting from a -2(f)(2) election (as well as any basis adjustments from “regular” Section 965(a) inclusions) only occur with respect to stock owned directly by the Section 958(a) U.S. shareholder or directly owned applicable property confirms that these basis adjustments are limited to top-tier foreign subsidiaries. This also explains the need for the basis netting rules in Prop. Reg. § 1.965-2(h)(2), discussed below, in order to produce a single net upward or downward adjustment at the top tier.

**Observation:** If a Section 958(a) U.S. shareholder owns all of its SFCs through a single top-tier holding company, and the specified E&P deficits of the E&P DFCs wipe out the post-1986 E&P of the DFICs, a -2(f)(2) election to make basis adjustments for allocated deficits appears to result in equal and offsetting upward and downward adjustments to the basis of the stock of the holding company, with no further adjustments at lower tiers. Thus, if a foreign group of subsidiaries is in an overall deficit position for Section 965 purposes, a -2(f)(2) election may yield no net change to basis.

In terms of the -2(f)(2) election itself, in order for the election to be effective, all Section 958(a) U.S. shareholders that are related must make the election, which is made in the form of a statement attached to the return. The election must be made no later than the due date for the Section 958(a) U.S. shareholder’s return for the first taxable year that includes the last day of the inclusion year of a DFIC or E&P DFC. Meeting this due date is critical for taxpayers choosing to avail themselves of the election since the provision states that relief under Treas. Reg. § 301.9100-2 or -3 is not available for late elections.

**Observation:** For calendar year taxpayers with October 15, 2018 filing deadlines, making the necessary calculations to determine whether the -2(f)(2) election is the “better” choice will be a burdensome, fast-paced task (on top of other, existing burdensome and fast-paced tasks). For taxpayers with filing deadlines within 30 days of the issuance of the Proposed Regulations, there is a transition rule providing 60 days after the publication of the Proposed Regulations in the Federal Register to make the election, meaning the election must be made by October 9, 2018.

### Gain Reduction Rule for Inclusion Year Distributions of Section 965(a) PTI

In general, the gain reduction rule provided in Prop. Reg. § 1.965-2(g) adopts the same rule outlined in Notices 2018-7 and -13, which allowed for a reduction in gain recognized under Section 961(b)(2) by reason of distributions during the inclusion year attributable to “Section 965 previously taxed earnings and profits” (or “Section 965 PTI”) in the inclusion year. This defined term means the sum of the Section 965(a) PTI of a DFIC and, if the Section 958(a) U.S. shareholder has made the -2(f)(2) election, the Section 965(b) PTI of the DFIC. Consistent with the gain reduction rule in the Notices, those taxpayers that benefit from the gain reduction rule will have their basis reduced accordingly. The rule effectively accelerates the creation of stock basis under Section 961(a) which, by implication, normally would not occur until the end of the taxable year.



**Observation:** Notably, while the example of the gain reduction rule in Notice 2018-13 explicitly provided that a distribution by a lower-tier CFC to its CFC parent of Section 965(a) PTI during the inclusion year would, in spite of Section 961(c), be eligible for the gain recognition rule, the Proposed Regulations remain ominously silent as to the consequences of lower-tier distributions. This is apparent in the distribution by CFC2 to CFC1 in Example 4 of -2(j).

## Rules of Application for Specified Basis Adjustments

As mentioned above, the mechanics of specified basis adjustments (*i.e.*, those basis adjustments arising by reason of Prop. Reg. §§ 1.965-2(e), (f)(2) and (g)) are addressed in Prop. Reg. § 1.965-2(h).

Basis is adjusted on the last day of the relevant entity's inclusion year, which is the same day that the Section 965(a) inclusion is taken into account by the Section 958(a) U.S. shareholder. As mentioned above, where multiple basis adjustments occur on the same day with respect to the same stock or applicable property, the adjustments are netted so that there is only a single basis adjustment as of the close of the day.

Yet another issue lurks in the timing of the -2(f)(2) election that can prove problematic for the unwary taxpayer. The basis adjustment is treated as though it happened on the last day of the inclusion year for an E&P DFC, meaning that if a reduction is in excess of basis, gain is recognized at the corporate tax rate in effect on the last day of the E&P DFC's tax year. In the case of a calendar year taxpayer, this would have been December 31, 2017—*i.e.*, when the 35 percent corporate rate was still in effect. Thus, there is an apparent bias in favor of an SFC with a fiscal year end—*e.g.*, a November 30 taxable year end. In such a case, any gain recognized would appear to be recognized at the 21 percent corporate rate, not the 35 percent corporate rate. Treasury should articulate what, if any, rationale would apply for this disparity.

In addition, basis adjustments are made with respect to each share of a Section 958(a) U.S. shareholder's stock in a DFIC or E&P DFC, or in its interest in applicable property, meaning adjustments are made in a manner consistent with the Section 958(a) U.S. shareholder's pro rata share of the Section 965(a) earnings amount or specified E&P deficit. Given that basis adjustments may only be made at the top-tier level, taxpayers with structures that have basis in their E&P DFCs at lower tiers, but comparatively little basis at the top tier, appear to be whipsawed by the provisions, trading E&P that could have been taxed at 8 or 15.5 percent for potential gain taxable at 21 percent.

## Disregarded Transactions and Managing Double Counting of E&P

The Proposed Regulations contain a number of rules that target and disregard actions that potentially reduce the Section 965 tax liability of a U.S. shareholder. Certain actions are only disregarded if they are undertaken with a principal purpose of reducing Section 965 tax liability, while others are disregarded regardless of the motivations for which they are undertaken. The Proposed Regulations generally track the rules announced in Notice 2018-26, with limited but significant modifications. However, in formulating these Proposed



Regulations, Treasury and the IRS appear to have rejected almost every taxpayer comment submitted in response to Notice 2018-26.

## Disregard of Cash Reduction, E&P Reduction, and Pro Rata Share Transactions

The anti-avoidance rule of Prop. Reg. § 1.965-4(b)(1) provides that a transaction is disregarded for purposes of determining the amounts of all “Section 965 elements” of a U.S. shareholder if: (i) the transaction occurs, in whole or in part, on or after November 2, 2017 (the “specified date”); (ii) the transaction is undertaken with “a” (not “the”) principal purpose of changing the amount of a “Section 965 element” of the U.S. shareholder; and (iii) the transaction would (absent the application of Prop. Reg. § 1.965-4(b)(1)) change the amount of the Section 965 element of the U.S. shareholder.

**Observation:** Importantly, consistent with Notice 2018-26, transactions that occur prior to November 2, 2017 are outside of the scope of the anti-avoidance rule under Prop. Reg. § 1.965-4(b)(1).

Notice 2018-26 did not use the term “Section 965 element,” but it did employ the underlying concepts in determining whether a taxpayer sought and/or achieved a reduction to its Section 965 tax liability. The term “Section 965 element” is defined in Prop. Reg. § 1.965-4(d) as, with respect to any U.S. shareholder, any of the following: (i) the Section 965(a) inclusion amount with respect to an SFC; (ii) the aggregate foreign cash position; or (iii) the amount of foreign income taxes of an SFC deemed paid under Section 960 as a result of a Section 965(a) inclusion.

**Observation:** While “Section 965 element” is a new term, Treasury is going after the same types of transactions as those identified in Notice 2018-26. The preamble to the Proposed Regulations observes that “[t]he Conference Report reflects an intent for the Treasury Department and the IRS to address all strategies for avoiding a section 965(a) inclusion,” and the anti-avoidance rules appear to hew to this mandate. Thus, each “element” remains narrowly drawn to include *only* those aspects immediately associated with a taxpayer’s inclusion and resulting liability under Section 965(a)—*i.e.*, the inclusion amount, the effective tax rate resulting from the cash position, and the deemed-paid foreign taxes that accompany the inclusion itself.

The Proposed Regulations provide that a “change” occurs with respect to a Section 965 element of a U.S. shareholder if, as a result of a transaction (or a change in accounting method or change in entity classification, as discussed below), a U.S. shareholder’s Section 965(a) inclusion amount with respect to an SFC is decreased, the aggregate foreign cash position of the U.S. shareholder is decreased, or the amount of foreign income taxes of an SFC deemed paid under Section 960 as a result of a Section 965(a) inclusion is increased. For these purposes, if a domestic passthrough entity (*i.e.*, a passthrough entity that is a U.S. person) is a U.S. shareholder, then a domestic passthrough owner (*i.e.*, a partner, shareholder, beneficiary, grantor, or owner), with respect to the domestic passthrough entity, that is not otherwise a U.S. shareholder, is treated as a U.S. shareholder.



Having defined what is targeted by the anti-avoidance rule, the Proposed Regulations then identify a series of transactions, as well as accompanying presumptions, that Treasury and the IRS believe result in an unwarranted change of a U.S. shareholder's Section 965 elements and thus will be disregarded. Here, the term "transfer" includes any disposition of stock or property, including a sale or exchange, contribution, distribution, issuance, redemption, recapitalization, or loan of stock or property, and includes an indirect transfer of stock or property. A person is treated as related to a U.S. shareholder if, either immediately before or immediately after the transaction (or series of related transactions), the person bears a relationship to the U.S. shareholder described in Section 267(b) or 707(b).

The first type of transaction identified by the Proposed Regulations is a "cash reduction transaction." A cash reduction transaction is a transfer of cash, accounts receivable, or cash-equivalent assets by an SFC to its U.S. shareholder (or a person related to such U.S. shareholder), or an assumption by an SFC of an account payable of its U.S. shareholder (or a person related to such U.S. shareholder), if such transfer or assumption would (absent the application of the anti-avoidance rule) reduce the aggregate foreign cash position of the U.S. shareholder. A cash reduction transaction is presumed to be undertaken with a principal purpose of changing the amount of a Section 965 element of a U.S. shareholder. However, this presumption does not apply to a cash reduction transaction that occurs in the ordinary course of business.

The Proposed Regulations except from the cash reduction transaction rules a narrow swath of transactions. Specifically, a distribution by an SFC to its U.S. shareholder is treated per se as not being undertaken with a principal purpose of changing the amount of a Section 965 element of the U.S. shareholder and thus is not subject to the cash reduction transaction rules. This exception, by its terms, applies only to a distribution by an SFC to a U.S. shareholder or a person related to such U.S. shareholder. Thus, a distribution from one SFC to another SFC related to a U.S. shareholder in order to fund a distribution to such U.S. shareholder would not be within the exception. However, a distribution from one SFC to another may not be within the rules because it may not reduce the aggregate foreign cash position of the U.S. shareholder (or any other Section 965 element of such shareholder), or the distribution occurs in the ordinary course of business.

On the other hand, notwithstanding the foregoing rule, a "specified distribution" is treated per se as being undertaken with a principal purpose of changing the amount of a Section 965 element of a U.S. shareholder. A "specified distribution" is a cash reduction transaction that is a distribution by an SFC of a U.S. shareholder if and to the extent that, at the time of the distribution: (i) there was a plan or intention for the distributee to transfer cash, accounts receivable, or cash-equivalent assets to any SFC of the U.S. shareholder; or (ii) the distribution is a non-pro rata distribution to a foreign person that is related to the U.S. shareholder.

**Observation:** Thus, "specified distributions" capture transactions in which cash (or a cash equivalent) of an SFC is distributed but the distributee had a intention to transfer the cash (or a cash equivalent) outbound to an SFC, or cash (or a cash equivalent) of an SFC is diverted on a non-pro rata basis to a related foreign person.



The second type of avoidance transaction identified by the Proposed Regulations is an “E&P reduction transaction.” These transactions are presumed to be undertaken with a principal purpose of changing the amount of a Section 965 element of a U.S. shareholder and are disregarded unless they are undertaken in the ordinary course of business. An E&P reduction transaction is a transaction between an SFC and any of the U.S. shareholders of the SFC, another SFC of the U.S. shareholder of the SFC, or any person related to the U.S. shareholder of the SFC if the transaction would otherwise reduce either the accumulated post-1986 DFI or the post-1986 undistributed earnings (as defined in Section 902(c)(1)) of the SFC or another SFC of any U.S. shareholder of such SFC.

Notwithstanding the foregoing, a “specified transaction” is treated per se as being undertaken with a principal purpose of changing the amount of a Section 965 element of a U.S. shareholder for purposes of Prop. Reg. § 1.965-4(b)(1). A “specified transaction” means an E&P reduction transaction that involves one or more of the following: (i) a complete liquidation of an SFC to which Section 331 applies (*i.e.*, a liquidation not eligible for nonrecognition treatment under Section 332); (ii) a sale or other disposition of stock by an SFC; or (iii) a distribution by an SFC that reduces the E&P of the SFC pursuant to Section 312(a)(3) (*i.e.*, an in-kind distribution of built-in loss property). Each of these specified transactions could have been utilized (*e.g.*, through the generation of a loss on stock) on or after November 2, 2017 to reduce E&P.

The third type of transaction identified by the Proposed Regulations is a so-called “pro rata share transaction.” Under Prop. Reg. § 1.965-4(b)(2)(v), such transactions are presumed to be undertaken with a principal purpose of changing the amount of a Section 965 element of a U.S. shareholder. Pro rata share transactions are further divided into two categories, pro rata share reduction transactions and E&P deficit transactions, each of which involves the transfer of stock of an SFC or an E&P DFC in an attempt to reduce the Section 965 tax liability of a U.S. shareholder.

A pro rata share reduction transaction is a transfer of stock of an SFC by either a U.S. shareholder of that SFC or a person related to a U.S. shareholder of that SFC (including by the SFC itself) to another person related to that U.S. shareholder if the transfer would otherwise: (i) reduce the U.S. shareholder’s pro rata share of the Section 965(a) earnings amount of the SFC; (ii) reduce the U.S. shareholder’s pro rata share of the cash position of the SFC; or (iii) both. An E&P deficit transaction is a transfer to either a U.S. shareholder or a person related to the U.S. shareholder of the stock of an E&P DFC by a person related to the U.S. shareholder (including by the E&P DFC itself) if the transfer would otherwise increase the U.S. shareholder’s pro rata share of the specified E&P deficit of the E&P DFC.

Note that there is no “ordinary course of business” exception from the presumption of a principal purpose for either type of pro rata share transaction. Additionally, an “internal group transaction” is treated per se as being undertaken with a principal purpose of changing the amount of a Section 965 element of a U.S. shareholder. An internal group transaction is a pro rata share transaction (including both pro rata share reduction transactions and E&P deficit transactions) if, immediately before or after the transfer, the transferor of the stock of the SFC and the transferee of such stock are members of the same affiliated group. For these purposes, an “affiliated group” is defined by reference to Section 1504(a)



without regard to paragraphs (1) through (8) of Section 1504(b) and a member of that affiliated group is any entity included in that affiliated group. In addition, partners in partnerships are treated as holding their proportionate share of stock held by a partnership and, if one or more members of an affiliated group own, in the aggregate, at least 80 percent of the interests in a partnership's capital or profits, the partnership will be treated as a corporation that is a member of the affiliated group.

Prop. Reg. § 1.965-4(b)(2) provides a series of rules for applying and rebutting (where possible) the exceptions and presumptions contained in Prop. Reg. §§ 1.965-4(b)(2)(iii) through (v) that can lead to the disregard of a transaction. For example, in the case of cash reduction transactions, E&P reduction transactions, and pro rata share transactions, the general presumption that such transactions were undertaken with a principal purpose of changing the amount of a Section 965 element of a U.S. shareholder may only be rebutted if the facts and circumstances clearly establish it was not such a principal purpose. A taxpayer which takes the position that it has rebutted this presumption must disclose so in a statement attached to its return for its taxable year in which or with which the relevant taxable year of the relevant SFC ends.

**Observation:** For this compliance cycle, taxpayers must identify any transactions that are presumed to be among these anti-avoidance transactions listed in the Proposed Regulations, and must therefore within a short timeframe determine whether a rebuttal must be disclosed with their tax returns.

In the case of cash reduction transactions and E&P reduction transactions, whether or not the ordinary course of business exception to the general presumption applies must be determined under all the facts and circumstances. Finally, the Proposed Regulations make clear that the per se rules in the case of certain cash reduction transactions, E&P reduction transactions, and pro rata share transactions, whether benefitting the taxpayer (*i.e.*, a distribution other than a specified distribution) or the government (a specified distribution, a specified transaction, or an internal group transaction), create irrebuttable presumptions that cannot be overcome by other evidence.

## Disregard of Accounting Method Changes and Entity Classification Elections

In addition to the foregoing anti-avoidance regulations, Prop. Reg. § 1.965-4(c)(1) disregards certain changes in methods of accounting and entity classification elections regardless of the motivations of the taxpayer. Specifically, any change in method of accounting for a taxable year of an SFC that ends in 2017 and 2018 is disregarded for purposes of determining the amounts of all Section 965 elements with respect to a U.S. shareholder if such change in method of accounting would otherwise change such Section 965 elements. As noted, this rule is applied without regard to the taxpayer's motivations for the change in method of accounting, regardless of whether the change was made in accordance with the procedures described in Rev. Proc. 2015-13, 2015-5 I.R.B. 419, and regardless of whether the change was properly made. However, it does not apply to a change in method of accounting for which the original and/or duplicate copy of any Form 3115, "Application for Change in Accounting Method," requesting the change was filed before November 2, 2017.





Furthermore, Prop. Reg. § 1.965-4(c)(2) provides that an entity classification election that is filed on or after November 2, 2017 is disregarded for purposes of determining the amounts of all Section 965 elements of a U.S. shareholder if the election would change the amount of any Section 965 element of the U.S. shareholder. Again, this rule is applicable without regard to the taxpayer's motivations for making the entity classification election. Not surprisingly, an election filed on or after November 2, 2017 is also disregarded under this rule even if the election itself was filed with an effective date that is before November 2, 2017.

### Disregard of Payments to Prevent Double Counting

Finally, Prop. Reg. § 1.965-4(f) contains rules that disregard certain transactions between related SFCs that occur after November 2, 2017 and on or before December 31, 2017 for the purpose of determining E&P on the December 31, 2017 measurement date. As with the changes in methods of accounting and entity classification elections discussed above, these rules apply regardless of the taxpayer's motivation for entering into the transactions, but they seem to help taxpayers by "putting back" E&P that could otherwise be subject to double counting for Section 965 purposes. Thus, a "specified payment" made by an SFC to another SFC is disregarded for purposes of determining the post-1986 E&P of both such SFCs as of the December 31, 2017 E&P measurement date.

The term "specified payment" means any amount paid or accrued by a payor SFC, including a distribution by the payor SFC with respect to its stock, if: (i) immediately before or immediately after the payment or accrual, the payor SFC and the payee SFC are related within the meaning of Section 954(d)(3); (ii) the payor SFC and the payee SFC do not have the same tentative E&P measurement date; (iii) the payment or accrual of the amount occurs after November 2, 2017, and on or before December 31, 2017; and (iv) the payment or accrual of the amount would otherwise reduce the post-1986 E&P of the payor SFC as of the E&P measurement date on December 31, 2017. Except in the case of an E&P DFC (determined prior to the application of Prop. Reg. § 1.965-4(f)(1)), the term "tentative E&P measurement date" means the E&P measurement date of an SFC that, without the application of Prop. Reg. § 1.965-4(f)(1), would result in the "greater of" amount of accumulated post-1986 DFI described in Section 965(a). In the case of an SFC that would be an E&P DFC, if Prop. Reg. § 1.965-4(f)(1) were not considered, the term "tentative E&P measurement date" means the E&P measurement date as of November 2, 2017.

The Proposed Regulations provide a number of examples of the application of Prop Reg. § 1.965-4(f)(1). In Example 1, USP, a domestic corporation, owns all of the stock of CFC1, a foreign corporation, which owns all of the stock of CFC2, also a foreign corporation. USP, CFC1, and CFC2 have calendar year taxable years. On November 2, 2017, each of CFC1 and CFC2 has post-1986 E&P of 100u. On November 3, 2017, CFC2 makes a deductible payment of 10u to CFC1. The payment does not constitute Subpart F income and CFC1 and CFC2 have no other items of income or deduction. The tentative E&P measurement date of CFC1 is December 31, 2017 (110u on December 31, 2017 is greater than 100u on November 2, 2017) and the tentative E&P measurement date of CFC2 is November 2, 2017 (100u on November 2, 2017 is greater than 100u on December 31, 2017).



In Example 1, the payment from CFC2 to CFC1 is a specified payment because: (i) CFC1 and CFC2 are related SFCs; (ii) CFC1 and CFC2 do not have the same tentative measurement date; (iii) the payment occurs after November 2, 2017, and on or before December 31, 2017; and (iv) the payment would otherwise reduce the post-1986 E&P of CFC2 as of the E&P measurement date on December 31, 2017. Therefore, the specified payment is disregarded and CFC1 and CFC2 each have post-1986 E&P of 100u as of December 31, 2017. As a result, the Section 965(a) earnings amount of each of CFC1 and CFC2 is 100u. The reasoning and conclusion in Example 2 is the same where the facts are the same except that the specified payment is a dividend paid from CFC2 to CFC1.

**Observation:** Under the rules of -4(f), specified payments are disregarded only for the purpose of computing the post-86 E&P of the payor and the payee as of the December 31, 2017 E&P measurement date. Thus, it would appear, for example, that a distribution disregarded under -4(f) would not be disregarded for the purpose of Section 959 and that the distribution would decrease the untaxed Section 959(c)(3) E&P of the distributor and increase the Section 959(c)(3) E&P of the distributee before any adjustments to the E&P of either SFC are made with respect to Section 965(a) or (b) (per the ordering rule in -2(b), discussed above). This interpretation is supported by two of the examples in -2(j), which explicitly reference the -4(f) rules with respect to the third step of the ordering rule, but not with respect to the second step.

Under the effective date rules of Prop. Reg. § 1.965-9(b), Prop. Reg. § 1.965-4 applies regardless of whether, with respect to a foreign corporation, the transaction, effective date of a change in method of accounting, effective date of an entity classification election, or specified payment described in Prop. Reg. § 1.965-4 occurred before the first day of the foreign corporation's last taxable year that begins before January 1, 2018, or, with respect to a U.S. person, the transaction, effective date of a change in method of accounting, effective date of an entity classification election, or specified payment described in Prop. Reg. § 1.965-4 occurred before the first day of the taxable year of the U.S. person in which or with which the taxable year of the foreign corporation ends. This effective date rule confirms that, for example, if a foreign corporation has a tax year that begins on December 1, 2017 (*i.e.*, its last taxable year that begins before January 1, 2018), an entity classification election that is filed on or after November 2, 2017 is nevertheless disregarded under Prop. Reg. § 1.965-4.

## Foreign Taxes and the Section 965(a) Inclusion

The Proposed Regulations also provide rules with respect to the provisions of Section 965 that relate to foreign tax credits.

Section 965(g) provides that no credit or deduction 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 Section 965(c) deduction is allowed. Prop. Reg. § 1.965-5(c)(1) clarifies that “taxes paid or accrued” refers to foreign income taxes paid or accrued directly by the taxpayer under Section 901 and “taxes treated as paid or accrued” includes foreign income taxes deemed paid under Section 960, those allocated to an entity under Treas. Reg. § 1.901-2(f)(4), and a distributive share of taxes paid by a partnership. The “applicable



percentage” concept is essentially a “haircut” on the foreign taxes allocable or sufficiently related to a Section 965(a) inclusion.

Prop. Reg. § 1.965-5(b) specifies that that the Section 965(g) haircut applies to any foreign income taxes and withholding taxes imposed on distributions of Section 965 PTI. Prop. Reg. § 1.965-5(c) further provides that foreign tax credits are disallowed completely with respect to taxes allocable to E&P offset by deficits under Section 965(b) and with respect to taxes imposed on the distribution or receipt of Section 965(b) PTI. Such disallowance incorporates a narrow interpretation of the application of former Section 960(a)(3)—namely, that former Section 960(a)(3) applies only to withholding and foreign income taxes imposed on an upper-tier foreign corporation on distributions of PTI from a lower-tier foreign corporation.

**Observation:** Treasury takes a great deal of liberty in its decision to haircut foreign tax credits from income and withholding taxes imposed on distributions of Section 965(a) PTI and to completely disallow foreign tax credits with respect to taxes allocable to E&P reduced under Section 965(b). Congress granted Treasury express authority to adjust basis with respect to the consequences of Section 965, but there is no indication that Congress intended to grant Treasury the authority to disallow foreign tax credits in circumstances other than those set forth in the statute. To be sure, Treasury will be hearing from taxpayers concerned that the Proposed Regulations overreach, going further than the statute allows in depriving taxpayers of the benefit of foreign tax credits.

The TCJA replaces Section 960(a)(3) with Section 960(b), and the Proposed Regulations reserve on the interaction of Section 965 with new Section 960(b). The preamble indicates that Treasury anticipates issuing regulations with similar rules in connection with new Section 960(b).

**Observation:** If rules are promulgated with respect to new Section 960(b) and those are similar to the rules proposed in connection with former Section 960(a)(3), the same concerns would apply with respect to application of the haircut under Section 965(g) to withholding taxes imposed on distributions of Section 965 PTI which are otherwise creditable under Section 901 and new Section 960(b). The issue discussed above with respect to taxes left behind in DFICs also applies here for post-inclusion year distributions of PTI.

The Section 78 gross-up rule applies with respect to the Section 965(a) inclusion and is modified under Prop. Reg. § 1.965-5(c)(3). The Proposed Regulations provide that Section 78 applies to a proportion of the foreign income taxes deemed paid by a domestic corporation with respect to its Section 965(a) inclusion amount pursuant to the following formula:

(Section 965(a) inclusion amount for a Section 958(a) U.S. shareholder inclusion year - Section 965(c) deduction amount allowable with respect to such inclusion amount) / Section 965(a) inclusion amount

The purpose of this provision is to ensure that that the haircut with respect to deemed paid foreign tax credit also applies to the Section 78 gross-up.



Pursuant to Prop. Reg. § 1.965-5(d), the “applicable percentage” under Section 965(g) is determined with respect to a Section 958(a) U.S. shareholder and a Section 958(a) U.S. shareholder inclusion year. As a result, a Section 958(a) U.S. shareholder might have more than one “applicable percentage” (and different amount of credits disallowed) as a result of differing aggregate foreign cash positions in different inclusion years. Also, if a person is a domestic passthrough owner of multiple domestic passthrough entities each of which is a Section 958(a) U.S. shareholder, the person might have a different “applicable percentage” with respect to each entity as a result of differing aggregate foreign cash positions of those entities, as well as a different applicable percentage with respect to the person’s Section 958(a) stock, if any. The applicable percentage is defined as the sum of the following:

(i)  $0.771 \times (\text{Section 958(a) U.S. shareholder's 8 percent rate amount for the inclusion year} / (\text{Section 958(a) U.S. shareholder's 8 percent rate amount for the inclusion year} + \text{Section 958(a) U.S. shareholder's 15.5 percent rate amount for the inclusion year}))$ ; and

(ii)  $0.557 \times (\text{Section 958(a) U.S. shareholder's 15.5 percent rate amount for the inclusion year} / (\text{Section 958(a) U.S. shareholder's 8 percent rate amount for the inclusion year} + \text{Section 958(a) U.S. shareholder's 15.5 percent rate amount for the inclusion year}))$ .

The math works out so that the foreign tax credit haircut is generally in proportion to the amount by which the Section 965(c) deduction reduces the tax imposed on the Section 965(a) inclusion from the amount of tax imposed at a 35 percent rate.

Prop. Reg. § 1.965-6 provides the rules for the computation of foreign income taxes deemed paid with respect to the Section 965 inclusion. The Proposed Regulations generally import the rules of former Section 902 to determine a U.S. shareholder’s deemed paid foreign income taxes. Under Section 902, deemed paid foreign income taxes are computed with respect to a dividend paid by a foreign corporation by multiplying the corporation’s foreign income taxes by a fraction in which the dividend is the numerator and the corporation’s post-1986 undistributed earnings (as determined under Section 902) is the denominator. With respect to this computation, the Proposed Regulations treat the Section 965(a) inclusion as a dividend paid by the DFIC (translated, if necessary, into the DFIC’s functional currency using the spot rate on December 31, 2017). In response to comments, the Proposed Regulations also clarify that if the Section 902 fraction would otherwise exceed one, the Section 902 fraction is one. Absent this rule, the Section 902 fraction could otherwise exceed one, for example, if the Section 965(a) inclusion is determined based on accumulated post-1986 DFI of a DFIC on November 2, 2017. If the denominator of the Section 902 fraction is zero or less, the Proposed Regulations clarify that the Section 902 fraction is zero and no foreign taxes are deemed paid.

**Observation:** Treasury decided not to adopt a rule providing that, to the extent a hovering deficit is treated as reducing the post-1986 E&P of a DFIC, those taxes associated with the hovering deficit should be added to the DFIC’s post-1986 foreign income taxes in the inclusion year. Treasury believes that the rules under Treas. Reg. § 1.367(b)-7 adequately address the issue.



Further, as indicated above, the Section 959(c)(3) E&P of an E&P DFC are increased by an amount equal to the deficit of the E&P DFC taken into account under the rules of Section 965(b)(4)(A). Treas. Reg. § 1.965-6(c)(3) provides that, for purposes of Section 902(c)(1) and determining the post-1986 undistributed earnings of the E&P DFC, the increase in the Section 959(c)(3) E&P of such corporation occurs as of the first day of the foreign corporation's first taxable year following the last taxable year that begins before January 1, 2018.

**Observation:** This rule prevents foreign taxes of E&P DFCs from being deemed paid as a result of the increase in E&P under Section 965(b)(4)(B). Thus, because Section 902 is repealed for taxable years that begin after January 1, 2018, foreign tax pools of E&P DFCs are effectively eliminated without utilization under the Proposed Regulations.

Prop. Reg. § 1.965-6 also provides a rule that addresses the effect of the Section 965(c) deduction and the impact of Section 965 PTI on the allocation and apportionment of deductions between foreign and domestic source income and between separate categories of foreign source income for purposes of determining the foreign tax credit limitation. The Proposed Regulations clarify that the Section 965(c) deduction does not result in the Section 965(a) inclusion being treated as exempt income or in SFC stock being treated as an exempt asset under Section 864(e)(3). Additionally, Section 965(a) PTI and Section 965(b) PTI do not cause income or assets to be treated as exempt for this purpose. As a general matter, these provisions prevent taxpayers from shifting the allocation and apportionment of deductions to domestic source income by applying Section 864(e)(3) to reduce the amount of foreign income and assets with respect to which deductions may be allocated and apportioned.

## Elections and Payment Rules

The Proposed Regulations would adopt much of the guidance on elections and payments that was previously provided via notice. Any person with a Section 965(h) net tax liability ("Section 965(h) tax liability") may elect to make payments in eight installments. The taxpayer may revoke the election only by paying the full remaining amount of the unpaid Section 965(h) tax liability. Once the election is made, the taxpayer may pay 8 percent of the tax liability for the first five installments, 15 percent for the sixth installment, 20 percent for the seventh installment, and finally 25 percent for the final eighth installment.

If a taxpayer files a return that reflects an increase in the amount of its Section 965(h) tax liability, or if a deficiency or additional liability is assessed, then such additional amount is prorated. However, a taxpayer must make the entire payment on notice and demand by the Secretary if the deficiency or additional liability is due to negligence, intentional disregard of rules and regulations, or fraud with intent to evade tax. Generally, the taxpayer must make the installment payments on or before the due date for the return for the relevant taxable year.

**Observation:** Here, the Proposed Regulations settle the question of whether an incorrect initial determination of Section 965(h) tax liability could trigger acceleration of the entire balance due (as well as interest and penalties). Such a situation should only arise if the underpayment is due to negligence, intentional disregard, or fraud.



A taxpayer must make the Section 965(h) election no later than the due date for the return for the relevant tax year, and, as with other elections provided in the Proposed Regulations, it cannot get relief for late elections under Treas. Reg. § 301.9100-2 or -3. The taxpayer must attach to its return a statement including its: (i) name and taxpayer identification number, (ii) total net tax liability under Section 965; (iii) Section 965(h) net tax liability; (iv) Section 965(i) net tax liability with respect to which a Section 965(i) election is effective, if applicable; and (v) the anticipated amounts of each installment.

A taxpayer that made a Section 965(h) election must make the payments on the unpaid portion of the remaining installments if certain acceleration events occur, including: (i) substantially all of the assets of the person are liquidated, sold, exchanged, or disposed of; (ii) the business ceases to exist; (iii) the person is no longer a U.S. person; (iv) the person becomes a member of a consolidated group after not being a member of any consolidated group; or (v) the person's consolidated group ceases to exist. The taxpayer must make the payments on or before the day that an acceleration event occurs, and certain exceptions apply. Additionally, a taxpayer may transfer its Section 965(h) tax liability to a transferee by entering into an agreement with the Service.

### Section 965(i) Election

Under Section 965(i), each shareholder of an S corporation that is a U.S. shareholder of a DFIC may elect to defer the payment of its Section 965(i) net tax liability ("Section 965(i) tax liability") with respect to the S corporation. The shareholder may defer the payment until the shareholder's taxable year that includes a "triggering event," which can be any of the following: (i) the corporation ceases to be an S corporation; (ii) substantially all of the assets of the S corporation are liquidated, sold, exchanged, or disposed of, the S corporation's business ceases to exist, or the S corporation ceases to exist; or (iii) the shareholder transfers any share of stock of the S corporation. A selling S corporation shareholder may enter into a transfer agreement to continue to defer the Section 965(h) tax liability. In addition, a shareholder of an S corporation may also make elections under both Section 965(i) and Section 965(n).

A taxpayer may revoke this election only by paying the full amount of Section 965(i) tax liability. A taxpayer may make this election before a triggering event occurs, and the election must be made no later than the due date for its return for each taxable year (including the last day of the taxable year of the S corporation in which it has a Section 965(a) inclusion to which the taxpayer's Section 965(i) tax liability is attributable). As with other elections, the taxpayer cannot get relief for late elections under Treas. Reg. § 301.9100-2 or -3.

### Section 965(m) Election and Special Rules for REITs

A REIT may elect to defer the inclusion of its REIT Section 965 amounts in gross income (for purposes of computing REIT taxable income under Section 857(b)), and include them in income according to the following inclusion schedule: 8 percent of REIT Section 965 amounts for the first five years that begin with the taxable year the amount would otherwise be included, 15 percent in the sixth year, 20 percent in the seventh year, and 25 percent in the eighth year. A REIT may revoke its election only by including the full amount of the REIT Section 965 amounts in its gross income.



A REIT with a Section 965(a) inclusion may make this election no later than the due date for the return for the first year in the inclusion schedule. No relief is available under Treas. Reg. § 301.9100-2 or -3, and a REIT cannot make a Section 965(h) election for any year in which the Section 965(m) election is in effect.

If a REIT makes a Section 965(m) election and subsequently liquidates, sells, exchanges, or disposes of substantially all of the assets of the REIT (*i.e.*, title 11), or ceases its business, any amount not yet included in gross income as a result of the Section 965(m) election will be so included as of the day before the date of the event. The unpaid portion of tax liability will be due on the date of the event.

Note that any Section 965(a) inclusions of a REIT are not taken into account as gross income of the REIT for purposes of applying paragraphs (2) and (3) of Section 856(c) for any taxable year that the REIT takes into account a Section 965(a) inclusion, regardless of whether the REIT has made a Section 965(m) election or whether it is a U.S. shareholder of a DFIC.

### Section 965(n) Election

A taxpayer may elect to not take into account a certain amount in determining (i) its net operating loss (“NOL”) under Section 172 for the taxable year, or (ii) the amount of taxable income for such taxable year that may be reduced by NOL carryovers or carrybacks to such taxable year under Section 172.

The applicable amount for Section 965(n) election is the sum of (i) Section 965(a) inclusions for taxable year reduced by Section 965(c) deductions for taxable year, and (ii) taxes deemed paid under Section 960(a)(1) for the taxable year with respect to Section 965(a) inclusions that are treated as dividends under Section 78 (for domestic corporations).

A taxpayer cannot revoke this election, and, once made, the election applies to both the NOL for the taxable year for which the election is made, and for the NOL carryovers or carrybacks to such taxable year, each in their entirety. Further, if an agent of a consolidated group makes the Section 965(n) election, it applies to all NOLs available to the consolidated group, including the components of the consolidated NOL deduction.

A taxpayer must make the election, and file a required statement, no later than the due date for the return for the taxable year to which the election applies (taking into account extensions), and the taxpayer cannot get relief for late elections.

### Election to Use Alternative Method for Calculating Post-1986 E&P

An SFC that does not have a 52-53-week taxable year may make an irrevocable election to compute the post-1986 E&P using alternative method as of the E&P measurement date on November 2, 2017 (but not on the E&P measurement date on December 31, 2017). On the other hand, an SFC that has a 52-53-week taxable year may also make an irrevocable election to use the alternative method to compute the amount of the post-1986 E&P (including a deficit) as of both E&P measurement dates.



An SFC that makes this election may compute the post-1986 E&P as the sum of (i) the corporation's post-1986 E&P (including a deficit) determined as of the notional measurement date, as if it were an E&P measurement date, and (ii) the corporation's annualized E&P amounts with respect to the notional measurement date. As used in the alternative method, "annualized E&P amount" is an amount equal to the product of the number of days between the notional measurement date and the E&P measurement date (not including the former and including the latter), multiplied by the daily earnings amount of the SFC. The notional measurement date is the closest end of a fiscal month to such E&P measurement date for an SFC with a 52-53-week taxable year, or October 31, 2017 for other all SFCs.

To use the alternative method, a controlling domestic shareholder must make the election no later than the due date for the return for (i) the first taxable year in which the person has a Section 965(a) inclusion amount with respect to the SFC, or (ii) the first taxable year in which the person takes into account a specified E&P deficit with respect to the corporation for purposes of computing a Section 965(a) inclusion amount with respect to another SFC. The taxpayer cannot get relief for late elections under Treas. Reg. § 301.9100-2 or -3.

## Affiliated and Consolidated Groups

Notice 2018-07 provided initial guidance regarding the treatment of U.S. corporations that are members of a consolidated or an affiliated group. Consistent with the Notice, the Proposed Regulations provide that all members of a consolidated group that are Section 958(a) U.S. shareholders of SFCs are treated as a single shareholder for certain portions of Section 965. Those portions include Section 965(b) (determination of aggregate foreign E&P deficit amount), (h) (payment of Section 965 tax liability in installments), (k) (extension of statute of limitations), and (n) (election to forgo use of NOLs).

For purposes of determining the amount of a Section 958(a) U.S. shareholder's initial Section 965(a) inclusion, (before accounting for any deductions or E&P deficits, Section 965(c) deductions to reach the 15.5 percent or 8 percent rates, or for any purpose specified in Prop. Reg. § 1.965-8(e)(1)), each member of a consolidated group is treated as separate. This separate entity treatment also applies to prevent a Section 958(a) U.S. shareholder from being deemed to pay any foreign income taxes under Section 960 that are paid by a foreign corporation that is not in a qualified group with the shareholder.

For purposes of calculating a Section 958(a) U.S. shareholder's Section 965(c) deduction, that shareholder's aggregate foreign cash position is determined by reference to its pro rata share of the consolidated group's aggregate foreign cash position. The Proposed Regulations provide a formula for each member of a consolidated group to calculate its pro rata share.

## Affiliated Groups

Section 965(b)(5) allows Section 958(a) U.S. shareholders that are members of the same affiliated group (as defined in Section 1504) to take the affiliated group's aggregate unused E&P deficit into account. The application of this rule is as follows. First, determine each Section 958(a) U.S. shareholder's separate Section 965(a) inclusion amount. Second, determine if the Section 958(a) U.S.





shareholder is an E&P net surplus shareholder and a member of a non-consolidated affiliated group. If the answer is yes to both questions, and the Section 958(a) U.S. shareholder has an overall positive Section 965(a) inclusion with respect to all SFCs it owns, measured on a pro rata basis, that shareholder can reduce its overall Section 965(a) inclusion amount by its applicable share of the affiliated group's aggregate unused E&P deficit. The aggregate unused E&P deficit is calculated by reference to only the Section 958(a) U.S. shareholders in the affiliated group that are E&P net deficit shareholders—*i.e.*, those that have an aggregate foreign E&P deficit that exceeds their aggregate Section 965(a) earnings amount. The aggregate unused E&P deficit is the sum of all of these shareholders' deficits.

## Considerations for Individuals

The Proposed Regulations confirm that, unless an individual U.S. shareholder makes a Section 962 election, the individual will be subject to higher rates of transition tax compared to a corporate shareholder. This is because the rate equivalent percentages used to determine a U.S. shareholder's Section 965 tax are based on the corporate rate although individual shareholders are generally subject to higher marginal tax rates than corporations. An individual shareholder would need to make a Section 962 election if she wished to be taxed at the corporate rate and claim the deemed paid foreign tax credit. For taxpayers that decide to make the Section 962 election, they should be aware that they will not be allowed to take into account the Section 965(c) deduction for any purpose other than for such taxpayers' Section 965 inclusion—*i.e.*, the 15.5 percent or 8 percent equivalent rates cannot be used to offset non-Section 965 income amounts. At least, however, a Section 965(c) deduction is not considered an itemized deduction. Individual U.S. shareholders should consider whether the Section 962 election is beneficial under their particular circumstances. Additionally, Treasury has reserved as to the basis consequences to individual U.S. shareholders following the application of Section 965.

With respect to the Section 965(h) election to defer payment of the transition tax, an acceleration event occurs if a U.S. individual becomes a non-U.S. person for income tax purposes. For example, an acceleration event would be triggered when an individual relinquishes U.S. citizenship or a green card, when an alien no longer meets the substantial presence test, or when a domestic trust becomes a non-U.S. trust. Individuals and trusts with a Section 965(h) election in effect should analyze the consequences of accelerating the transition tax before making decisions that impact their U.S. tax status.

## Considerations for Passthroughs

The Proposed Regulations address the use of passthrough entities, which they define as partnerships, S corporations, or any other person to the extent that the income or deductions of such person are included in the income of one or more direct or indirect owners or beneficiaries of the person. Moreover, the Proposed Regulations follow the statutory requirement to treat S corporations as partnerships for purposes of Sections 951 through 965.



## Distributive Share Considerations

Recognizing the possibility for allocations of Section 965(a) inclusions to be mismatched with Section 965(c) deductions, the Proposed Regulations provide that the two items can be netted and treated as separately stated items for purposes of Section 705 basis computations. Related to determining each partner's tax consequences associated with a Section 965(a) inclusion, no deduction is allowed with respect to any foreign taxes (including a distributive share thereof) treated as paid or accrued for which a Section 965(c) deduction is allowed.

## Look-Through of Certain Domestic Partnerships

A partnership is treated as an entity for purposes of determining whether it is a U.S. shareholder with respect to an SFC. Additionally, for purposes of determining the Section 958(a) U.S. shareholder of an SFC, and consequently the Section 958(a) stock owned by the Section 958(a) U.S. shareholder, a controlled domestic partnership is treated as a foreign partnership if two requirements are satisfied. First, the controlled domestic partnership is a Section 958(a) U.S. shareholder of the SFC and thus owns Section 958(a) stock of the SFC. Second, if the controlled domestic partnership (and all other controlled domestic partnerships in the chain of ownership of the SFC) were treated as foreign, (i) the SFC would continue to be an SFC; and (ii) at least one U.S. shareholder of the SFC would be treated as a Section 958(a) U.S. shareholder of the SFC, and would be treated as owning (within the meaning of Section 958(a)) tested Section 958(a) stock of the SFC through another foreign corporation that is a direct or indirect partner in the controlled domestic partnership.

The Proposed Regulations illustrate this via an example whereby a domestic partnership, wholly owned by two CFCs under common control by a domestic parent, is treated as a foreign partnership. The result is that the common parent is attributed stock in CFCs of the domestic partnership, thereby increasing the domestic parent's Section 965 inclusion by virtue of being a Section 958(a) U.S. shareholder.

## S Corporations

If an SFC was owned by an S corporation, the transition tax rules permit an indefinite deferral of tax until a triggering event occurs. Taxpayers who contributed SFC shares to an S corporation before the end of 2017 or who are considering doing so before the end of the fiscal year of a fiscal year CFC must consider the robust anti-avoidance rules.

## Anti-Abuse Rule

In the event a partnership is involved in a transaction involving certain internal group transactions, each member of an affiliated group, within the meaning of Section 1504, that holds an interest in a partnership is treated as proportionately holding stock held by such partnership. If one or more members of an affiliated group own, in the aggregate, more than 80 percent of the capital or profits in a partnership, such partnership is treated as a member of the affiliated group.



## SALT

As taxpayers grapple with the Proposed Regulations, they should also consider the state tax impact of the deemed repatriation provisions.

Although approaches differ, each state with a corporate income tax draws upon the Code in some way. Thus, the key to understanding whether and to what extent the deemed repatriation will be subject to state corporate income tax is the state's conformity to the Code. As a general matter, a state may conform to the Code on either a static or rolling basis. States that conform to the Code on a static basis do so as of a fixed date, which may or may not be the most recent version of the Code, rolling conformity states conform to the version of the Code that is currently in effect, and some states only conform to specific Code sections (selective conformity) on either a static or rolling basis. In addition to how a particular state conforms to the Code provisions, an equally important issue is whether such state conforms to federal *interpretations* of those provisions (e.g., Treasury regulations, rulings, etc.). With the release of the Proposed Regulations, an additional threshold question exists as to whether these regulations will apply at the state and local level. Thus, taxpayers should pay particular attention to the language of a state's conformity statute to determine whether Treasury regulations apply in that state.

For those states conforming to a prior version of the Code, the Section 965 inclusion may never appear in the state tax base absent legislative change. Additionally, even among states with rolling conformity or conformity as of a static date that includes Section 965 and related authorities, many exclude or allow a deduction from the state tax base for dividends or Subpart F income. Depending on the state's specific language, the deemed repatriation income (which, under Section 965, increases the income includible under Section 951(a)) may or may not fall within the state's Subpart F exclusion or deduction or the state's dividend received deduction.

Taxpayers should also review each applicable state's corporate income tax conformity to the deduction contained in Section 965(c). If a state does not permit the Section 965(c) deduction, taxpayers would be required to include the gross Section 965 inclusion amount in the tax base. Moreover, issues may arise when cash is actually distributed by the taxpayer's foreign business. Depending on a state's conformity to the federal PTI provisions, a cash distribution could be taxed at the state level unless a state-specific deduction applies (e.g., a dividends received deduction).

If the deemed repatriation is included in the state corporate income tax base as a result of the state's conformity to the Code and the state does not permit a deduction for or otherwise exclude the deemed repatriation income from the state tax base as a dividend or as Subpart F income, taxpayers should explore alternative methods to mitigate the impact of the income inclusion. For example, taxpayers should explore the possibility of treating the inclusion amount as non-unitary income. In addition, taxpayers should consider the impact on state tax apportionment. As a general rule, factor representation should be required (*i.e.*, if an item of income is includible in the state tax base, the receipts associated with that item of income should be included in the state apportionment factor). For example, any income resulting from the Section 965 provisions should be



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included in the sales factor denominator or the factors of the foreign corporations generating the deemed repatriation should be included with the taxpayer's factors.

Finally, Section 965 and the Proposed Regulations raise several state tax consistency concerns that taxpayers should keep in mind. First, state filing methods (*e.g.*, separate reporting, combined reporting) are often different from the federal consolidated group method, and it is unclear how tax items computed on a consolidated basis (*e.g.*, unused E&P deficits) should be computed for state tax purposes. Second, when making basis adjustments pursuant to the rules previously discussed herein—assuming they apply for state tax purposes in the first instance—taxpayers should note that their adjusted basis in stock or property may not be the same for both state and federal income tax purposes. Finally, because states are not always bound by federal elections, it is unclear whether any of the elections associated with the deemed repatriation (including the elections provided under Section 965(h), (i), (m), (n), and the election to compute post-1986 E&P using the alternative method) are applicable absent express guidance. For example, taxpayers who wish to make the installment election under Section 965(h) should know that for state income tax purposes they may be required to pay the full amount of state income tax resulting from the Section 965(a) inclusion amount in the year such amount is deemed repatriated, even if they have a valid Section 965(h) election in place.

As states continue to enact legislation and release guidance addressing the deemed repatriation provisions, taxpayers should continue to monitor the impact of that guidance on their state tax filing positions.

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