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REPORT ON SECTION 965

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I. Introduction

A. Background

This Report[1] ("Report") makes recommendations for guidance addressing the application of section 965[2], as amended by "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," P.L. 115-97 (the "Act"). This Report also addresses Notice 2018-07 (issued December 29, 2017)[3] and Notice 2018-13 (issued January 19, 2018) (the "Notices"). Each of the Notices announced that the Department of the Treasury (the "Treasury") and the Internal Revenue Service (the "Service") intend to issue regulations for determining amounts required to be included in gross income by United States shareholders under section 951(a)(1) pursuant to section 965.

We commend Treasury and the Service for taking these thoughtful and significant first steps in providing guidance under section 965. In this Report, we suggest some improvements and recommend areas in which we believe additional guidance is required.

B. Overview of New Section 965

Section 965 requires U.S. shareholders that own 10 percent of the voting stock of controlled foreign corporations ("CFC") and all foreign corporations in which a domestic corporation owns a 10 percent voting interest to include in their income their shares of the undistributed post-1986 earnings and profits of such corporation, as specially determined. It is clear from the statutory framework that the objective of section 965 is that a U.S. shareholder's share of such undistributed earnings be included in income but it is also clear that it was only intended to be included in income once. Although section 965 provides a number of detailed rules to assist in its operation, the drafters appeared to have expected that the mechanics of the Subpart F regime would fill in many of the gaps.[4] Unfortunately, the Subpart F regime cannot fill many of the gaps due to the specialized nature of many of the provisions of section 965 and what appears to be the implicit assumption

[1] The principal drafters of this Report were Edward Gonzalez, Brian Krause, and Jay Cosel, with contributions from William Alexander, Neil J. Barr, Kimberly S. Blanchard, Andrew H. Braiterman, Loren R. Lembo, Jeffrey Maddrey, Michael Mollerus, Yaron Z. Reich, Michael Schler, Karen G. Sowell, Shun Tosaka, and Gordon E. Warnke. This Report reflects solely the views of the Tax Section of the New York State Bar Association ("NYSBA") and not those of the NYSBA Executive Committee or the House of Delegates.

[2] Unless otherwise indicated all section references are to the Internal Revenue Code of 1986, as amended (the "Code") and the Treasury Regulations issued thereunder.

[3] 2018-4 I.R.B. 317, modified by, Notice 2018-13, to be published in 2018-06 I.R.B.

[4] For example, the Subpart F regime is an income inclusion regime whereas section 965 provides for both an income inclusion and a deduction.

of the drafters that the ownership of a "specified foreign corporation" would remain static during the inclusion year.

Consequently, as described below, section 965 raises many interpretative issues. Unlike other provisions of the Act, section 965 generally has an impact that is short-lived because taxpayers' income inclusions pursuant to the statute will occur exclusively in 2017 and 2018. Immediate guidance from Treasury and the Service is, nevertheless, critical because of the impact that these rules have on taxpayers' 2017 and 2018 financial statements. Given the uniqueness of section 965, and its short-lived nature, we urge Treasury and the Service to exercise their regulatory authority to fill the interpretative gaps in a manner consistent with the legislative intent to subject the income to tax only once at the favorable corporate rates specified in the statute.

II. Need for Guidance Providing for Simplifying Conventions Generally

Section 965 requires taxpayers to obtain a substantial amount of information from specified foreign corporations, including the foreign corporation's "accumulated post-1986 deferred foreign income" (hereinafter referred to as "deferred E&P") as of the November 2, 2017 and December 31, 2017 measurement dates and the corporation's foreign cash position as of three different dates. Many taxpayers are required to gather information relating to their specified foreign corporations ("SFCs")[5] for periods that pre-date their ownership of such SFCs in order to comply with section 965.

In some cases, foreign corporations and their U.S. shareholders will have maintained similar information for purposes of complying with the Code's international provisions as in existence prior to the Act (including the Subpart F regime, the passive foreign investment company rules, and the deemed-paid foreign tax credit). In other cases, however, section 965 compliance requires a completely new and potentially daunting administrative burden for taxpayers. The difficulties are compounded by the fact that SFCs, particularly those that are not controlled by U.S. shareholders, may be quite reluctant—or even completely unwilling—to assist their U.S. shareholders in this task, particularly in the time frame required in order to comply with section 965.[6]

[5] "Specified foreign corporation" is generally defined to mean any CFC or any foreign corporation (other than a non-controlled passive foreign investment company) that has a U.S. shareholder that is a domestic corporation. § 965(e).

[6] The Act's repeal of section 958(b)(4) results in even more U.S. taxpayers, including individuals, that are 10% U.S. shareholders of majority foreign-owned foreign corporations being subject to the transition tax. As in effect prior to repeal, section 958(b)(4) provided that subparagraphs (A), (B), and (C) of section 318(a)(3) were not to be applied so as to consider a United States person as owning stock which is owned by a person who is not a United States person. The subparagraphs of section 318(a)(3) generally attribute stock owned by a person to a partnership, estate, trust, or corporation in which such person has an interest (so-called "downward attribution"). For example, stock of a corporation owned by a person that owns 50 percent or more in value of the stock of another corporation is treated as owned by such other corporation.

In recognition of the administrative burdens posed by section 965, section 3.02 of Notice 2018-13 announced that Treasury and the Service intend to issue regulations providing that taxpayers may make an election to determine an SFC's deferred E&P as of a measurement date using an "alternative method." The purpose of the alternative method is to eliminate the need for taxpayers to determine an SFC's deferred E&P as of a date that does not fall on the last day of a month. An SFC (other than an SFC with a 52-53 week taxable year) would thus be permitted to do an interim closing of the books on October 31, 2017, rather than on November 2, 2017, compute a daily earnings amount for the stub period through October 31, and add two days' worth of earnings and profits to the earnings and profits as of October 31 in order to determine the SFC's earnings and profits as of November 2, 2017.

Recommendations

We believe Section 3.02 of Notice 2018-13 represents a significant first step in easing the compliance challenges that section 965 presents for taxpayers. Nevertheless, we suggest that Treasury and the Service issue further guidance that makes additional simplifying conventions available to taxpayers.

With respect to SFCs that were not either CFCs or "section 902 corporations" within the meaning of section 909(d)(5) under pre-Act law (*i.e.*, SFCs that may not have had any reason for determining earnings and profits under U.S. federal income tax principles or furnishing their U.S. shareholders with any information), taxpayers should be able to determine deferred E&P and cash positions as of the various dates required under section 965 based on financial statements and statements of retained earnings that are filed with a governmental entity or audited by an independent accountant. In many cases, we believe this is the only information regarding their SFCs to which minority U.S. shareholders will have any access.

We believe additional conventions should also be available for measuring deferred E&P in order to avoid potential distortionary effects of determining deferred E&P as of a mid-year date. These are discussed below.

III. Need for Guidance Regarding Measurement of Post-1986 Earnings and Profits and Deficits

A. Mid-Year Measurement Dates

Pursuant to section 965(a), an SFC's deferred E&P is required to be determined on November 2, 2017 and December 31, 2017. An SFC with deferred E&P on at least one of the measurement dates is treated as a "deferred foreign income corporation" ("DFIC"). A DFIC's Subpart F income is increased by the greater of the two amounts in its last taxable year beginning before January 1, 2018.

As other commenters have pointed out, the requirement to measure a foreign corporation's earnings and profits on a date that does not correspond to the end of the corporation's taxable or fiscal year will cause distortionary effects in many cases.[7] It also represents a substantial compliance burden for taxpayers.

Taxpayers often have significant items of expense for the year that do not arise until at or close to the end of the year. Accordingly, the deferred E&P of a DFIC as of the November 2 measurement date may overstate earnings and be inconsistent with economic reality, because it includes income accrued through that date with respect to the measurement year, but not the deductions that are properly allocable against the income.[8] For example, foreign income taxes are generally not treated as accruing until the end of a corporation's foreign tax year.[9] Depending upon the jurisdictions in which a DFIC operates, foreign income taxes may constitute a very substantial expense. This expense clearly relates to income that is earned over the DFIC's foreign tax year, and in other contexts Treasury and the Service have provided rules apportioning foreign taxes between periods falling within the same tax year in order to achieve a proper matching of income with the associated foreign taxes.[10] Another potential mismatch occurs in the case of DFICs that pay a significant portion of annual compensation in the form of bonuses that do not become fixed until sometime in December (after the November 2 measurement date).

The "alternative method" proposed in Notice 2008-13 does not address this issue.

Recommendations

[7] *See* Letter to Department of the Treasury from The Securities Industry and Financial Markets Association (Dec. 22, 2017), 2018 TNT 2-8.

[8] In the case of foreign income taxes that may not accrue until year-end, this problem is compounded by section 78, which would effectively require a U.S. shareholder to include in income an amount equal to its indirect foreign credits related to its section 965 inclusion, even though a portion of the underlying foreign income taxes did not reduce the deferred E&P.

[9] For an accrual method taxpayer, a foreign tax liability accrues when the "all events" test is satisfied. *See* Reg. §1.446-1(c)(1)(ii). To satisfy the all events test, in general, a liability must have arisen in fact; the amount of the liability must be susceptible to reasonably accurate determination; and economic performance must have occurred. *See* § 461(h); Treas. Reg. § 1.446-1(c)(1)(ii). In the case of a foreign income tax liability, however, economic performance occurs when the requirements of the all events test other than economic performance (*i.e.*, payment) are met. Treas. Reg. § 1.461-4(g)(6)(iii)(B).

[10] *See* Treas. Reg. § 1.338-9(d) (allocating foreign taxes of a target in a stock sale in connection with which a section 338 election is made if the foreign taxable year of target does not close on the acquisition date); Treas. Reg. § 1.901-2(f)(4) (allocating foreign taxes of a partnership or disregarded entity that is a foreign taxpayer in cases where a change in ownership occurs during the entity's foreign taxable year and such taxable year does not close as a result of such change).

We recommend that Treasury and the Service issue guidance permitting taxpayers to use a ratable allocation of the earnings and profits for the entire year or other reasonable method in order to calculate earnings and profits on the measurement dates, in order to mitigate the distortionary effects of an interim closing approach and ease the administrative burden on taxpayers. The ratable allocation method should exclude income or loss from extraordinary transactions, which can be taken into account in the appropriate period.

This recommendation is consistent with other areas of U.S. federal income tax law. For example, Treasury Regulation section 1.1502-76(b) provides that items (other than extraordinary items) may be ratably allocated between a separate return and the consolidated return when a corporation joins or leaves a consolidated group based on a day count.

Alternatively, some other rules need to be adopted to permit items of expense that accrue at year end but relate to the entire year to be taken into account, particularly with respect to the November 2 date. For example, the alternative method of Notice 2018-13 could be retained but with the additional feature that items that accrue at year-end[11] (and were not taken into account in closing of the books) are allocated over the measurement period. We believe it is especially important to address the treatment of foreign income taxes, which represent a substantial expense for many DFICs and should be treated as accruing with the related income for this purpose.

B. Sales, Redemptions and Distributions During the Transition Year

Section 965(d)(3) provides that the deferred E&P of SFCs are determined "… without diminution by reason of dividends distributed during the taxable year … other than dividends distributed to another specified foreign corporation" (the "no-diminution" rule). This provision presents a number of issues because parties could have undertaken transactions both before and after any meaningful details regarding tax reform were known and the consequences as a result of section 965 may be very different from those that they reasonably anticipated.

Example 1.

(i) Facts. USP owns CFC 1, which as of December 31, 2016 had $50 post-1986 earnings and profits, $20 of which was previously taxed income within the meaning of section 959 ("PTI"), and $50 of cash. The equity of CFC 1 had a fair market value of $100 and USP had a tax basis of $20 in the stock of CFC 1. CFC 1 had a December 31 tax year. In February 2017, CFC 1 distributed all of its cash of $50 to USP and in March 2017, USP entered into a binding agreement to sell the stock of CFC 1 to USCo, an unrelated U.S. corporation, for $50. The transaction closed in June

[11] As mentioned above, foreign taxes do not generally accrue until the end of a foreign corporation's tax year, which may differ from its tax year for U.S. federal income tax purposes.

2017. CFC 1 earned an additional $10 of E&P in 2017, none of which was Subpart F income as defined in section 952.

(ii) Analysis. Under the law in effect at the time of the transactions, USP expected to recognize dividend income of $30 and gain of $50 from the sale of the CFC 1 stock, $10 of which would be treated as a dividend from CFC 1 under section 1248(a). USCo expected that it would not recognize any income on account of CFC 1's pre-acquisition E&P and that CFC 1 would have $10 of PTI attributable to USP's section 1248(a) amount.

Under section 965(a), it appears that USCo is required to include in income $40 of CFC 1's deferred E&P, because it is the owner of the CFC 1 stock on December 31, 2017 and the amount of CFC 1's deferred E&P is generally determined without reduction for distributions made during its 2017 tax year (subject to application of section 965(f), discussed below). However, it appears that USP is also required to include in income that $40 of E&P as a result of the February 2017 dividend distribution and the section 1248(a) amount recognized on the sale of the CFC 1 stock. The $40 of E&P would not be attributable to PTI described in section 959(c)(2) by reason of section 965(a) with respect to USP, protected by the gain-reduction rule set forth in the Notices (discussed below), because USP was not the U.S. shareholder of CFC 1 on December 31, 2016 that recognized the section 965(a) inclusion. Note that the deferred E&P inclusion would be more distortive if the distribution to USP had been, in whole or in part, a distribution of property that triggered gain under section 311(b). It should also be noted that this treatment will create a built-in loss with respect to the stock of CFC 1 held by USCo because USCo can never get the cash that was distributed to USP.

Section 965(f) could be used as a basis for reducing USCo's section 965(a) inclusion. Under section 965(f), a U.S. shareholder's section 965(a) inclusion is reduced based on distributions made by the SFC during the inclusion year to shareholders that were not U.S. shareholders on the last date of the year under principles similar to section 951(a)(2). We note, however, that section 951(a)(2) requires pro-rating distributions made during the year to other shareholders based on their holding period during the year. Because section 965(a) requires multiple years of income to be recognized, this pro rata allocation method could still result in an acquirer of SFC shares recognizing a section 965(a) inclusion on E&P that accrued before its holding period started that was previously distributed to other shareholders. In the case of USCo, it would still have a $20 section 965(a) inclusion because it owned the CFC 1 stock for half the year. Alternatively, in light of the fact that section 965(d)(3) requires that only periods during which a foreign corporation was an SFC be taken into account, it might be possible to argue that in this context the principles of section 951(a)(2) should be interpreted as allowing a proration between shareholders over the period that the entity was an SFC.

Similar issues could arise with respect to redemptions during the inclusion year, particularly redemptions that are treated as dividends under section 301. In such cases, the remaining

U.S. shareholder may have to include in income the redeemed shareholder's share of the deferred earnings.

Recommendation

As an initial matter, there should be clarification of how the seller in Example 1 or a redeemed shareholder should be treated. Does section 965(a) alter their treatment or is section 965(a) solely affecting the treatment of the taxpayer who holds the SFC shares on the last day of the inclusion year? We believe that the most appropriate rule is that the no-diminution rule under section 965(d)(3) was only intended to be factored in computing deferred E&P and should not affect the treatment of transactions during the inclusion year for former shareholders of the SFC.

With respect to the holders of the shares of the SFC at the end of the inclusion year, there are a number of potential solutions to the over-inclusion issue. None of the potential solutions are perfect from the standpoint of both solving the issue and clearly coming within the applicable statutory language. We believe that the purpose of the no-diminution rule was to prevent taxpayers from engaging in transactions that could reduce the deferred E&P. Based on this likely motivation, we believe that some of the over-inclusion issues could be solved by providing that if the stock purchase involves a qualified stock purchase under section 338, the no-diminution rule would not apply to pre-sale distributions paid to the selling shareholders. Situations involving a qualified stock purchase are less likely to be motivated solely by tax planning and the terms would be arm's length. Similarly, distributions prior to sales between unrelated parties, but which involve sales of less than 80% of the stock, could also be given effect. It is also possible to limit this special rule to transactions occurring before the date of the first release of the text of section 965.

In cases involving related parties, such as a redemption, a possible solution is to permit a reduction of E&P by the redeemed shareholder's allocable share of E&P based on their relative stock ownership. In such a case, the reduction of E&P would not be the full amount that is treated as a dividend under section 301, but the U.S. shareholder at the end of the inclusion year would not be including in its income another shareholder's E&P, which it could never get.

C. Application of E&P Deficit Rules to SFCs with PTI and E&P Deficits

Section 3.01 of Notice 2018-13 contains rules for determining whether an SFC is a DFIC or an E&P deficit foreign corporation. This determination is significant because if the SFC is an E&P deficit foreign corporation, then its E&P deficit will be available to reduce its U.S. shareholders' income inclusion under section 965 with respect to other SFCs of the U.S. shareholder. Example 2 of Notice 2018-13 illustrates that when the same SFC has PTI and a deficit in E&P described in section 959(c)(3), the deficit is required to be netted against the PTI. Specifically, in the example FS has 100u of PTI and an E&P deficit of 90u. The example concludes that the 100u

of PTI and the 90u E&P deficit are netted, resulting in FS having positive E&P of 10 and not qualifying as an E&P deficit foreign corporation.

Recommendation

Under Notice 2018-13, assuming an identical amount of positive non-PTI E&P in its DFICs, a U.S. shareholder of an SFC with PTI and an E&P deficit will pay more transition tax than a U.S. shareholder of an SFC with no PTI and the same sized E&P deficit. It will also pay more transition tax than a U.S. shareholder whose PTI is in an SFC with positive non-PTI E&P.[12] The methodology of the Notice can create significant and unjustified differences between similarly situated taxpayers based merely on the existence and location of PTI among affiliated SFCs. It is also inconsistent with the result that would have been obtained if affiliated SFCs were treated as a single corporation, which is a base of comparison that Treasury utilized to determine the appropriate treatment of intercompany payables and receivables among affiliated SFCs in Notice 2018-07. Had Treasury issued this guidance last November, the result could have easily been avoided had the SFC with the E&P deficit and PTI merged with a DFIC before the E&P measurement dates. The result could also have been avoided had an SFC with an E&P deficit distributed its PTI to its U.S. shareholders prior to the E&P measurement dates.

Congress specifically excluded PTI from the definition of "accumulated post-1986 deferred foreign income," which reflects an intent to exclude PTI from the computation of deferred E&P under section 965. Congress granted Treasury broad authority under section 965 to issue "necessary or appropriate" regulations.[13] Section 965 itself does not define "deficit," and we urge Treasury to exercise its regulatory authority to exclude PTI from this calculation as well.[14]

[12] It appears that in this situation the deficit is not required to be allocated against the PTI in the DFIC.

[13] We note that Treasury and the Service may be assuming by negative inference that the definition of "post-1986 earnings and profits" for purposes of section 965 includes earnings attributable to PTI, because the definition in section 965(d)(2) of "accumulated post-1986 deferred foreign income" provides that "post-1986 earnings and profits" are reduced by the amount of a DFIC's PTI and effectively connected income. A more natural reading of the term "post-1986 earnings and profits," however, excludes PTI altogether, because section 965(d)(3) is based almost verbatim on section 902(c), which has always reduced post-1986 undistributed earnings and profits by PTI. Significantly, such a reading is specifically mandated by the longstanding regulation interpreting that same language. *See* Treas. Reg. § 1.902-1(a)(9).

Thus, it is at least equally reasonable to conclude that the reference to PTI in section 965(d)(2) is intended to clarify and resolve any ambiguity regarding whether PTI (and ECI) is to be subjected to additional tax under section 965. Given the clear policy objectives of section 965 described above and the ambiguous, at best, statutory scheme, and in light of Treasury's and the Service's interpretation of section 902(c), Treasury and the Service should consider exercising their regulatory authority (as they did under section 902(c)) to exclude PTI from all relevant computations under section 965.

[14] Notice 2018-13 does not address whether the PTI and E&P deficit in FS continue to be available after they are netted for purposes of determining whether FS is a DFIC or E&P deficit foreign corporation. We believe that they should continue to be available and that Treasury should confirm that in regulations.

D. Hovering Deficits and Related Foreign Income Taxes

Section 3.03 of Notice 2018-13 states that Treasury and the Service intend to issue regulations "clarifying that all deficits related to post-1986 earnings and profits, including hovering deficits, are taken into account for purposes of determining the post-1986 earnings and profits (including a deficit) of" an SFC. We believe this is an appropriate result, clearly contemplated by the legislative history of section 965. In its discussion of deficits, the Conference Report includes the following passage:

> For example, assume that a foreign corporation organized after December 31, 1986 has $100 of accumulated earnings and profits as of November 2, 2017, and December 31, 2017 (determined without diminution by reason of dividends distributed during the taxable year and after any increase for qualified deficits), which consist of $120 general limitation earnings and profits and a $20 passive limitation deficit, the foreign corporation's post-1986 earnings and profits would be $100, even if the $20 passive limitation deficit was a hovering deficit. Foreign income taxes related to the hovering deficit, however, would not generally be deemed paid by the U.S. shareholder recognizing an incremental income inclusion. However, the conferees expect the Secretary may issue guidance to provide that, solely for purposes of calculating the amount of foreign income taxes deemed paid by the U.S. shareholder with respect to an inclusion under section 965, a hovering deficit may be absorbed by current year earnings and profits and the foreign income taxes related to the hovering deficit may be added to the specified foreign corporation's post-1986 foreign income taxes in that separate category on a pro rata basis in the year of inclusion.[15]

Recommendation

While section 3.03 of Notice 2018-13 allows taxpayers to take hovering deficits into account in determining deferred E&P, it is silent on the treatment of related foreign income taxes that are otherwise suspended under Treasury Regulation section 1.367(b)-7(d)(2)(ii). We recommend that Treasury and the Service consider issuing guidance on the treatment of such foreign income taxes. In general, we believe that it may be appropriate to treat those taxes as being included in a DFIC's post-1986 foreign income tax pool. Allowing these taxes to be claimed as credits in connection with the transition tax is consistent with treating the separate corporations

[15] H.R. Rep. No. 115-466, at 490 (footnotes omitted).

that engaged in a section 381 transaction giving rise to a hovering deficit as a single DFIC—if foreign operations had historically been conducted in a single DFIC rather than through two or more separate corporations, then there would be neither a hovering deficit nor any suspended foreign income taxes.

E. Potential Double Counting of Earnings and Profits of SFCs With Inclusion Years Ending November 30, 2018

Section 3.02 of Notice 2018-07 provides rules that would seem to obviate most issues related to double counting of E&P. One exception, however, may be distributions by a first-tier November 30 SFC to its U.S. shareholder occurring between November 2 and December 1, 2017 (because such distributions occur after the November 2 measurement date, and thus may not reduce the section 965 inclusion, but prior to the SFC's inclusion year, and thus would seem not to be PTI).

Recommendation

We recommend that Treasury and the Service consider issuing guidance regarding the proper treatment of distributions by November 30 SFCs occurring between November 2, 2017 and December 1, 2017, either by treating such distributions as PTI, or by providing that the deferred E&P as of November 2, 2017 is reduced by such distributions, to the extent necessary to prevent double counting.

IV. Need for Guidance Regarding Measurement of Cash Position

A. Notional Cash Pooling Arrangements

1. Cash Pooling Arrangements Generally

Corporate groups frequently take a centralized approach to managing the deployment of cash within the group and to hedging risks associated with the group's treasury and finance functions. In a cash pooling arrangement, the treasury center, typically together with a third-party financial institution, centrally manages the group's cash. In all pooling arrangements, the participating group members will typically each enter into a separate account agreement with the financial institution operating the pool. In addition, the participating members typically enter into an agreement among themselves specifying the key terms of the pooling arrangement, including the frequency of sweeps and the mechanism for calculation and payment of interest among the participating members.

There are two basic types of cash pooling arrangements: (i) physical cash pooling and (ii) notional cash pooling. There are some differences between these two types of arrangements.

In a physical cash pooling arrangement (also sometimes referred to as a zero balance arrangement, or a cash sweep), several group members will open accounts with the same financial institution. At pre-established frequent intervals (usually daily, although in some cases weekly, monthly or quarterly intervals might be used), the bank automatically moves cash from the accounts of group members that have positive account balances to the account of the treasury center (this account is sometimes called the pool leader's account or the header account). The bank then automatically moves cash from the header account into the accounts of group members that have negative account balances. If, after this process, the header account has a positive balance, the financial institution pays interest on that balance; or, if the header account balance is negative, the treasury center is charged interest. These cash movements typically are automated rather than manual, as automation provides significantly greater efficiency and limits possibilities for error.

The second basic type of cash pooling arrangement is often referred to as notional or virtual cash pooling. Such an arrangement resembles physical cash pooling, in that participating group members typically all establish accounts with the same financial institution, and the treasury center acts as the pool leader. However, in a notional pooling arrangement, cash is not swept out of, or deposited into, any group member's account by the financial institution. Each group member retains its own account relationship with the bank and its own deposit or overdraft balance. On each measurement date, the financial institution determines whether each group member has a positive or negative balance in its account and aggregates the account balances. If the aggregate is positive, then the financial institution pays the treasury center an amount of interest on that positive amount; if the aggregate is negative, then the treasury center must borrow either from the financial institution or from some other corporation in the group (*e.g.*, the parent) in order to increase the negative amount to zero. Absent such borrowing, participants in the pooling arrangement with negative balances generally cannot have an aggregate negative balance in excess of the aggregate positive balance of those participants with positive balances.

Group members participating in notional pooling may separately account for the absence of interest payable to the financial institution on members' negative account balances; the absence of interest receivable from the financial institution on members' positive account balances; and payments of interest to, or by, the pool header on the notional aggregate balance. Therefore, the total amount of interest income and expense recorded by participants in physical and notional pools should be similar; any variance should be attributable to differences between the interest rates paid/charged by the financial institutions and the transfer pricing policies implemented by group members, rather than to the difference in counterparty described above.

2. General Treatment of Cash Pools for U.S. Federal Income Tax Purposes

Physical and notional pooling arrangements are economically similar insofar as each pool member has the right to access cash on a demand basis as needed. Nevertheless, the overall amount of liquid assets (*i.e.*, net cash) held by a group of related corporations is the same regardless of whether they are members of a physical or notional pooling arrangement. Nevertheless, because of the formal structure of the rights and obligations under each arrangement, the characterization of physical and notional pooling arrangements for U.S. federal income tax purposes may be different.

For U.S. federal income tax purposes, a physical cash pooling arrangement like the one described above is typically viewed as creating loans to the treasury center from the other group members with positive balances, and from the treasury center to the group members with negative account balances. Interest typically is accrued on these loans. Loans are repaid automatically through the sweep mechanism as cash becomes available to the borrower, with balances shifting each time a periodic sweep occurs.

In a notional pooling arrangement, the parties to the relationship for U.S. federal income tax purposes might be viewed as including the facilitating financial institution. Because group members typically each continue to have their own individual overdrafts and deposits directly with the bank, it could be argued that notional pooling should be treated for U.S. and foreign tax purposes as loans from the financial institution operating the pool to group members that have negative account balances, and to the financial institution from group members that have positive account balances. For purposes of the section 385 regulations, Treasury and the Service have indicated that they generally view notional cash pooling arrangements as in substance loans directly between and among the affiliated group members, rather than loans between the members and the financial institution, in circumstances where the financial institution is merely acting as an intermediary administrative clearing house to facilitate cash movements among members of the affiliated group.[16]

3. Application of Section 965(c)(3) and Notice 2018-07

Section 965(c)(3)(B)(ii) provides that the "aggregate foreign cash position" of a specified foreign corporation includes that corporation's "net accounts receivable." Notice 2018-07 recognizes that if there are accounts receivable or short-term obligations between related SFCs, this may "inflate the aggregate foreign cash position of a U.S. shareholder relative to the actual aggregate amount of liquid assets (other than the intercompany receivables) owned by the specified foreign

[16] T.D. 9790 (October 21, 2016) ("For example, a notional cash pool in which the cash received by a non-member cash pool provider from expanded group members is required to equal or exceed the amount loaned to expanded group members will generally be treated as a loan directly between expanded group members, even though the interests may be in form documented as debt between an expanded group member and a nonmember facilitator").

corporations of the United States shareholder." The Notice then goes on to reason that intercompany receivables would inflate the measure of liquid assets because "if the specified foreign corporations were treated as a single corporation, the liquid assets of the specified foreign corporations would have been reduced."

To address this concern, Notice 2018-07 takes the position that receivables and payables between SFCs that are related within the meaning of section 954(d)(3) will be disregarded. Specifically, the Notice clarifies that for purposes of applying section 965(c)(3)(B)(ii), Treasury and the Service "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."[17]

We agree with the underlying policy position of Notice 2018-07, which is that the appropriate measure of liquid assets for purposes of computing the aggregate foreign cash position under section 965(c)(3) should be based on the total net liquidity of an affiliated group of SFCs. We believe that those policies apply equally to both physical cash pooling and notional cash pooling and thus they should be treated in the same manner for purposes of section 965. The reasoning can be illustrated with the following example.

Example 2.

US1 is a U.S. corporation that is the 100% owner[18] of five specified foreign corporations: CFC1, CFC2, CFC3, CFC4, and CFC5. CFC1, CFC2, CFC3, and CFC4 are operating companies that participate in a pooling arrangement with CFC5, which is a corporate treasury center dedicated to the management of any cash pooling arrangement. Without regard to any pooling arrangement, the cash balance of each CFC would be as follows:

- CFC1: $100
- CFC2: $50
- CFC3: ($50) (*i.e.*, it has a cash deficit)
- CFC4: ($25)

[17] Notice 2018-07 § 3.01(b).

[18] We have used a single U.S. shareholder with 100% ownership for ease of illustration. The underlying analysis and policy rationale should not be different in cases where there are multiple U.S. shareholders and/or unrelated owners. We also note that in general, it is typical for all members of a cash pooling arrangement (whether physical or notional) to be part of the same controlled group of corporations (as such term is used in section 1563(a)).

- CFC5: $0 (*i.e.*, it is solely a treasury center and so would not exist without a pooling arrangement)[19]

Regardless of whether CFCs 1-5 are participants in a physical or notional pooling arrangement, the net liquid assets held by US1's CFCs is $75.

In a physical cash pooling arrangement, CFCs 1-4 would be treated as having receivables from (or payables to) CFC5 of $100, $50, ($50), and ($25), respectively. Under Notice 2018-07, these would all be disregarded. CFC5 would have a cash balance with the financial institution of $75 (*i.e.*, cash pooled from CFC1 and CFC2, less cash advanced to CFC3 and CFC4). Therefore, the aggregate foreign cash position of US1 would be $75.

Under the policy rationale of the Notice, the result should be identical under a notional pooling arrangement.[20] However, if the notional pooling balances would otherwise be treated as receivables/payables directly between the financial institution and CFCs 1-4, CFC5 would not, in this example, have a receivable or payable with the financial institution (setting aside any interest paid or other extraneous transactions). In that case, as currently promulgated, Notice 2018-07 would not permit US1 to reduce the cash position of CFC1 and CFC2 by the cash deficits of CFC3 and CFC4. Therefore, US1 would have an aggregate foreign cash position of $150, which overstates the liquid assets of its group of CFCs.

Recommendation

We request that Treasury clarify that both physical cash pooling and notional cash pooling arrangements will be treated in a similar manner under section 965. We believe that a straightforward allocation approach can be used to achieve the policy objectives of Notice 2018-07. Under this approach, where related-party SFCs are participants in a notional cash pooling arrangement, SFCs that have positive cash balances would reduce their aggregate foreign cash position in respect of any negative balances of related-party SFC's that are participants in the pooling arrangement. The net positive cash balance of the SFC pool participants would then be allocated pro rata to each SFC in proportion to such SFC's share of the positive balances in the pool.

Applying this approach to the example above, the net positive cash balance of the participants in the pooling arrangement is $75 (*i.e.*, 100 + 50 - 50 - 25). That $75 net positive balance would be allocated between CFC1 and CFC2—the only entities with positive balances—based on each such entity's proportionate share of the gross positive balances of such pool participants.

[19] The treatment of CFC5 as a dedicated treasury center entity is solely for ease of illustration. We do not believe that the analysis should be different if CFC5 had its own operations and cash balance.

[20] An SFC's cash position should be the same whether it participates in a notional cash pooling arrangement or a physical cash pooling arrangement.

CFC1 would thus be allocated a positive cash balance of $50 (*i.e.*, $75 x (100 ÷150)). And CFC2 would be allocated $25 (*i.e.*, $75 x 50 ÷ 150).

We believe that this approach is consistent with the approach in Notice 2018-07 as it applies to physical cash pooling arrangements, is consistent with the treatment of notional cash pooling under section 385, and is consistent with the policy of avoiding double counting of liquid assets when determining the aggregate foreign cash position for purposes of section 965(c)(3).

B. Definition of "Accounts Payable"

Notice 2018-13's definition of "accounts payable" likely creates unfavorable results for a wide variety of taxpayers, raising significant policy questions as well as factual difficulties.[21] Section 3.04(a) of the Notice provides that "the term 'accounts payable' means payables arising from the purchase of property described in section 1221(a)(1) or 1221(a)(8) or the receipt of services from vendors or suppliers." Section 1221(a)(1) describes inventory, while section 1221(a)(8) describes supplies. Noticeably and surprisingly absent is any reference to payables arising from property described in Section 1221(a)(2) (depreciable property or real property used in a trade or business), or any reference to payables accrued to license intellectual property. To illustrate the scope of this extremely limited definition, accounts payable incurred by a manufacturer (i) to acquire equipment, (ii) to license intellectual property rights or (iii) to pay employees would all fail to qualify as "accounts payable."

These results are particularly surprising when one realizes that cash payments for any of the foregoing items would clearly reduce the "cash position" under section 965(c)(3)(B). No explanation is provided for why a purchase of supplies is viewed as creating an account payable while a license of IP is not. Similarly, it is challenging to explain why a purchase of machinery should be regarded differently from a purchase of inventory. The Notice articulates a rationale of trying to measure liquidity; whether liquidity is impacted by a purchase of inventory versus a purchase of equipment, for example, would seem irrelevant.[22]

[21] We note that section 965(c)(3)(C)(ii) refers to a "corporation's accounts payable (determined consistent with the rules of section 461)." The meaning of the parenthetical is not entirely clear. Section 461 and the Treasury Regulations thereunder are timing provisions, but do not expressly refer to accounts payable. The parenthetical may simply mean that only accounts payable that have accrued in accordance with section 461 principles are taken into account. We do believe, however, that the inclusion of the parenthetical supports the argument that "accounts payable" should not be construed narrowly for purposes of section 965(c).

[22] In addition to the foregoing, this definition appears to depart from existing guidance on what constitutes an "account payable" for U.S. federal income tax purposes. For example, Rev. Proc. 99-32 defines the payable/receivable that may be created via a transfer pricing adjustment as an "account payable" and an "account receivable," fostering a rationale of allowing cash payments to match transfer pricing adjustments without incremental tax consequences. Under Notice 2018-13, however, accounts payable created by virtue of such

Recommendation

We recommend that Treasury and the Service further consider the appropriate definition of "accounts payable".

C. Treatment of Non-Corporate Entities as SFCs

Section 965(c)(3)(E) provides that an entity (other than a corporation) is required to be treated as an SFC of a U.S. shareholder for purposes of determining such U.S. shareholder's aggregate foreign cash position if any interest in the entity is held by an SFC of the U.S. shareholder, and the entity would be an SFC of the U.S. shareholder if it were a foreign corporation.

Under this rule, certain partnerships in which SFCs own interests will themselves be treated as SFCs for purposes of determining the relevant U.S. shareholders' aggregate foreign cash positions. Notably, however, rather than functioning as a look-through rule that treats an SFC as owning its allocable share of the liquid assets of a partnership in which the SFC owns an interest, section 965(c)(3)(E) instead simply treats a partnership as an SFC. As a consequence, under the plain text of the statute, a U.S. shareholder would be required to take into account not only the cash position of a partnership that is attributable to an SFC's interest in the partnership, but also the cash position that is attributable to any interest in the partnership held by the U.S. shareholder itself.

Example 3. Partnership Owned by U.S. Shareholder and its SFC.

USP, a domestic corporation, owns 100% of CFC 1. USP owns 5%, and CFC 1 owns 95%, of PRS, a foreign partnership. PRS's cash position as of each of the relevant measurement dates is $100.

Under section 965(c)(3)(E), PRS is treated as an SFC because if PRS were a corporation, it would be 100% owned (directly and indirectly) by USP. In the absence of any guidance to the contrary, the full $100 of cash held by PRS would be taken into account by USP in determining its aggregate foreign cash position.

As a policy matter, a U.S. shareholder's allocable share of the cash position of a partnership should not be taken into account in determining the shareholder's aggregate foreign cash position. The purpose of measuring a U.S. shareholder's aggregate foreign cash position is to impose the

adjustments would not be "accounts payable" for purposes of assessing liquid assets under section 965(c)(3). We can discern no rationale for distinguishing between account payables based on the asset that gave rise to the account payable. Forcing taxpayers to make such distinctions will potentially impose onerous requirements on taxpayers.

transition tax at a higher rate on the portion of a foreign corporation's deferred E&P that is attributable to liquid assets.[23] Accordingly, only liquid assets that are held by foreign corporations—directly, or indirectly through a partnership—should be taken into account.[24]

Importantly, the Conference Report states that the conferees anticipate that Treasury and the Service will issue guidance addressing the application of section 965(c)(3)(E) in these circumstances.[25]

Recommendation

We recommend that Treasury and the Service issue guidance providing that a U.S. shareholder's share of the cash position of a non-corporate entity that is treated as an SFC pursuant to section 965(c)(3)(E) is disregarded. Under this principle, in Example 3 above, USP would take into account $95 of the cash of PRS in determining its aggregate foreign cash position, and not the full $100.

We also recommend that Treasury and the Service issue guidance clarifying that the term "entity" in section 965(c)(3)(E) does not include an entity that is disregarded as an entity separate from its owner for U.S. federal income tax purposes (a "DRE"). For purposes of applying section 965(c), we believe DREs should simply be disregarded and liquid assets held by a DRE should be considered as being held directly by the entity's owner.

V. Need for Guidance Regarding PTI and Basis Adjustments

Section 965 gives rise to a number of issues regarding distributions made by DFICs during and after their inclusion year and basis adjustments that are made in connection with U.S. shareholders' inclusions under section 951(a)(1) pursuant to section 965. We believe section 3.03 of Notice 2018-07 and section 4 of Notice 2018-13 address several of these issues and commend Treasury and the Service for their efforts. Nevertheless, additional guidance is needed to clarify a

[23] *See* Senate Budget Committee Explanation, p. 358;

[24] There may be partnerships that are jointly owned by U.S. shareholders and their SFCs and to which the relevant SFC has contributed a disproportionate share of cash and cash equivalents compared to the U.S. shareholder (which may have contributed operating assets, for example). In situations where the SFC's contribution of liquid assets was undertaken with a principal purpose of reducing its cash position, the anti-abuse rule in section 965(c)(3)(F) permits the Service to disregard the transfer. Outside this context, in non-abusive transactions in which an SFC has contributed liquid assets to a bona fide partnership in exchange for a partnership interest, we do not believe it is generally appropriate to "trace" specific partnership property back to the contributing SFC.

[25] *See* H.R. Rep. No. 115-466, at 492.

few remaining interpretative questions and correct certain adverse consequences arising from the application of section 965.

Generally, section 961 provides rules for adjusting a U.S. shareholder's basis in stock of SFCs[26] and other property to account for inclusions pursuant to section 951(a) and distributions of PTI. Section 961(a) provides for positive basis adjustments to account for inclusions in gross income under section 951(a), while section 961(b)(1) provides for negative basis adjustments to reflect distributions of PTI. To the extent the amount of a distribution of PTI exceeds the U.S. shareholder's basis in the SFC stock, the U.S. shareholder is required to recognize gain under section 961(b)(2).[27]

A U.S. shareholder's pro rata share of the increase in Subpart F income of an SFC required by section 965(a) is included in the gross income of the U.S. shareholder for its taxable year in which or with which the taxable year of the SFC beginning before January 1, 2018 ends.

Thus, for a December 31 DFIC, a U.S. shareholder with respect to such DFIC included an amount in income under section 951(a)(1) pursuant to section 965 for its taxable year that included December 31, 2017. The deferred E&P that gave rise to this inclusion became PTI on December 31, 2017, and the distribution of this PTI results in the application of section 961(b).

Section 965(b)(1) provides that, if a taxpayer is a U.S. shareholder with respect to at least one DFIC and at least one E&P deficit foreign corporation,[28] then the portion of deferred E&P which would otherwise be taken into account under section 951(a)(1) by a U.S. shareholder with respect to each DFIC is reduced by the amount of such U.S. shareholder's aggregate foreign E&P deficit that is allocated to such DFIC.

Section 965(b)(4)(A) states:

> For purposes of applying section 959 in any taxable year beginning with the taxable year described in [section 965(a)], with respect to any United States shareholder of a deferred foreign income corporation, an amount equal to such shareholder's reduction under [section 965(b)(1)] which is allocated to such deferred foreign income corporation under this subsection shall be treated as an amount

[26] Although section 961 refers to CFCs, section 965(e)(2) provides that, for purposes of sections 951 and 961, an SFC shall be treated as a CFC for purposes of taking into account Subpart F income of such corporation for purposes of section 965(a) (and for purposes of applying section 965(f)).

[27] § 961(b)(2); Treas. Reg. § 1.961-2(c).

[28] Under section 965(b)(3)(B), "E&P deficit foreign corporation" means, with respect to any taxpayer, any SFC with respect to which such taxpayer is a U.S. shareholder, if, as of November 2, 2017, (i) such specified foreign corporation has a deficit in post-1986 earnings and profits, (ii) such corporation was an SFC and (iii) such taxpayer was a U.S. shareholder of such corporation.

> which was included in the gross income of such United States shareholder under section 951(a).

Thus, under section 965(b)(4)(A), the amount by which a shareholder reduces its section 951(a)(1) inclusion with respect to a DFIC as a result of the allocation of a deficit is treated as PTI. Section 965(b)(4)(A) does not, however, by its terms expressly treat the allocation of a deficit as an amount which was included in income under section 951(a) for purposes of applying section 961(a). Thus, section 965(b) may have the effect of creating PTI in DFICs that is not matched by corresponding basis adjustments. Consequently, as illustrated in Example 5 and Example 6 below, the operation of section 965(b) may result in a U.S. shareholder being in a position where it is not possible to make a distribution from a foreign subsidiary without triggering unfavorable U.S. federal income tax consequences, including during tax years following the inclusion year when the participation exemption under section 245A is applicable.

Under section 959(e), distributions made during the taxable year are generally treated as first made from PTI and thereafter from E&P that is not PTI. Accordingly, distributions made by a December 31 DFIC during its tax year that ended December 31, 2017 in many cases are retroactively treated as distributions of PTI. If the U.S. shareholder did not have sufficient basis in the stock of the DFIC at the time of the distribution, then the U.S. shareholder would have recognized gain under section 961(b)(2). As a result, the E&P that was distributed may have been subject to U.S. federal income tax at rate of up to 50.5%, *i.e.*, the section 965(a) inclusion at the 15.5% effective rate and the section 961(b)(2) gain at the 35% corporate rate in effect in 2017. In light of the fact that section 965(a) was introduced in November and enacted at the end of December, the taxpayer may have reasonably expected that under the law in effect at the time of the distribution, the distribution would be treated as a dividend (and not a distribution of PTI), and that foreign tax credits would be available.

For a November 30 DFIC, a U.S. shareholder with respect to such DFIC will include an amount in income under section 951(a)(1) pursuant to section 965 for its taxable year that includes November 30, 2018. The deferred E&P that gives rise to such inclusion will constitute PTI when distributed, with the distribution resulting in the application of section 961(b). Accordingly, if the U.S. shareholder does not have sufficient basis in its stock of the DFIC at the time of the distribution, then the U.S. shareholder would recognize gain under section 961(b)(2).

As discussed above, one important Congressional purpose in enacting section 965 was to encourage U.S. multinationals to repatriate heretofore untaxed foreign earnings and to do so as soon as possible, including during the inclusion year. The statute on its face, however, may discourage repatriations before the last day of a DFIC's taxable year if a U.S. shareholder does not have basis in its DFIC stock that is sufficient to offset distributions occurring on an earlier date. The rule in section 3.03 of Notice 2018-07 attempts to resolve this issue. It provides that if a U.S. shareholder receives distributions from a DFIC during the inclusion year that are attributable to

PTI described in section 959(c)(2) by reason of section 965(a) ("Section 965 PTI"), the amount of gain recognized by the U.S. shareholder with respect to the stock of the DFIC under section 961(b)(2) will be reduced (but not below zero) by the "section 965(a) inclusion amount"[29] (the "gain-reduction rule"). Notice 2018-07 does not expressly apply the gain-reduction rule to distributions to a U.S. shareholder from an entity (an "upper-tier entity") that is not a DFIC (for instance, an E&P deficit foreign corporation) that has received distributions from a DFIC (a "lower-tier DFIC") attributable to Section 965 PTI. Notice 2018-07 could, moreover, be interpreted to provide that even when the upper-tier entity is a DFIC, the amount of gain recognized by the U.S. shareholder that is reduced by reason of the gain-reduction rule is limited solely to the section 965(a) inclusion amount of the U.S. shareholder with respect to the upper-tier entity, rather than also including the section 965(a) inclusion amount with respect to the lower-tier DFIC from which such upper-tier entity has received distributions attributable to Section 965 PTI.

Notice 2018-13 addresses some of these issues. It states that Treasury and the Service intend to issue regulations providing that the gain-reduction rule will also apply to distributions received from a DFIC through a chain of ownership described in section 958(a).[30] Specifically, Section 4 of Notice 2018-13 states that such regulations will provide that if a U.S. shareholder receives distributions through a chain of ownership described under section 958(a) from a DFIC during the inclusion year that are attributable to Section 965 PTI, the amount of gain recognized under section 961(b)(2) by the U.S. shareholder with respect to the stock or property of any entity in the ownership chain described in section 958(a) through which the distribution is made will be reduced (but not below zero) by the section 965(a) inclusion amount of the U.S. shareholder with respect to such DFIC. The gain-reduction rule will apply similarly to reduce the amount of gain that would otherwise be recognized under section 961(c) by any CFC in the ownership chain described in section 958(a) through which the distribution is made to a U.S. shareholder for purposes of determining the amount included under section 951(a)(1) in the gross income of the U.S. shareholder.

Recommendation

While the Notices address many of the issues raised by distributions made by DFICs during their inclusion year, we believe further guidance is necessary.

[29] The term "section 965(a) inclusion amount" is defined as the portion of the section 965(a) earnings amount that is taken into account under section 951(a)(1) by a U.S. shareholder with respect to each DFIC reduced by the amount of such U.S. shareholder's aggregate foreign E&P deficit that is allocated to such DFIC under section 965(b)(2) (the "Section 965 inclusion amount"). Notice 2018-13, § 4, modifying Notice 2018-07 § 3.03.

[30] *See* Notice 2018-13, § 4.

A. PTI Ordering Rule and Timing of Basis Adjustments

Section 4 of Notice 2018-13 only applies to distributions "that are attributable to" a U.S. shareholder's Section 965 PTI. It is not clear under this Notice how to determine what portion, if any, of a distribution is "attributable to" Section 965 PTI if the distributing DFIC also earns, or otherwise has, other Subpart F income during the inclusion year.

To achieve the section 965 policy objective of encouraging U.S. multinationals to repatriate untaxed foreign earnings, distributions received by a U.S. shareholder from a DFIC during the inclusion year should first be treated as attributable to Section 965 PTI and then to other Subpart F income.

Example 4.

(i) Facts. USP, a domestic corporation that is a calendar year taxpayer, owns all of the stock of CFC, a DFIC with an inclusion year that ends on November 30, 2018. The functional currency of CFC is the U.S. dollar. USP's adjusted basis in the stock of CFC is zero. CFC has deferred E&P of $100 as of December 31, 2017 (the applicable measurement date). USP therefore has a section 965(a) inclusion amount of $100 with respect to CFC on November 30, 2018. On March 1, 2018, CFC earns $30 of Subpart F income (as defined in section 952) which will be included in the gross income of USP under section 951(a) in its taxable year ending December 31, 2018. On March 15, 2018, USP causes CFC to make a cash distribution of $100 to USP.

(ii) Analysis. Under Treasury Regulation section 1.961-1(a)(1),[31] the increase to USP's tax basis in its CFC stock for its section 965(a) inclusion and other Subpart F income earned during the inclusion year may not be effective until November 30, 2018, the last day of the CFC's taxable year. In such case, on March 15, 2018, the date of the distribution, USP's basis in the CFC stock would be zero, and absent the application of the Notices' gain-reduction rule, USP would recognize $100 of gain as a result of the distribution.

Since neither of the Notices nor section 965 include an ordering rule, it is not clear how the distribution received by USP on March 15, 2018 should be treated. One possibility is that it should be sourced first from Section 965 PTI to the extent thereof, and then from non-Section 965 PTI (*i.e.*, the PTI attributable to the $30 of Subpart F income earned during CFC's inclusion year).

[31] Treasury Regulation section 1.961-1(a)(1) provides, in pertinent part, that "[t]he basis of a United States shareholder's… [s]tock in a controlled foreign corporation… shall be increased under section 961(a), *as of the last day in the taxable year of such corporation on which it is a controlled foreign corporation*, by the amount required to be included with respect to such stock or such property in such shareholder's gross income under section 951(a) for his taxable year in which or with which such taxable year of such corporation ends." (Emphasis added.) This regulation has created some uncertainty as to whether the basis increase would be available for mid-year distributions of E&P that subsequently become PTI.

Alternatively, it could be sourced first from non-Section 965 PTI, or proportionately from both Section 965 PTI and non-Section 965 PTI.

If the distribution is first treated as being attributable to Section 965 PTI, then the gain-reduction rule would apply to the entire $100 distribution. Under this scenario, USP would not recognize any taxable gain as a result of the distribution.

If, on the other hand, any part of a distribution is treated as being attributable to the $30 of Subpart F income earned during the inclusion year, then the gain-reduction rule would not apply to that portion of the distribution and the distribution may result in USP recognizing gain pursuant to section 961(b)(2).[32]

Recommendation

We recommend that guidance be issued that clarifies that distributions received by a U.S. shareholder from a DFIC, either directly or through a chain of ownership, during an inclusion year are first treated as attributable to Section 965 PTI and then to non-Section 965 PTI. We also recommend that guidance be issued clarifying that to the extent gain under section 961(b)(2) is reduced by the section 965(a) inclusion amount, such amount is excluded from the calculation of the basis increase under section 961(a).

As an alternative to the gain-reduction rule, we recommend that Treasury and the Service consider an ordering rule for basis adjustments due to section 965 inclusions and distributions as follows.

Treasury and the Service could replace the gain-reduction rule with basis adjustment rules analogous to the rules applicable in the S corporation or partnership context. Similar to the basis adjustment rules under section 961, section 1367(a) provides that the basis of a shareholder's stock in an S corporation is increased by the shareholder's pro rata share of the income of the S corporation and is decreased (but not below zero) by distributions made to the shareholder. Generally, a shareholder recognizes gain to the extent a distribution exceeds the shareholder's basis in its stock.[33] For purposes of determining whether a distribution exceeds basis, section 1368(d)(1) and

[32] Under section 959 and the applicable regulations, the $30 portion of the distribution treated as attributable to the current year Subpart F income, however, would otherwise be excludable from USP's gross income when distributed because such amount represents earnings and profits attributable to amounts which are included in USP's gross income for the taxable year of the distribution under section 951(a). § 959(a); Treas. Reg. § 1.959-1(b) Example.

[33] § 1368(b)(2).

applicable regulations further provide that a shareholder of an S corporation increases its basis in its S corporation stock for its share of income before taking distributions into account.[34]

Similarly, section 705(a) provides that a partner's basis in its partnership interest is increased by the partner's distributive share of partnership income and is decreased (but not below zero) by distributions by the partnership. To the extent that the amount of money distributed to a partner exceeds the partner's basis in its partnership interest, the partner recognizes taxable gain. Under the partnership rules, advances or drawings of money or property against a partner's distributive share of income are treated as current distributions made on the last day of the partnership taxable year with respect to such partner.[35] By treating such distributions of money as occurring on the last day of the partnership taxable year, income allocations to the partner will increase the partner's basis in its partnership interest before taking the distribution of money into account.

In lieu of the gain-reduction rule, we recommend that Treasury and the Service consider adopting a basis adjustment ordering rule analogous to the S corporation rule and provide that a U.S. shareholder of a DFIC takes into account its section 965(a) inclusion amount for purposes of adjusting its basis in its DFIC stock before taking into account any distributions from the DFIC during the inclusion year. In the alternative, Treasury and the Service could adopt a rule similar to the partnership rule and provide that Section 965 PTI distributions are treated as current distributions made on the last day of the DFIC's taxable year. Under either alternative, a U.S. shareholder would get the benefit of increasing its basis in the DFIC stock for its section 965(a) inclusion amount before taking the Section 965 PTI distribution into account and thereby avoid recognition of gain to the extent of the basis increase.

B. PTI Adjustments in Excess of Basis Increases May "Trap" Earnings and Profits

Under the Notices, the "section 965(a) inclusion amount" means the portion of the deferred E&P that is taken into account under section 951(a)(1) by a U.S. shareholder with respect to each DFIC *reduced* by the amount of such U.S. shareholder's aggregate foreign E&P deficit that is allocated to such DFIC under section 965(b)(2). As described above, under section 965(b)(4)(A), the amount by which a shareholder reduces its section 951(a)(1) inclusion with respect to a DFIC as a result of the allocation of a deficit is treated as PTI. Nevertheless, section 965(b)(4)(A) does not provide for a corresponding increase in basis under section 961(a).

If a U.S. shareholder's inclusion amount with respect to a DFIC is reduced by an E&P deficit allocated from another SFC, a distribution by such DFIC of all of its E&P may exceed the

[34] § 1368(d)(1); Treas. Reg. § 1.1368-1(e)(2).

[35] Treas. Reg. § 1.731-1(a)(1)(ii).

U.S. shareholder's section 965(a) inclusion amount, resulting in taxable gain to the U.S. shareholder. Such gain would not be subject to the gain-reduction rule.

Example 5.

(i) Facts. USP, a domestic corporation, owns all of the stock of CFC1 and all of the stock of CFC2, each with an inclusion year ending December 31, 2017. The functional currency of CFC1 and CFC2 is the U.S. dollar. As of December 31, 2016, CFC1 did not have any E&P described in section 959(c)(1) or (c)(2), and USP's adjusted basis in the stock of CFC1 was zero. As of each of the measurement dates, CFC1 has post-1986 E&P of $100. CFC2 is an E&P deficit foreign corporation with a specified E&P deficit of $50. On July 1, 2017, USP caused CFC1 to make a cash distribution of $100 to USP that USP anticipated would be treated as a dividend from CFC1's E&P described in section 959(c)(3).

(ii) Analysis. Although USP reasonably anticipated that the July 1 distribution by CFC1 would be treated as a dividend (and would allow USP to claim indirect foreign tax credits in accordance with section 902), the subsequent enactment of section 965 alters USP's tax treatment. Under section 965(a), CFC1's Subpart F income is increased by its deferred E&P of $100 for its 2017 tax year. USP's section 965(a) inclusion amount is $50, determined by reducing its section 951(a)(1) inclusion of $100 by the E&P deficit allocated to it in the amount of $50. Under section 965(b)(4), USP has a PTI account of $100 with respect to CFC 1.

The July 1, 2017 distribution by CFC1 is retroactively recharacterized as a distribution of $100 of PTI. Under the gain-reduction rule, the amount of gain recognized by USP with respect to its CFC1 stock under section 961(b)(2) will be reduced (but not below zero) by $50, USP's section 965(a) inclusion amount. Accordingly, USP is required to recognize $50 of taxable gain as a result of CFC1's distribution.

Example 6.

(i) Facts. The facts are the same as in Example 5 above, except that CFC1 did not make any distributions during 2017.

(ii) Analysis. As of January 1, 2018, CFC1 has $100 of PTI and $0 of E&P described in section 959(c)(3). USP's adjusted basis in its CFC1 stock is $50, because it was increased by the amount of USP's section 951(a)(1) inclusion with respect to CFC1. Distributions by CFC1 occurring after December 31, 2017 are not subject to the Notices' gain-reduction rule, since the gain-reduction rule only applies to distributions during a DFIC's inclusion year.

It may not be possible for USP to receive any future distributions from CFC1 without triggering unfavorable U.S. federal income tax consequences. Because CFC1 has $100 of PTI but USP has only $50 of basis in its CFC1 stock, and distributions made by a CFC during its taxable

year are generally treated as first made from PTI, the first $50 of distributions from CFC1 would result in USP recognizing gain under section 961(b)(2).

Significantly, this situation persists even if CFC1 has earnings following its inclusion year, the distribution of which would qualify for the 100% dividends-received deduction under section 245A. Because distributions by CFC1 will be treated as first made from PTI, the first $50 distributed by CFC1 will result in USP recognizing taxable income on a dollar-for-dollar basis. Effectively, post-2017 E&P will be "trapped" by the PTI.

Recommendation

We recommend that Treasury and the Service consider issuing guidance that would allow U.S. shareholders to repatriate Section 965 PTI in full without triggering taxable gain under section 961(b)(2), including by applying the gain-reduction rule to the full extent of a U.S. shareholder's section 951(a)(1) inclusion of deferred E&P (without reduction for any deficit allocated against the inclusion pursuant to section 965(b)). Because it is common for U.S. shareholders to own foreign corporations with substantial deficits in earnings and profits, we believe that a regime that creates PTI that is not matched by corresponding basis adjustments will impede the repatriation of deferred E&P as well as future earnings in many cases, and will also have unduly harsh—and what at the time may have been unforeseeable—consequences for taxpayers that received distributions in 2017 prior to the introduction of the new legislation.

On the other hand, adopting this approach could potentially be viewed as overly generous. Many aspects of section 965, including section 965(b), seem to be premised (at least in part) on the principle that U.S. shareholders that divided foreign operations among multiple corporations should be treated similarly to U.S. shareholders that consolidated their foreign operations in a single corporation (a "one-CFC" approach).

Returning to Example 5 and Example 6 above, if CFC 1 and CFC 2 had been combined into a single corporation, USP would have included the same net $50 of deferred E&P in income pursuant to section 951(a)(1), and would have adjusted its basis in the stock of its CFC by $50 under section 961(a) as a result of the inclusion. Thus, absent further transactions affecting its tax position, USP would not have sufficient basis in its CFC stock to receive a $100 distribution without triggering gain. On the other hand, a single CFC would only have had $50 of PTI, rather than the $100 of PTI that is created in CFC1 in the examples; consequently, unlike the examples, post-inclusion year foreign earnings would not be "trapped" behind $50 of excess PTI and could be repatriated tax-free with the benefit of section 245A.

One alternative for addressing these issues that we recommend Treasury and the Service consider would be providing rules that permit taxpayers to appropriately utilize basis in the stock of E&P deficit foreign corporations in order to offset section 961(b)(2) gain resulting from distributions of Section 965 PTI. For example, the gain-reduction rule could be expanded so that it also

operates to reduce section 961(b)(2) gain by the basis in the stock of an E&P deficit foreign corporation to the extent a deficit of such E&P deficit foreign corporation was allocated to reduce the taxpayer's section 951(a)(1) inclusion in respect of the relevant DFIC. This is consistent with a "one-CFC" approach; if CFC1 and CFC2 in Example 5 and Example 6 were a single CFC, then USP's basis in the combined entity would generally be equal to its aggregate basis in the stock of CFC1 and CFC2. In order to address the issue of "trapped" PTI illustrated in Example 6, if Treasury and the Service were to adopt such a rule, it should apply to DFICs' inclusion year as well as succeeding tax years in order to avoid the "trapped" E&P issue illustrated by Example 6.

C. Effective Date of Gain-Reduction Rule

The gain-reduction rule applies to a "U.S. shareholder that receives a distribution during the inclusion year," but the Notices state that the implementing regulations will be "effective beginning the first taxable year of a foreign corporation (and with respect to United States shareholders, the taxable years in which or with which such taxable years of the foreign corporation ends)" to which section 965 applies. Under this effective date provision, distributions made during December 2017 by a November 30 SFC to a December 31 U.S. shareholder would not be entitled to the gain-reduction rule, notwithstanding that the U.S. shareholder received the distribution during the SFC's inclusion year.

Recommendation

We recommend that guidance be issued clarifying that distributions made to a U.S. shareholder during the inclusion year are within the scope of the effective date provisions of the Notices and any regulations promulgated pursuant thereto.

VI. Need for Guidance Regarding Election Under Section 965(n)

A. Clarification of Section 965(n)(1)(A)

Section 965(n)(1) provides that if a United States shareholder of a DFIC makes an election for the taxable year described in section 965(a), then the section 965(a) inclusion amount (plus the section 78 gross-up amount with respect thereto and after taking into account the participation exemption deduction under section 965(c)) shall not be taken into account (A) in determining the amount of the "net operating loss deduction under section 172 of such shareholder for such taxable year" or (B) in determining the amount of taxable income for such taxable year "which may be reduced by net operating loss carryovers or carrybacks to such taxable year under section 172."[36]

[36] We note that the references to "taxable year" in section 965(n)(1) are somewhat ambiguous. Section 965(n)(1) first refers to "the taxable year described in subsection (a)." The only reference to a taxable year

Clause (B) is clearly meant to permit a taxpayer to elect to exclude the section 965(a) inclusion amount (plus the section 78 gross-up amount with respect thereto and after taking into account the participation exemption deduction under section 965(c)) in determining the amount of net operating loss carryovers and carrybacks from other taxable years to the inclusion year. However, the use of the term "net operating loss deduction" in clause (A) makes the intended effect and purpose of clause (A) unclear. Section 172(a) states that "for purposes of this subtitle" the term "net operating loss deduction" means the deduction allowed by section 172(a). Section 172(a) permits a deduction for the taxable year in an amount equal to the aggregate of (i) the net operating loss carryovers to such year, and (ii) the net operating loss carrybacks to such year. (By contrast, section 172(c) defines the term "net operating loss" for purposes of section 172 as the excess of the deductions allowed by chapter 1 over gross income, computed with the modifications specified in section 172(d).)

If the term "net operating loss deduction" as used in clause (A) means the amount of the deduction, in the inclusion year, equal to the aggregate net operating loss carryovers and carrybacks from other taxable years to the inclusion year, then clause (A) has exactly the same effect as clause (B), and thus is superfluous. There is absolutely no indication that Congress intended this result. Although there is nothing in the legislative history that explicitly describes the purpose of section 965(n),[37] we believe that the purpose of section 965(n) is to permit a taxpayer to elect to have taxable income in the inclusion year at least equal to its aggregate section 965(a) inclusion amount (plus the section 78 gross-up amount with respect thereto and after taking into account the participation exemption deduction under section 965(c)), the tax on which could then be reduced by allowable foreign tax credits. In the absence of section 965(n), a taxpayer's aggregate section 965(a) inclusion amount (plus the section 78 gross-up amount with respect thereto and after taking into account the participation exemption deduction under section 965(c)) might be reduced, in whole or in part, by either a current year net operating loss (computed without regard to section 965) or one or more net operating loss carryovers or carrybacks. Either would prevent the taxpayer from utilizing, in whole or in part, foreign tax credits which would otherwise be allowable in the absence of such net operating losses (which foreign tax credits, given the participation exemption deduction in section 245A and other changes made by the Act, might never be used in the future). In light of this purpose, it should make no difference whether the net operating loss at issue is a

in section 965(a) is to the "last taxable year of a [DFIC] which begins before January 1, 2018." The later references to "taxable year" in section 965(n)(1)(A) and (B), however, only make sense as references to the taxable year of the U.S. shareholder of such DFIC. Congress presumably meant to refer to the taxable year of the U.S. shareholder of such DFIC in which the U.S. shareholder has a section 965(a) inclusion amount with respect to which DFIC. We assume for purposes of this discussion that this is in fact how section 965(n) should be interpreted and applied, although clarification to that effect would be welcome.

[37] H.R. Rep. No. 115-466, at 486.

current year net operating loss (computed without regard to section 965) or a net operating loss carryforward or carryback.

Recommendation

We recommend that Treasury issue guidance that provides that, if a taxpayer makes the election under section 965(n)(1) with respect to a taxable year, the amount described in section 965(n)(2) shall not be taken into account in determining the amount of the net operating loss under section 172 of such shareholder for such taxable year.

B. Consolidated Groups

The consolidated return rules adopt the principles of section 172. A consolidated net operating loss ("CNOL") occurs when the aggregate of the members' deductions exceeds their income.[38] A CNOL can be carried back or carried forward, subject to limitations.

On its face, the election in section 965(n) does not seem applicable to consolidated groups because the CNOL is determined at the group level, and carried over at the group level, rather than by any particular member of the group has a section 951(a)(1) inclusion pursuant to section 965.

Recommendation

We recommend that Treasury and the Service issue guidance providing that a consolidated group is permitted to make an election under section 965(n), which election would exclude the impact of section 965 on the members of the consolidated group from the calculation of the CNOL and in determining the amount of consolidated taxable income which may be reduced by a CNOL carryover or carryback.

VII. Need for Guidance Regarding Treatment of Individuals Who Are Subject to the Transition Tax

Under section 965(c), a U.S. shareholder of a DFIC is allowed a deduction in the taxable year in which it is required to include amounts in gross income under section 951(a)(1) pursuant to section 965. The deduction is intended to result in a 15.5% rate of tax on deferred E&P that is attributable to the cash position, and an 8% rate of tax on all other earnings.[39] The amount of the deduction is the sum of the "15.5 percent rate equivalent percentage" of the inclusion amount that is attributable to the aggregate foreign cash position, plus the "8 percent rate equivalent percentage" of the portion of the inclusion amount (if any) that exceeds the aggregate foreign cash

[38] *See* Treas. Reg. § 1.1502-21(e).

[39] H.R. Rep. No. 115-466, at 491.

position. The "15.5 percent rate equivalent percentage" and the "8 percent rate equivalent percentage" are calculated based on the corporate tax rate.

Because the deduction is calculated in the same manner for individual taxpayers, it results in individuals being subject to the transition tax at higher effective tax rates, as illustrated by the following examples.[40]

Example 7. Tax Rate Imposed on Corporate Taxpayer's Deferred E&P Attributable to Cash

USP owns 100% of the stock of CFC 1. Both are calendar year taxpayers. CFC 1 is the only DFIC in which USP owns an interest. On December 31, 2017, USP has a section 951(a)(1) inclusion pursuant to section 965 of $100. CFC 1's cash position is $100 on each of the relevant measurement dates; accordingly, USP's aggregate foreign cash position is $100.[41]

Under section 965(c), USP is entitled to a deduction of $55.71 (*i.e.*, $100 x (35% - 15.5%) ÷ 35%). USP has a gross income inclusion of $100 and an offsetting deduction of $55.71, resulting in net income of $44.29. Imposing the 35% corporate tax rate on this amount results in a tax liability of $15.50—equivalent to taxing the full $100 of deferred E&P at a 15.5% rate. If CFC 1's inclusion year ended on November 30, 2018 instead of December 31, 2017, so that USP's inclusion is in 2018 when the corporate tax rate is 21%, then USP would be entitled to a deduction of $26.19 (*i.e.*, $100 x (21% - 15.5%) ÷ 21%), again resulting in an effective tax rate of 15.5%.

Example 8. Tax Rate Imposed on Individual Taxpayer's Deferred E&P Attributable to Cash

The facts are the same as in Example 7, above, except that individual A, a U.S. citizen, owns 100% of the stock of CFC 1. Assume that in 2017, A is subject to the highest marginal U.S. federal income tax rate applicable to individuals, 39.6%.

Pursuant to section 965(c), A is entitled to a deduction in the same amount as USP, *i.e.*, $55.71. Subjecting Individual A's net income of $44.29 (*i.e.*, $100 - $55.71) to income tax at the 39.6% rate results in a U.S. federal income tax liability of $17.54. Thus, A's effective U.S. federal income tax rate on A's inclusion of CFC 1's deferred E&P is 17.54%, rather than 15.5%.[42] The rate disparity is exacerbated if the inclusion year of CFC 1 ends on November 30, 2018, because the difference between the corporate and individual rates is even more pronounced in 2018. If

[40] Significantly, while the transition tax applies to individual U.S. shareholders and corporate U.S. shareholders alike, individuals are not entitled to the benefits of the Act's transition to a quasi-territorial system. *See* § 245A.

[41] In the interest of simplicity, Examples 7–9 ignore the potential availability of indirect foreign tax credits.

[42] Individual A may also be subject to the Medicare tax of 3.8% on this net income.

CFC 1 had a November 30 taxable year, A would be subject to an effective U.S. federal income tax rate of 27.31%, rather than 15.5%, on A's inclusion in 2018.

The Conference Committee recognized this anomaly. The Conference Report states:

> The use of rate equivalent percentages is intended to ensure that the rates of tax imposed on the deferred foreign income is similar for all U.S. shareholders, regardless of the year in which section 965 gives rise to an income inclusion. Individual U.S. shareholders, and the investors in U.S. shareholders that are pass-through entities generally can elect application of corporate rates for the year of inclusion.[43]

At the end of the passage cited above, the Conference Report includes a footnote which states: "Sec. 962 allows individuals to make the election for a specific taxable year, subject to regulations provided by the Secretary." It is not clear whether by the reference to section 962 Congress intended to incorporate only the corporate rate election of section 962(a) or all of section 962.

Generally, a section 962 election is available to individuals who are U.S. shareholders of foreign corporations and are required to include amounts in gross income under section 951(a). The election can be made each year.[44] An election pursuant to section 962 has a number of consequences. First, the electing individual's gross income inclusions under section 951(a) are subject to U.S. federal income tax at corporate rates.[45] In addition, the election allows the individual to benefit from the indirect foreign credit under section 960 (which is otherwise unavailable to non-corporate U.S. shareholders).

For purposes of applying section 962, the corporate tax rate applies (i) to all amounts required to be included in the individual's gross income under section 951(a) for the taxable year, plus (ii) all amounts which would be required to be included in his gross income under section 78 for such taxable year with respect to the amounts referred to in clause (i) if such shareholder were a domestic corporation.[46] For purposes of section 962, the amount that is subject to taxation at the

[43] H.R. Rep. No. 115-466, at 491.

[44] *See* Section 962(a).

[45] Section 962(a)(1).

[46] Treas. Reg. § 1.962-1(b).

corporate tax rate cannot be reduced by any deduction of the U.S. shareholder even if his deductions exceed his gross income.[47]

The applicability of the corporate tax rate and the availability of indirect foreign tax credits are generally favorable tax consequences for an individual that makes the election under section 962. A section 962 election also involves unfavorable consequences. Section 962(d) overrides the normal application of section 959, by providing that when earnings and profits attributable to amounts that were included in income and subject to a section 962 election are distributed, those earnings and profits are required to be included in gross income to the extent they exceed the amount of U.S. federal income tax paid on such earnings and profits.[48] Additionally, under section 961(a), the increase in CFC stock basis that a U.S. shareholder ordinarily receives in respect of a section 951(a)(1) inclusion is limited for an individual who makes a section 962 election to the amount of U.S. federal income taxes the individual pays with respect to the section 951(a)(1) inclusion. The general effect of section 962 is to put the individual taxpayer in roughly the same position with respect to Subpart F income subject to the election as if the individual owned its CFC stock indirectly through a U.S. corporation that has a section 951(a)(1) inclusion in respect of such stock.

Thus, a section 962 election has the potential to result in double taxation of earnings and profits. Moreover, contrary to the statement in the Conference Report, a section 962 election may not result in deferred E&P being subject to the same 15.5% and 8% tax rates that are imposed on actual corporate taxpayers. While a section 962 election may have seemed a simpler way to create parity between corporations and individuals, it was not designed for the provisions of section 965. The following example illustrates these issues.

Example 9. Consequences of Section 962 Election

The facts are the same as in Example 8 above, except that individual A elects the application of section 962 in 2017. In addition, CFC 1 distributes $100 to A on January 1, 2018.

In 2017, Individual A has a gross income inclusion of $100 under section 951(a)(1) pursuant to section 965, and is entitled to a deduction of $55.71 pursuant to section 965(c). Under one interpretation of section 962(a)(1), it seems A would be subject to the 35% corporate tax rate on the $100 inclusion, prior to any available deduction, and the application of section 962 would not alter the treatment of the deduction to which A is entitled pursuant to section 965(c). Accordingly, assuming that A is able to offset other taxable income with the $55.71 deduction, the tax benefit

[47] Treas. Reg. § 1.962-1(b).

[48] Treasury Regulation section 1.962-3 contains detailed ordering rules on the allocation of distributions from a CFC among the various earnings and profits accounts in cases where a U.S. shareholder has made a section 962 election.

of the deduction would be $22.06 (*i.e.*, 39.6% x $55.71). Netting this tax benefit against the $35 of tax liability imposed on A's income inclusion, A's effective tax rate on the $100 of deferred E&P of CFC 1 would be 12.94%, rather than the 15.5% rate that applies to corporate taxpayers.

This interpretation of section 962 is clearly inconsistent with the legislative history of section 965, which suggests that Congress intended for the same effective tax rates to apply to individuals and corporations. Section 962 was enacted as part of the original Subpart F regime, and was tailored for net income inclusions since that is how Subpart F operates. The interplay of section 962 with section 965 raises an interpretative question: because section 965 operates by requiring a U.S. shareholder to include an amount in gross income, but permits a deduction that partially offsets the gross income inclusion in order to reach the effective tax rate that was intended to apply by Congress, should section 962, alternatively, be interpreted as applying to A's net inclusion of $44.29 so that the cash tax liability of A is equivalent to the tax liability of a corporation?[49]

Turning to A's tax treatment in 2018, when Individual A receives a distribution of $100 of Section 965 PTI, A would be required to include a portion of the distribution in income, because, under section 962(d), the amount of Section 965 PTI would be excluded from gross income only to the extent of the amount of tax paid by A in respect of his inclusion in 2017. Thus, depending upon which of the two interpretations of section 962(a) set forth above is correct, either $65 (*i.e.*, $100 - $35) or $84.50 (*i.e.*, $100 - $15.50) of the distribution would be included in A's gross income. In any case, A's aggregate U.S. federal income tax liability in 2017 and 2018 combined would, as a result of the application of section 962, exceed what it would have been had A not elected under section 962 (*i.e.*, $17.54, as illustrated in Example 8 above).

Finally, we note that the election under section 962 is generally only available to U.S. shareholders.[50] The passage from the Conference Report excerpted above states: "Individual U.S. shareholders, *and the investors in U.S. shareholders that are pass-through entities* generally can elect application of corporate rates for the year of inclusion." (Emphasis added.) Unless the individual investors that own an interest in a DFIC indirectly through a pass-through entity that is a U.S. shareholder of the DFIC also qualify as U.S. shareholders of the DFIC, however, the election would seem to be unavailable to them.

[49] We note that a similar issue arises in the application of section 962 to individuals' inclusions of global intangible low-taxed income (GILTI) pursuant to section 951A. Although it appears from the language of section 962 and the Treasury Regulations thereunder that the deduction allowed under section 250 does not apply in determining the amount of income subject to taxation at the corporate rate, applying the deduction appears to be more consistent with the statutory scheme of putting the individual U.S. shareholder in the same position as if the individual owned the CFC shares indirectly through a U.S. corporation.

[50] *See* Section 962(a); Treas. Reg. § 1.962-2(a).

Example 10. Tax Rate Imposed on Investors in a Pass-Through Entity That is a U.S. Shareholder

The facts are the same as in Example 7, above, except that LLC 1, a Delaware limited liability company treated as a partnership for U.S. federal income tax purposes, owns 100% of the stock of CFC 1. LLC 1, in turn, is owned by a number of U.S. individuals, each of whom owns less than 10% of the interests in LLC 1.

Under the plain language of the statute, it is not clear that the individual members of LLC 1 are eligible to make an election under section 962 because none of them owns a large enough interest in LLC 1 to qualify as a U.S. shareholder of CFC 1. Like individual A in Example 8 above, the members of LLC 1 will be subject to an effective U.S. federal income tax rate of 17.54% on their respective distributive shares of CFC 1's deferred E&P.

Recommendation

We recommend that Treasury and the Service consider what relief can be provided for individuals under the authority granted under section 965(o) so that the taxes paid on the section 965(a) inclusion amount (after taking into account the participation exemption deduction under section 965(c)) are no greater than those of a corporation. We recognize that it may be difficult as a matter of statutory construction to apply section 962 solely to equalize rates on section 965(a) inclusions for individual and corporate taxpayers, as section 962 clearly contemplates providing an individual with an indirect foreign tax credit while providing for a second level of tax on distributions. We believe, however, that it may be possible to interpret the reference to section 962 in the legislative history as only referring to the rate election in section 962(a), which would be consistent with recognizing that section 965 is not an identical regime to Subpart F because it provides for both an income inclusion and a deduction. The desired result would be that individual taxpayers be entitled to treat the full amount of their section 951(a)(1) inclusions as PTI (notwithstanding section 962(d)), and to make adjustments to their basis in their stock in the relevant DFICs in an amount equal to the amount included in gross income under section 951(a)(1) (notwithstanding the special rule in section 961(a) that generally limits basis adjustments for U.S. shareholders that make section 962 elections). The guidance should also ensure that electing individuals are subject to the corporate tax rate on the net amount of their income inclusions in order to achieve parity with corporate taxpayers.

VIII. Need for Guidance Regarding Section 965(h)(1) Election to Pay Transition Tax Liability in Installments

A. Treating Taxpayers as Having Made Section 965(h)(1) Elections by Default

Under section 965(h)(1), a U.S. shareholder may elect to pay the net tax liability resulting from the application of section 965 in eight annual installments (the "Section 965(h)(1) Election").

Under the election, the payments for each of the first five years equal 8 percent of the net tax liability, the sixth installment equals 15 percent of the net tax liability, the seventh installment equals 20 percent of the net tax liability, and the eighth installment equals 25 percent of the net tax liability. The timely payment of installments does not incur an interest charge.

Section 965(h)(2) provides that if a Section 965(h)(1) Election is made, then the first installment is required to be paid by the due date (determined without regard to any extension of time for filing the return) for the tax return for the taxable year described in section 965(a) (*i.e.*, the inclusion year for an SFC), and each succeeding installment is required to be paid by the due date for the tax return for the taxable year following the taxable year with respect to which the preceding installment was made. Section 965(h)(5) states that the Section 965(h)(1) Election shall be made not later than the due date for the return of tax for the taxable year described in section 965(a) and shall be made in such manner as the Secretary shall provide.

Because the Section 965(h)(1) Election does not result in any interest charge, we believe most (if not all) eligible taxpayers will desire to make the election. For calendar year corporate taxpayers with income inclusions in 2017, the first installment payment pursuant to a Section 965(h)(1) Election will be due on March 15, 2018. As described above, gathering all of the information necessary to compute the transition tax liability represents a substantial administrative burden for taxpayers. Failure to pay any installment under section 965(h) on a timely basis may trigger an acceleration of the remaining payments.[51]

Recommendation

We recommend that future guidance provide that all eligible taxpayers will be treated as having made a Section 965(h)(1) Election in the absence of an affirmative election to the contrary. Taxpayers that choose not to pay their transition tax liability in installments could "elect out" of this treatment by attaching a statement to their tax returns for the years that includes the relevant section 951(a)(1) inclusions. This approach should also eliminate the administrative burden the Service is otherwise likely to face from taxpayers flooding it with requests for relief for failure to make the election in a timely manner.

B. Certain Transactions Should Be Treated as Qualifying for the Exception to the Acceleration Rule

Under section 965(h)(3), generally, in the event of certain transactions or occurrences, any remaining transition tax installment payments of a taxpayer that has made a Section 965(h)(1) Election are accelerated and no longer eligible to be made annually over the remainder of the eight year period (the "Acceleration Rule"). The triggers for the acceleration rule are: (1) an addition to

[51] *See* section 965(h)(3) discussed *infra*.

tax for failure to pay any installment required under section 965(h) on a timely basis; (2) a liquidation or sale of substantially all the assets of the taxpayer (including in a title 11 or similar case); (3) a cessation of business by the taxpayer; or (4) any similar circumstance.

The acceleration rule does not apply, however, to the sale of substantially all of the assets of a taxpayer to a buyer if the buyer enters into an agreement with the Secretary under which such buyer is liable for the remaining installments as if such buyer were the taxpayer.[52]

Where the acceleration rule applies, the remaining installments are due on the date that the triggering event occurs (or in the case of a title 11 or similar case, the day before the petition is filed).

The transactions Congress included in the Acceleration Rule suggest that Congress was focused on situations where payment of the remaining installments becomes less certain, including as the result of a loss in the credit quality of the U.S. shareholder. By providing the exception for certain dispositions of substantially all of a U.S. shareholder's assets, Congress recognized that, in a situation where a transferee acquires such assets and agrees to "step into the shoes" of the U.S. taxpayer with respect to any remaining installment payments, it is inappropriate to apply the Acceleration Rule.

Against this backdrop, we believe that certain transactions that would otherwise trigger the Acceleration Rule should potentially be viewed as falling under the exception to the rule because there is a successor taxpayer (a "buyer") that is legally liable to make any remaining installment payments and acquires substantially all of the U.S. shareholder's assets.

The first such transaction is the liquidation of a U.S. shareholder that is a member of a consolidated group (other than the common parent).[53] A liquidation[54] generally triggers the Acceleration Rule under section 965(h)(3). Nevertheless, in the case of a liquidation of a member of a consolidated group (other than the common parent), other members of the consolidated group generally receive assets of the liquidating member comprising at least 80% of the net value of its aggregate assets. Pursuant to Treasury Regulation section 1.1502-6, the other members of the consolidated group also remain liable for the U.S. federal income tax liabilities of the liquidating member. The second category of transactions are section 381 transactions where the transferee

[52] Section 965(h)(3).

[53] The discussion focuses on liquidations of a U.S. shareholder. However, we believe that other intragroup transactions in which substantially all of the relevant U.S. shareholder's assets remain within the consolidated group (such as a merger of a U.S. shareholder into another member of the same consolidated group) should be similarly treated.

[54] We refer to actual liquidation of the legal entity, as well as deemed liquidations pursuant to an entity classification election under Treasury Regulation section 301.7701-3.

succeeds to the tax attributes of the transferor and in most cases assumes all of the liabilities of the transferor.

The third category of transactions with respect to which guidance is needed is the application of the Acceleration Rule to transfers of stock of a C corporation in connection with which an election under section 338(h)(10) or section 336(e) is made. Section 338(h)(10) elections are available in connection with certain sales of stock of a domestic C corporation, and section 336(e) elections are available in connection with certain sales and distributions of stock of a domestic C corporation. In the case of both elections, for U.S. federal income tax purposes, a hypothetical new corporation ("new target") is considered to purchase the assets of the existing corporation ("old target") in a taxable transaction, and old target is deemed to liquidate. Significantly, the same legal entity remains in existence following the transaction, and "new target" generally remains liable for the U.S. federal income tax liabilities of "old target."[55]

In considering the Acceleration Rule it should be noted that when the U.S. shareholder is a member of a consolidated group, it is not clear whether the tax liability created by section 965 is the liability of the member or the group as a whole.

Section 108(i)(5)(D) sets forth an acceleration rule that is similar in some respects to the Acceleration Rule in section 965(h)(3) (although section 108(i) addressed the deferral of income inclusions rather than payments of tax, and section 108(i)(5)(D) expressly dealt with partnerships and likely involved companies in some financial difficulties). Treasury Regulation section 1.108(i)-1 provides guidance under section 108(i)(5)(D) which may, in appropriate circumstances, serve as a model for guidance with respect to the Acceleration Rule.

Recommendation

We recommend that guidance be issued providing that certain transactions qualify for the exception to the acceleration rule whereby a successor to a U.S. shareholder that has not made all of its installment payments pursuant to a Section 965(h)(1) Election effectively steps into the shoes of the U.S. shareholder with respect to the remaining installment payments. In many of these circumstances, we do not believe it should be required for the successor to enter into an agreement with the Service to be liable for the predecessor U.S. shareholder's remaining installment payments.

In particular, we recommend that the guidance provide that the Acceleration Rule is not triggered by the liquidation of a U.S. shareholder that is a member of a consolidated group (other than the common parent). Instead, the other members should be responsible for making any remaining installment payments of the U.S. shareholder that liquidated on the same schedule.

[55] *See* Treas. Reg. § 1.338-1(b)(3)(i); Treas. Reg. § 1.336-2(f).

Similarly, Treasury and the Service should consider issuing guidance providing that the exception to the Acceleration Rule is available in transactions in which a person acquires substantially all of a U.S. shareholder's assets in connection with either a merger (whether or not it qualifies for tax-free treatment under section 368(a)) or any other asset reorganization described in section 368(a). In a merger, the transferee generally assumes the liabilities of the merged corporation by operation of law, so an express agreement on the part of such transferee to be liable for the remaining section 965(h) installment payments may be superfluous. On the other hand, in asset reorganizations where the U.S. shareholder actually liquidates (or merges into a disregarded entity of the acquiror), it may be appropriate to require that the person acquiring substantially all of the U.S. shareholder's assets enter into such an agreement with the Service.

Guidance should also be provided regarding transactions involving section 338(h)(10) elections or section 336(e) elections in respect of a U.S. shareholder that is a member of a consolidated group. Although these transactions are treated as asset sales for U.S. federal income tax purposes, it is not clear that it is appropriate to trigger the Acceleration Rule because under applicable law both the selling consolidated group and the target potentially continue to be liable for the tax. It is important to provide clarity on whether in such a case the liability remains with the consolidated group, the target, or both. We believe that it might be preferable to have the liability, contrary to the provisions of Treasury Regulation sections 1.338-1(b)(3)(i) and 1.336-2(f), remain with the selling group. Such a result is more consistent with the treatment of these transactions as asset sales. The selling consolidated group is also more aware of the scope of the liability and can continue to make the installment payments.

We note that Treasury Regulation section 1.108(i)-1(b)(2)(ii)(B)(2)(iii) provides for an additional acceleration event, the "net value acceleration rule." We do not believe that in light of the statutory language of section 965(h) it would be appropriate to add such a concept as an additional acceleration event in the context of Section 965(h)(1) Elections. Nevertheless, we believe that satisfying a similar financial requirement may be an appropriate condition to granting additional exceptions to the Acceleration Rule.

In any case, we believe the transactions discussed above do not implicate the concerns underlying the Acceleration Rule, because after the transaction another person (or persons) continues to be legally liable for the U.S. federal income tax liability of the U.S. shareholder and has acquired the assets of the U.S. shareholder, just as a buyer that enters into an agreement with the Service as contemplated by section 965(h)(3) would.

In addition, we recommend that Treasury and the Service issue guidance providing that for purposes of the exception to the triggering rule in section 965(h)(3), an appropriate statement (or form) signed by the buyer and furnished to the Service should ordinarily be treated as an "agreement" with the Service. Because a triggering event generally causes unpaid transition tax installments to become due immediately, a simple and expedient procedure is necessary.

C. Partners in Partnerships Should Be Eligible to Make Section 965(h)(1) Elections

Section 965 does not address the treatment of partnerships with respect to amounts required to be included in gross income under section 951(a)(1) pursuant to section 965, nor with respect to the election to pay the tax in installments. Section 965 references a "U.S. shareholder" as the person that is required to include the deferred foreign earnings in income and then states that the United States shareholder may elect to pay the tax liability in installments. A partnership is a U.S. shareholder but it is not the actual taxpayer.

In the case of a partnership this presents a number of issues. For example, a Delaware partnership may have an interest in a specified foreign corporation that, as a result of the ownership by the partnership, is a CFC. The partners in the partnership are the taxpayers who must include their pro rata share of the deferred E&P in income. Nevertheless, the U.S. shareholder is the partnership. Thus, there is an unresolved issue of whether the election to pay the tax liability in installments is made by the partner, the partnership, or not at all because the U.S. shareholder is not the party directly liable for the tax. There is nothing in the statute or the legislative history indicating that a taxpayer that has an inclusion amount under section 965 should be disadvantaged because the inclusion flows from its interest in a partnership rather than from direct ownership. Accordingly, the installment election should be made available, directly or indirectly, to a partner in a partnership that is the U.S. shareholder. The next question is whether the election should be made by the partnership or the partner.

<u>Recommendation</u>

The rationale for providing that the partner can make the election with respect to its allocable portion of the inclusion is that the partner is the taxpayer. It is more appropriate for a partner to make the "with and without" calculations because that calculation is supposed to be made by the taxpayer, which the partnership is not. Consideration must also be given to the new partnership audit procedures that ordinarily make adjustments at the partnership level. In this case because the adjustment affects the liability of the person who was a partner at the close of the inclusion year, any increased tax should only be borne by the person who was the partner at the close of the inclusion year; requiring such adjustment to be paid by a person who was not a partner in the inclusion year is inconsistent with the section 965 concept of adjusting the subsequent installments that are to be paid by the taxpayer at the end of the inclusion year. The original taxpayer, and not the partnership or someone who was not a partner during the inclusion year (including a subsequent purchaser of an interest in the partnership), is the appropriate party to comply with adjustments to the installments provided in section 965(h)(4). If the partner is the proper party to make the installment election, consideration must be given to what are the appropriate acceleration events. The major question in this context is whether, in addition to the acceleration events set forth in section 965(h)(3), the sale or disposition of the partnership interest that gives rise to the inclusion

should be an acceleration event. We note that the disposition of the shares of the SFC is not otherwise an acceleration event. As noted above, the acceleration events relate to events that could call into question whether the deferred tax liability would be paid and not an issue of the taxpayer's liquidity. Accordingly, we believe that the acceleration events should be limited to the events enumerated in section 965(h)(3). We note, however, that the sale of a partnership interest is an acceleration event for purposes of section 108(i).

IX. Treatment of Section 965(a) Inclusions by Regulated Investment Companies

Sections 965 expressly deals with the treatment of section 965(a) inclusions by real estate investment trusts but does not address the treatment of regulated investment companies ("RICs"). RICs are subject to similar tests regarding the nature of their income and assets. A section 965(a) inclusion is a specialized item of income which is unlikely to be treated as a dividend. Thus, it is not certain that it would be treated as a dividend or "other income" for purposes of section 851(b)(2)(A). Treasury and the Service have taken the position in Proposed Treasury Regulation section 1.851-2(b)(2)(i) that amounts included in income under section 951(a)(1)(A)(i) are not treated as a dividend or "other income" for purposes of section 851(b)(1)(A) unless the earnings attributed to such amounts are distributed.[56] A RIC may be subject to section 965 with respect to DFICs that it does not control so that it cannot force the payment of a distribution.[57] Thus, it may have a section 965(a) inclusion without receiving any distribution in respect of such income.

Recommendation

Regardless of Treasury's and the Service's position in the proposed regulation, we recommend that Treasury and the Service make clear that section 951(a)(1) inclusion pursuant to section 965 is a dividend or other income with respect to its investment business within the meaning of section 851(b)(2)(A).

X. Application of Section 958(b)(4) Repeal in Accordance with Congressional Intent

The Act amended the stock ownership attribution rules of section 958(b) so that the stock of a foreign corporation owned by a foreign person is attributed "downward" from a foreign parent to a 50% owned U.S. corporate subsidiary (determined based on value) or to a partnership in which

[56] We have previously recommended in NYSBA Tax Section Report 1359 that section 951(a)(1)(A) inclusions be treated as "other income" under section 851(b)(2)(A).

[57] Note that in the case of a foreign company that is not a CFC, a RIC may hold a more than 10% voting interest without being required to include amounts in its income under section 951.

the foreign corporation owns equity. The effect of this amendment is to turn many foreign companies that were not previously CFCs into CFCs. According to the Conference Report, the amendment was intended to render ineffective "de-control" transactions, in which the foreign parent corporation of a U.S. shareholder of a CFC causes the foreign corporation to lose its CFC status by acquiring more than 50% of the foreign corporation's stock in exchange for the contribution of cash or property.[58] The repeal of section 958(b)(4) applies retroactively to "the last taxable year of foreign corporations beginning before Jan. 1, 2018, and each subsequent taxable year of such foreign corporations," and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.[59] In effect, the amendment is retroactively effective to the first day of the last taxable year that begins before January 1, 2018 (*e.g.*, January 1, 2017 for calendar year foreign corporations and November 30, 2017 for November 30 foreign corporations). As a result, the amendments to section 958(b) will cause additional foreign corporations to be considered SFCs for purposes of section 965.

Section 958(b) was apparently intended to have a more narrow scope than the statutory language suggests. According to the Senate Finance Committee explanation of the Senate bill, it was the intent of Congress that downward attribution should not apply to cause a foreign corporation to be treated as a CFC with respect to a U.S. shareholder that is not related to the U.S. person to whom ownership of the foreign corporation's stock was attributed within the meaning of section 954(d)(3).[60] The Conference Report further confirms that it was the intent of the conferees that the Senate interpretation apply.[61] According to a discussion on the Senate floor that is part of the Congressional Record, a technical amendment was proposed to codify this explanation, but was rejected as unnecessary to reflect the intent of the Senate Finance Committee or the conferees and that "the Treasury Department and Internal Revenue Service should interpret the stock attribution rules consistent with this explanation of the bill."[62]

Example 11.

FC, a foreign corporation that is not a CFC, is the 100% owner of US1, a U.S. corporation. FC also owns 50% of the stock of FC2, a foreign corporation that, prior to the repeal of section 958(b)(4), was not a CFC. US2 is a U.S. corporation that is unrelated to FC and US1. US2 owns 10% of the stock of FC2.

[58] H.R. Rep. No. 115-466, at 508.

[59] *Id.*

[60] S. Prt. 115-20, at 378.

[61] H.R. Rep. No. 115-466, at 508.

[62] 207 Cong. Rec. S8110 (daily ed. Dec. 19, 2017) (statement of Sen. Purdue).

Read literally, the amendment to section 958(b) appears to cause FC2 to become a CFC with respect to US2. FC's 50% ownership of the stock of FC2 would be attributed downwards to US1, causing FC2 to become treated as if more than 50% of its stock was owned by U.S. shareholders. However, according to the Congressional Record, it was Congress' intent that FC2 should not be treated as a CFC with respect to US2 because US2 is not related to US1 within the meaning of section 954(d)(3).

Recommendation

The Senate's and Conference Committee's instructions to Treasury and the Service regarding the proper interpretation of amended section 958(b) raises questions as to the role of legislative history when interpreting a statute. Furthermore, it is not clear to us whether the specific grant of regulatory authority in section 965(o) would provide Treasury and the Service with the authority to interpret section 958(b) consistent with the legislative history. We note that narrowing the number of taxpayers subject to section 965 as a result of this retroactive amendment to section 958(b) is desirable given the compliance issues described in this Report. We encourage Treasury and the Service to consider this further, particularly with respect to section 965. We recommend adding clarifying language on this point to any technical corrections bill that is considered by Congress.