



KPMG report: Issues and analysis of section 965 proposed regulations

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On August 9, the U.S. Department of the Treasury and IRS (together, “Treasury”) published [proposed regulations](#) [PDF 770 KB] (REG-104226-18) relating to the “transition tax” under section 965 (**proposed regulations**).¹ Comments on the proposed regulations and requests for a public hearing must be received by October 9, 2018.

The proposed regulations are generally consistent with prior guidance issued by Treasury² and KPMG’s interpretation of section 965 and such guidance.³ The proposed regulations answer several open technical and structural questions, but also raised others. The discussion below examines the framework of the proposed regulations and the significant issues answered and raised therein.

Answers to open questions

Proposed regulations

There had been speculation that Treasury would follow the Notices with temporary and proposed regulations with immediate legal effect, or would at least issue proposed regulations that affirmatively allowed for taxpayer reliance. As is, the proposed regulations only allow reliance for the payment and election rules contained in section 1.965-7. Otherwise, the proposed regulations do not constitute law and have only limited binding effect.

Section 965(b) PTI

Treasury helpfully settled on the term “section 965(b) PTI” for the previously taxed earnings (**PTI**) generated by the allocation of specified foreign corporation (**SFC**) deficits (**specified E&P deficits**) to SFC’s with a section 965(a) earnings amount.⁴ The proposed regulations also cleared up questions on the tax treatment of distributions of this PTI. Taxpayers are allowed a foreign tax credit for withholding taxes imposed on section 965(b) PTI as it is distributed up a section 958(a) chain of ownership. Those foreign tax credits are subject to the “applicable percentage” haircut determined under section 965(g)(2). But no credit is allowed for the SFC’s foreign income taxes that are otherwise attributable to such PTI. In addition, section 965(b) PTI is not subject to gain or loss recognition under section 986(c).

¹ All section references are to the Internal Revenue Code of 1986, as amended (**Code**), and to the Treasury regulations promulgated thereunder.

² See Notice 2018-07, 2018-4 I.R.B. 317 (December 29, 2017); Notice 2018-13, 2018-6 I.R.B. 341 (January 19, 2018); Notice 2018-26, 2018-16 I.R.B. 480 (April 2, 2018) (each, a Notice and collectively, the “**Notices**”). See also Rev. Proc. 2018-17, 2018-9 I.R.B. 384 (February 13, 2018) (regarding taxable year changes for SFCs).

³ Notice 2018-07 TaxNewsFlash; Notice 2018-13 TaxNewsFlash; Rev. Proc. 2018-17 TaxNewsFlash; Notice 2018-26 TaxNewsFlash.

⁴ See Prop. reg. §1.965-2(e), (f). The corporations with such deficits are E&P deficit foreign corporations (**EPDFCs**) and the SFCs with positive earnings are deferred foreign income corporations (**DFICs**). See section 965(b)(3)(B) (defining an EPDFC) and section 965(d)(1) (defining a DFIC).

Basis adjustments

The proposed regulations address the basis consequences of section 965(a) inclusion amounts, as well as those arising from section 965(b) PTI.⁵ With respect to section 965(a) inclusion amounts, the proposed regulations effectively provide an expanded section 961(a) approach. Consistent with section 961(a), the basis adjustments apply to the basis in SFC stock or interests in pass-through entities that are directly held by the section 958(a) United States shareholder (**USSH**). In addition, if a first-tier pass-through entity owns SFC stock or interests in other pass-through entities that ultimately own SFC stock, the basis in any intermediary pass-through entities and the SFC stock owned by any first-tier or intermediary pass-through entity is also adjusted.

Nevertheless, the proposed regulations do not provide any adjustments for SFC stock owned directly or indirectly by another foreign corporation. It is unclear whether and to what extent this silence is saying something about how section 961(c) does (to the extent section 961(c) is self-executing) or could apply to lower-tier SFC inclusions. The preamble to the proposed regulations gives no indication. In the very least and as discussed below, presumably lower-tier adjustments will be addressed in future guidance.

With regard to section 965(b) PTI, there was concern under the statute that such PTI was not accompanied by a section 961 basis adjustment. If so, distributions of such PTI would eventually result in gain recognition, potentially at multiple levels in an SFC chain, in an amount equal to the section 965(b) PTI.

The proposed regulations allow a USSH to elect to make basis adjustments to the stock of both the EPDFC and any DFIC whose accumulated post-1986 deferred foreign income is reduced by the specified E&P deficit of such EPDFC.⁶ These adjustments follow the same modified section 961(a) approach discussed above and therefore do not contemplate adjustments for any SFC stock owned directly or indirectly by other foreign corporations. The basis adjustment election must be consistently made by all USSHs that are related under section 267(b) or section 707(b).

Making such election prevents a DFIC from having the eventual gain recognition that would arise upon the distribution of the section 965(b) PTI. It also allows a USSH to take advantage of the gain reduction rule, otherwise only applicable to section 965(a) PTI, with respect to inclusion year distributions of section 965(b) PTI. Nevertheless, such election reduces the basis of any EPDFC by the amount of the section 965(b) PTI, and, to the extent the EPDFC does not have adequate basis, results in gain recognition. Therefore, the decision to make the basis adjustment election, keeping in mind the consistency requirement, will often require a careful weighing of the benefits and burdens.

⁵ Prop. reg. §1.965-2(d).

⁶ Prop. reg. §1.965-2(f)(2).

No section 965(h) cliff

Under the statute and the Notices, there was concern that the failure to correctly determine the “net tax liability” under section 965(h)(6) would effectively render the section 965(h) installment election void, creating potential interest and penalty exposure. The proposed regulations helpfully provide that understatements of net tax liability can be corrected and added to future installments, provided the understatement is not attributable to negligence, intentional disregard of the statute or regulations, or fraud.⁷ This standard raises the question of whether a taxpayer that disregards the proposed regulations in filing its return that is due prior to the finalization of such regulations will be considered to have been negligent or to have retroactively intentionally disregarded the regulations. In addition, such standard will likely prompt taxpayers to be deliberate in documenting their processes and positions with respect to their section 965 liability.

Compliance burdens

The statute, Notices, and now the proposed regulations allow taxpayers a number of choices on how section 965 applies to them. One cost of such choices is the disclosures required under the proposed regulations to explain the taxpayer’s positions. The proposed regulations provide for the following elections and affirmative taxpayer statements:

- Election to make the section 961(a) basis adjustment for DFIC stock by the amount of section 965(b) PTI (which has the corollary effect of reducing the basis of EPDFCs);
- Election to calculate November 2, 2017 post-1986 earnings and profits (for non-52-53 week taxpayers) and November 2, 2017, and December 31, 2017 post-1986 earnings and profits (for 52-53 week taxpayers) under the alternative method for calculating earnings and profits by effectively “closing the books” at a relevant month-end and pro-rating to the measurement date;
- Statement rebutting the application of a presumption with respect to the anti-avoidance rules in section 1.965-4;
- Statement explaining the exclusion of cash amounts giving rise to double counting;
- Reporting the use of specified deficits if the section 965(a) USSH’s pro rata share of specified E&P deficits exceeds its aggregate section 965(a) inclusion amount; and
- Electing under sections 965(h) (8-year installment treatment); (i) (S corporations); (j) (REITs); and (n) (segregating NOLs and current year losses)

These elections and statements are due by the due date for the taxpayer’s tax return (including extensions). In certain cases, limited transition relief is granted if the relevant tax returns are filed before the finalization of the proposed regulations. In each case,

⁷ Prop. reg. §1.965-7(b)(1)(ii)(C).

however, the proposed regulations provide that relief under section 301.9100-2 or section 301.9100-3 (that is, “9100 relief”) is not available for late elections.

Form 5471 filing

Outside of section 965, Notice 2018-13 addressed the effect of the repeal of section 958(b)(4) on certain reporting requirements. In particular, the Notice provided that the instructions to Form 5471 would contain a filing exception when “the foreign corporation is a CFC solely because **such** United States person is considered to own stock of the CFC owned by a foreign person under section 318(a)(3)” (emphasis added). This exception left the concern that it may not apply in situations where the foreign corporation was considered to be owned by multiple United States persons. The preamble to the proposed regulations restates the commitment to change the Form 5471 instructions but replaces “such” with “a”, so that the exception applies when “the foreign corporation is a CFC or specified foreign corporation solely because **a** United States person is considered to own the stock of the CFC or other specified foreign corporation owned by a foreign person under section 318(a)(3)” (emphasis added). This change appears intended to address the “multiple United States person owners” issue.

Open questions (and things that might not be working right)

Double counting cash

Notice 2018-07 provided that “[a]ll members of a consolidated group that are United States shareholders will be treated as a single United States shareholder for purposes of determining the aggregate foreign cash position of the consolidated group and for purposes of taking such aggregate foreign cash position into account under section 965(c)(1).” The Notice further provided that “[T]he Treasury Department and the IRS intend to issue regulations providing that, with respect to a United States shareholder, any receivable or payable of a specified foreign corporation from or to a related specified foreign corporation will be disregarded to the extent of the common ownership of such specified foreign corporations by the United States shareholder.” For this purpose, “related” was determined by reference to section 954(d)(3), which determines relatedness of corporations by reference to 50 percent control or common control. Taken together, these provisions provided that receivables and payables held between SFCs owned by a consolidated group would be disregarded for purposes of determining a USSH’s aggregate foreign cash position.

The proposed regulations do not follow the Notice in that they do not provide “single United States shareholder” treatment for purposes of determining the aggregate foreign cash position. Rather, each USSH computes its aggregate foreign cash position, the amounts for all of the group’s USSHs are aggregated, and then the cash is notionally spread to the USSHs based on the ratio of the group’s cash to the section 965(a) inclusion amount.⁸ The preamble to the proposed regulation does not provide an explanation for

⁸ Prop. reg. §1.965-8(e)(3).

this change. In addition, the proposed regulation's rule for disregarding related SFC obligations still appears to apply only to the extent of an SFC's common USSH ownership. Therefore, that rule would not appear to apply to the extent that SFCs are owned by different USSHs within a consolidated group.

When does section 965(b) PTI arise?

It is not clear if section 965(b) PTI arises when a specified E&P deficit entirely eliminates a DFIC's section 965(a) earnings amount. The proposed regulations provide that section 965(b) PTI arises "provided the section 958(a) U.S. shareholder includes the section 965(a) inclusion amount with respect to the deferred foreign income corporation in income."⁹ This language suggests that no section 965(b) PTI arises if there is no section 965(a) inclusion amount by the DFIC. Presumably the DFIC's earnings that are offset by the deficit would remain as undistributed foreign earnings potentially eligible for the 100 percent dividends received deduction under section 245A.

Nevertheless, an example in the proposed regulations clearly concludes that a DFIC with no section 965(a) inclusion amount will have its earnings converted to section 965(b) PTI.¹⁰ In addition, section 965(b)(4)(A)'s rule creating section 965(b) PTI does not appear to be conditioned on a DFIC's earnings giving rise to a section 965(a) inclusion amount. It is therefore unclear whether the operative rule's seeming requirement for a section 965(a) inclusion amount was intended.

When does the E&P bump from deficit allocations arise?

Section 965(b)(4)(B) provides that to the extent a specified E&P deficit of an EPDFC is allocated to a DFIC, the earnings and profits of the EPDFC is increased "with respect to" the EPDFC's tax year to which section 965 applies. The timing of this increase could be relevant in determining whether any deemed paid foreign tax credits could arise with respect to a fiscal year EPDFC, as well as the treatment of distributions from an EPDFC in the inclusion year. The proposed regulations deny the foreign tax credit possibility by providing that the increase to earnings and profits does not occur until the subsequent year for purposes of section 902, but do not provide any explicit rule regarding when the earnings and profits increase arises as a more general matter. This amount is also not current year earnings and profits as defined in section 316(a)(2).

Distributions between measurement dates

The proposed regulations retained the anti-E&P double counting measure provided in Notice 2018-07.¹¹ This provision ignores certain payments between related SFCs made between the November 2, 2017, and December 31, 2017, measurement dates. As relates to distributions between related SFCs, the coordination between this rule and the proposed regulation's general rules regarding the ordering and characterization of various

⁹ Prop. reg. §1.965-2(d)(1).

¹⁰ Prop. reg. §1.965-2(j) Example 5.

¹¹ Prop. reg. §1.965-4(f).

distributions and the application of section 965 and the “regular” subpart F rules is unclear.¹² In particular, the latter ordering rules say to determine the consequences of SFC-to-SFC distributions before taking into account the USSH’s section 965 consequences. That would suggest that such distributions generally move non-section 965 PTI and section 959(c)(3) earnings and profits before section 965 is taken into account. The anti-double counting measure would then apply to disregard the distribution for purposes of applying section 965. This could result in the section 965 inclusion being sourced from the distributing, lower-tier SFC, while untaxed earnings (and the associated cash) are at the distributee, upper-tier SFC. It is unclear whether any section 965 PTI would be created in this situation, and this treatment creates concerns that foreign taxes could be trapped in chains of SFCs and potentially be lost.

Dividing by zero?

The proposed regulations provide for a “haircut” of foreign taxes paid or deemed paid when such taxes are properly attributable to a section 965(a) inclusion or a distribution of section 958(a) or (b) PTI.¹³ The amount of the “haircut” is equal to the applicable percentage. In cases where the USSH does not have a section 965(a) inclusion because its specified E&P deficits exceed its pro rata share of deferred foreign income, application of the proposed regulation’s definition of applicable percentage would provide a “divide by zero” result. Because this rule is disallowing a portion of the foreign taxes that may be claimed as a foreign tax credit, the rule could be read to require no disallowance in such case. Because taxes are generally creditable upon section 965(b) PTI distributions, this could mean that any taxes paid with respect to a distribution of section 965(b) PTI could be creditable. As a policy matter, this result does not appear unreasonable, notwithstanding the strangeness of the computation.

Holding the line

In a number of areas, the proposed regulations retained rules that had raised policy and administrability concerns.

Computing deficits and PTI

Treasury kept its position from Notice 2018-13 that an EPDFC’s specified E&P deficit is determined taking into account all of an EPDFC’s earnings and profits, including PTI. In the preamble, Treasury justified this position on a very literal distinction between the definition of post-1986 earnings and profits in section 965(d)(3), which does not specifically exclude PTI, and the definition of accumulated post-1986 deferred foreign income, which does specifically exclude PTI earnings and profits. Treasury did not, however, articulate a policy justification for why the retention versus distribution of PTI earnings and profits by a CFC in pre-reform years should affect the overall determination of net untaxed earnings and profits that are subject to section 965, or whether this result was actually intended by Congress. (The formulation of these paragraphs is essentially

¹² See Prop. reg. §1.965-2(b).

¹³ Prop. reg. §1.965-5.

unchanged since being introduced in the then-Ways and Means Committee Chairman's 2014 tax reform bill). The preamble does indicate that Treasury is "considering other rules with respect to the definitions of post-1986 earnings and profits, accumulated post-1986 deferred foreign income, and specified E&P deficit in connection with the finalization of these proposed regulations," citing the broad grant of regulatory authority in section 965(o), and requested comments thereon.

Subpart F and post-1986 earnings and profits

A taxpayer's post-1986 earnings and profits as of a measurement date are calculated by subtracting only the subpart F income of the SFC that accrued through such date (apparently determined by using a closing-of-the-books method).¹⁴

Accounting methods and entity classification

Accounting method changes and check-the-box elections may be disregarded without regard to whether the change in method or check-the-box election were made with a principal purpose of changing the amount of a section 965 element (that is, a reduction of the USSH's section 965(a) inclusion amount or aggregate foreign cash position, or an increase in the USSH's foreign taxes deemed paid pursuant to section 960 because of a section 965(a) inclusion amount).¹⁵ Additionally, with respect to accounting method changes, the proposed regulations provide that any such change will be disregarded for section 965 purposes even if the change is from an impermissible method to a permissible one and even if the method is specifically allowed pursuant to Rev. Proc. 2015-13.

Comments and more to come

Given the proposed nature of the regulations, it remains to be seen the extent to which the proposed regulations are merely setting out Treasury's "opening" position, while it is still deliberating a range of options. The preamble expressly recognized certain areas where Treasury has not necessarily settled on a final position.

Hovering deficits

The proposed regulations helpfully provided that for purposes of section 965, hovering deficits under section 381 are treated like any other earnings and profits deficit.¹⁶ The proposed regulations did not address the treatment of foreign tax credits "trapped" within such deficits, which are otherwise currently addressed in section 1.367(b)-7. Treasury requested comments on the treatment of hovering deficits, including, for example, when a hovering deficit creates a specified earnings and profits deficit.

¹⁴ Prop. reg. §1.965-1(f)(7).

¹⁵ Prop. reg. §1.965-4(c).

¹⁶ Prop. reg. §1.965-1(f)(29)(iii).

Basis issues

The preamble requested comments on the extent to which further rules are needed with respect to basis adjustments, including for purposes of determining interest expense allocation under section 1.861-12T(c)(2).

Section 904 foreign tax credit limitation

The proposed regulations did not address the treatment of section 965 inclusions under the section 904 foreign tax credit rules. The preamble requested comments on the extent to which any section 904 guidance is needed, and, in particular, with respect to the determination of the section 904 limitation on distributions of section 965 PTI.

Sections 959 and 961

The proposed regulations did not address the application of section 959 to the differing varieties of PTI arising in the inclusion year. In particular, ordering rules appear necessary to determine how to account for such PTI. It appears that Treasury is working on separate section 959 guidance, perhaps working toward finalization of the 2006 proposed regulations under Sections 959 and 961.¹⁷ Such guidance would presumably address inclusion year PTI issues and the application of section 961(c) to lower-tier SFCs as a result of the application of section 965.

¹⁷ See Prop. reg. §§1.959-1 to -4, 1.961-1 to -4.

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