



United States Tax Alert

Transition tax guidance: proposed regulations released

On August 1, 2018, Treasury and the IRS released proposed regulations (the "Proposed Regulations") under section 965 (the "transition tax" provision of P.L. 115-97). The Proposed Regulations restate the guidance provided in prior guidance, with some modifications, and provide additional guidance related to section 965. The regulations were published in the Federal Register on August 9, 2018. This alert will cover some key international tax, passthrough, corporate, individual, state income tax and ASC 740 considerations.

International tax considerations

Earnings and profits (E&P) and inclusion amount

DFIC/EDFIC overlap

The Proposed Regulations include the rule from Notice 2018-13 providing that a specified foreign corporation (SFC) cannot be both a deferred foreign income corporation (DFIC) and an earnings and profits deficit foreign corporation (EDFIC). In such case, the entity is classified solely as a DFIC. An entity is only treated as an EDFIC if its deficit in post-1986 undistributed earnings exceeds its post-1986 earnings described in sections 959(c)(1) and (c)(2).

Post-1986 E&P

The Proposed Regulations provide that the E&P of a SFC is not reduced to account for distributions to other SFCs during the inclusion year, unless the recipient increases its post-1986 E&P by the amount of such distribution.

Consistent with prior notices, the Proposed Regulations provide that hovering deficits are taken into account in computing the post-1986 E&P. However, the Proposed Regulations further provide that such deficits are not taken into account for other purposes (e.g., determining the post-1986 undistributed earnings in computing the deemed paid foreign tax credit).

Pro rata share

Where there are multiple classes of stock, any deficit is allocated among shareholders who hold common stock and in proportion to their common stock.

Certain transactions disregarded

Payments between measurement dates

The Proposed Regulations include the rule that disregards certain payments (including distributions) by SFCs between measurement dates. However, unlike prior guidance, the Proposed Regulations provide that *if disregarded*, the effect of the rule is to increase the E&P of the payor SFC.

Anti-abuse rule

The Proposed Regulations retain the anti-abuse rule of Notice 2018-26. In retaining the rule, the IRS and Treasury made the following comments in the preamble:

- The anti-abuse rule can apply, even if the reduction in a section 965 tax liability is offset by an increase in tax pursuant to another provision.
- Although comments requested a de minimis exception, none was provided.
- The provisions addressing accounting method changes were retained. In addition, this rule applies even if the change is to go from an impermissible to a permissible method.

Treatment of previously taxed income (PTI) and foreign tax credits

Section 960(a)(3) credits on PTI

The Proposed Regulations provide that no credit is allowed for any amount of foreign taxes that were paid on the income giving rise to the PTI when earned by the controlled foreign corporation (CFC). That is, no credit is allowed on net income taxes paid on E&P that becomes PTI under section 965(b)(4)(A), where such taxes were not taken into account under section 960 by reason of a section 965 inclusion. However, a credit is allowed on withholding taxes paid on the distribution of both 965(a) and 965(b) PTI. This credit is subject to a haircut under section 965.

Basis adjustments and gain reduction rule

Gain reduction rule

The Proposed Regulations retain the gain reduction rule, with important modifications:

- The gain reduction rule applies to the distributions during an inclusion year to reduce the gain recognized by the amount of

the “section 965 previously taxed earnings” (a new defined term).

- The section 965 previously taxed earnings include any earnings included in income under section 965(a) and any earnings treated as included in income under section 965(b)(4)(A). However, the gain reduction rule only applies to take into account section 965(b)(4)(A) PTI if the basis reduction election is made.
- If the gain reduction rule applies, the basis in the stock or applicable property with respect to which the election is made is reduced pursuant to the basis adjustment rule.

Basis adjustment rule

The Proposed Regulations provide a one-time election which would allow a US shareholder to increase the basis in its DFICs by the amount of any section 965(b)(4)(A) PTI. However, this basis-increase election requires that a corresponding downward basis adjustment be made to any corporation that has a deficit which offsets the E&P. If there is insufficient basis to reduce, then the gain can be recognized as a reduction.

A consistency requirement applies for US shareholders who are related to each other under either section 267(b) or 707(b).

Cash, cash equivalents and currency/translation

Cash positions

- **Notional cash pooling arrangements** - The Proposed Regulations do not adopt comments to treat notional pooling arrangements as intercompany loans for section 965 purposes. The Proposed Regulations provide that whether the arrangement is treated as loans between related parties or between a participant and a third party is based on federal income tax principles.
- **Publicly traded stock owned by SFCs** - The Proposed Regulations do not provide an exception for publicly traded stock from the definition of cash position.
- **Other asset positions that might not be “liquid”** - The Proposed Regulations do not provide an asset-specific liquidity test, such as an exception or special rule for cash used for foreign acquisitions, blocked/restricted/segregated cash, cash expected to be spent within a short amount of time, section 956 loans, cash held as a fiduciary/trust, cash required to be held by regulation, pledged cash, etc.
- **Commodities representing inventory/supplies** - The Proposed Regulations do not provide an exception or special rule for commodities representing inventory or supplies.
- **Derivatives as cash positions** - The Proposed Regulations add “cash-equivalent assets” as a category to the definition of cash position, which includes derivatives. Derivatives can have positive or negative values and are netted (but not below zero) for this purpose. The Proposed Regulations provide special netting/exclusion rules for derivatives that are properly identified as bona fide hedging transactions within the meaning of Treas. Reg. § 1.954-2(a)(4)(ii).
- **Accounts payable** - Accounts payable only include payables arising from the purchase of property described in sections 1221(a)(1) or 1221(a)(8) or from the receipt of services from vendors or suppliers, provided the payables have a term upon issuance of less than one year. The preamble suggests that such term does not include payables related to the licensing of IP, payables to employees in the ordinary course of

business, and payables arising from property described in 1221(a)(2). The Proposed Regulations do not provide a rule allowing accounts payable to offset other components of the cash position.

- **Short-term obligations** – The Proposed Regulations provide that all loans that are payable on demand by the lender (or that must be repaid within one year of such demand) are treated as short-term obligations.

Translation rates

- **E&P** – Taxpayers should use the 12/31/2017 spot rate to translate E&P and deficits from a CFC’s currency to US dollars (USD), and to reverse-translate inclusion amounts and allocated deficits from USD to a CFC’s currency, as applicable. Taxpayers should use the 12/31/2017 spot rate to adjust E&P of an EDFC per section 965(b). Taxpayers should use the 12/31/17 spot rate to translate section 961 adjustments for 965(b) PTI. The Proposed Regulations introduce a special rule related to changes in functional currency between 11/2/2017 and 12/31/2017.

Foreign exchange gain/loss on PTI

- **Section 986(c) on section 965(a) PTI** – Gain or loss on section 965(a) PTI is measured based on fluctuations between 12/31/17 and the distribution date. Such gain or loss is haircut in the same proportion as the reduction by a section 965(c) deduction amount.
- **Section 986(c) on section 965(b) PTI** – Section 986(c) does not apply to section 965(b) PTI because, according to the Proposed Regulations, section 965(b) PTI is not included in gross income under section 951(a)(1).

Observation: The difference in value of section 965(b) PTI between the distribution date and 12/31/17 presumably should be subject to tax, either through section 986(c) or through a specific translation of section 961 basis reduction and section 961 gain or loss.

Partnership and flow-through entity considerations

PTI basis adjustments

For purposes of determining a foreign passthrough entity’s basis in section 958(a) stock, a specified basis adjustment is made with respect to section 958(a) stock of a section 958(a) US shareholder that is owned through the foreign passthrough entity in the same manner as if the section 958(a) stock were owned directly by the section 958(a) US shareholder. This rule also applies to “applicable property” (i.e., property by reason of which a US shareholder is treated under section 958(a)(2) as owning stock of a foreign corporation).

Outside basis adjustments

The Proposed Regulations provide mechanical rules clarifying that a partner (or S corporation shareholder) receives the appropriate outside basis in a domestic partnership (or S corporation) with respect to the gross amount of the entity’s section 965(a) inclusion allocated to the partner (or shareholder).

Accumulated adjustment account (AAA) adjustments

The Proposed Regulations also provide mechanical rules clarifying that an S corporation's AAA is increased by the amount of the gross section 965(a) inclusion.

Consistent allocations of section 965 amounts

A domestic passthrough entity must allocate its section 965(c) deduction to its owners in the same proportion as the section 965(a) inclusion is allocated to the owners.

Treatment of certain US partnerships as foreign partnerships

Expanding on Notice 2010-41, the Proposed Regulations provide that certain controlled domestic partnerships are treated as foreign partnerships for purposes of determining the section 958(a) US shareholder of an SFC and the ownership of the stock of an SFC under section 958(a). See also Notice 2018-26 and Notice 2009-7.

Section 958(b)(4) attribution

Stock owned, directly or indirectly, by or for a partner will not be considered as being owned by a partnership under the constructive ownership rules if the partner owns less than 5% of the interests in the partnership's capital and profits.

Treatment of affiliated groups

Consistent with prior Notices, all members of the consolidated group are generally treated as a single US shareholder. However, all members of a consolidated group are not treated as a single US shareholder for certain other purposes, including for purposes of determining (i) the amount of any members' inclusion or (ii) the foreign income taxes deemed paid.

Considerations for individual, trust, and estate shareholders

The Proposed Regulations provide no relief for higher tax rates for individuals, unless a section 962 election is made. Section 962(b) elections to be taxed at corporate rates may be made by individuals, as well as trusts and estates, but consistent with prior guidance, elections are limited to situations where the individual making the election is a US shareholder. Furthermore, a section 965(c) deduction is permitted if the section 962 election is made.

Net Investment Income tax

Section 965(a) inclusions are subject to section 1411, the net investment income (NII) tax. No section 965(c) deduction is permitted for 1411 purposes (i.e., the net investment income tax due is the product of the gross 965(a) inclusion times the 3.8% NII tax rate). Finally, the NII tax on section 965(a) inclusions may not be paid in installments; the entire tax is due with the 2017 returns.

Section 965(h) elections to pay transition tax in installments

For individual taxpayers who have a net tax liability under section 965 in the individual's 2017 taxable year of less than \$1 million (i.e., the total of all eight installments is less than \$1 million) and who make a timely election under section 965(h) but missed the April 18, 2018 deadline for making the first of the eight annual installment payments, the guidance in IRS FAQ#16 still applies: the IRS will waive the late-payment penalty (but will not waive the interest) and will not accelerate subsequent installments under section 965(h)(3) if the individual pays the full amount of the first installment (and the second installment) by the due date for its 2018 return (determined without regard to extensions) (i.e., April 15, 2019 for most calendar year taxpayers).

If IRS FAQ #16 does not apply (e.g., an individual's net tax liability under section 965 exceeds \$1 million) and the first installment payment is underpaid, Prop. Reg. § 1.965-7(b)(1)(ii) provides that the deficiency or additional amount will be prorated to the installments if the person:

- Is assessed a deficiency with respect to the person's section 965(h) net tax liability, or
- Timely files a return increasing the amount of its section 965(h) net tax liability above the amount taken into account in the payment of the first installment of section 965(h) liability, or
- Files an amended return increasing the amount of section 965(h) net tax liability.

Note: An adjustment will need to be made to ALL installments; therefore, the balance of the first installment payment is due upon the applicable event described above (i.e., the assessment of deficiency, the filing the 2017 income tax return, or the amendment the 2017 income tax return). The subsequent installment amounts are increased such that the applicable percentage of the re-determined net tax liability under section 965 is paid in at each subsequent installment due date.

As a reminder, nearly all of the states require payment of the liability in the year of the section 965 inclusion and do not allow for the section 965(h) election, or otherwise spreading the liability over eight years.

ASC 740 considerations

The Proposed Regulations represent new information that an entity will need to evaluate with respect to its tax positions and reflect adjustments, if any, in its financial statements in the reporting period that includes August 1, 2018.

As the Proposed Regulations pertain to new provisions of the tax code implemented in connection with P.L. 115-97, and given that SAB 118 requires the recognition of provisional amounts during the measurement period for items that are still open and for which a reasonable estimate can be made, it may be acceptable to incorporate such new information into an entity's provisional amounts reflected in financial statements that had not been issued by August 1, 2018.

If an entity has yet to issue its financial statements and does not elect to incorporate this new information into their provisional amounts, but otherwise believes that the Proposed Regulations may have a material impact on the provisional amounts recorded in such financial statements, an entity should also consider the potential need for additional disclosure as discussed in ASC 855-10-50-2.

State income tax considerations

The Proposed Regulations reaffirm the need to carefully analyze the derivative state income tax impacts of amounts included in income under section 965. To date, much of the attention has been focused on the issues such as a state's IRC conformity date (e.g., rolling versus "fixed date") and the application (and percentage) of a state subtraction modification (typically only for corporate income tax purposes) for foreign dividend income and/or subpart F income. The guidance provided in the Proposed Regulations also appears to directly impact the analysis of federal-state filing group differences. Specifically, instances of aggregating US corporations as a single shareholder for calculating 10% shareholders, computation of PTI and/or netting of basis/E&P require close analysis as many states (including some that require filing a combined return for an affiliated group of corporations engaged in a unitary business) do not follow the federal consolidated return regulations.

In general, to the extent the section 965 computation is changed by the Proposed Regulations, the state computation will also change. As a reminder, most states do pick up all or some portion of the section 965 addition to subpart F. However, the states do not follow the participation exemption under section 245A and actual dividend distributions made in subsequent years may result in states (including states not conforming to section 965, like California) picking up all or some portion of the dividend. As such, state-specific consideration of previously taxed income and/or state basis will also need to be considered.

State conformity to federal elections under section 965 and Proposed Regulations

Federal taxpayers are eligible to make a number of elections under section 965. Issues may arise regarding whether taxpayers can opt out of such federal elections or whether the states will require taxpayers to conform to federal elections for state purposes. Questions may also arise regarding how elections made at the federal level may apply when state filing groups may not include the entity that made the federal election or such groups include a different set of affiliates.

Section 965(n) includes a specific election that allows federal taxpayers to refrain from using current year or carryover net operating losses (NOLs) to offset the federal section 965 inclusion. This provision apparently stems from multinational taxpayers that want to use foreign tax credits rather than NOLs to reduce the corresponding tax. Many states do not conform to federal NOL provisions, but in certain states (e.g., Maryland), taxpayers may not wish to be bound by the federal election as the foreign tax credits will not offset Maryland state taxes on the section 965 inclusion.

State compliance considerations

Since the section 965 amount added to subpart F will not be included on the face of the federal return, accommodation will be needed on each of the affected state returns to account for the inclusion as well as any state-specific partial dividend received deduction to the extent available. Nearly all states require payment of the liability in the year of the section 965 inclusion and do not allow taxpayers to spread the liability over eight years.

Disregarded transactions under Prop. Reg. § 1.965-4

Provisions in the Proposed Regulations allow the IRS to “disregard transactions undertaken with the principal purpose of changing the amount of a section 965 element of a United States shareholder” (Prop. Reg. § 1.965-4(a)). These provisions extend to accounting method changes and “entity classification elections.” Issues might arise from state-specific applications of these rules, or whether the federal application of these rules should or should not apply at the state level.

Disallowance of deductions for foreign taxes

Prop. Reg. § 1.965-5(c)(2) provides that “[n]o deduction (including under Section 164) is allowed for the applicable percentage of any foreign income taxes treated as paid or accrued with respect to any amount for which a section 965(c) deduction is allowed.” Several states require taxpayers to add back their federal section 965(c) deductions, so taxpayers may be able to deduct these foreign taxes for state purposes.

Provisions for affiliated and consolidated groups

Prop. Reg. § 1.965-8 provides extensive rules for applying section 965 and the regulations thereunder “to members of an affiliated group (as defined in Section 1504(a)), including members of a consolidated group (as defined in Sec. § 1.1502-1(h)).” It is unclear whether these provisions will apply to states that do not conform to the federal consolidated return regulations.

Other considerations

Section 965(h) elections

As noted above, the Proposed Regulations provide rules regarding certain elections and payments. The rules cover both individual taxpayers (as previously described) as well as corporate and passthrough taxpayers. It bears that repeating that, in response to concerns that an underpayment of the first installment would prevent a taxpayer from making an election under section 965(h), the Proposed Regulations provide that if a taxpayer makes a section 965(h) election and does not pay the correct amount for the first installment, the remaining installment payments due pursuant to the section 965(h) election will not be accelerated, and the taxpayer’s section 965(h) election will not be affected if the person files a return by the due date (taking into account extensions, if any) increasing the amount of its section 965(h) net tax liability beyond that taken into account in paying the first installment.

Reporting requirements

For the 2017 tax year, the Proposed Regulations generally refer to the FAQ on the IRS website (last updated June 4, 2018) for reporting section 965-related amounts, filing returns with such amounts, and how and when to make payments with respect to a net tax liability under section 965.

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