

US Final Section 965 regulations largely follow proposed regulations, but include significant changes

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Executive summary

On 15 January 2019, final regulations under Internal Revenue Code¹ Section 965 (the Final Regulations) were made available on the Internal Revenue Service (IRS) website. (The Final Regulations are expected to be published shortly in the Federal Register). The Final Regulations are generally consistent with the proposed regulations published on 9 August 2018 (the Proposed Regulations), but make certain modifications. Notable changes include:

- ▶ Determining the aggregate foreign cash position of a consolidated group by treating the consolidated group as a single United States (US) shareholder
- ▶ Excluding certain commodities from the cash position of a specified foreign corporation (SFC)
- ▶ Requiring a US shareholder of an SFC at any point during the inclusion year to include in gross income its pro rata share an SFC's Section 965 amount, even if the SFC ceases to be an SFC during the transition year
- ▶ Treating certain changes in method of accounting (i.e., those that would result in an increase in the Section 965(a) inclusion amount) as regarded for Section 965 purposes
- ▶ Clarifying the inclusion ordering rules, including for Section 1248 amounts and amounts paid between SFCs that are disregarded for Section 965 purposes

- ▶ Clarifying that Section 965(b) previously taxed earnings and profits (PTI) are treated as included under Section 951 for purposes of Section 1248(d)(1)
- ▶ Allowing a US shareholder to limit the basis adjustments required under the basis-shifting election to avoid gain recognition from the election
- ▶ Allowing US shareholders to elect to not disregard payments between SFCs occurring between earnings and profits (E&P) measurement dates
- ▶ Making foreign taxes associated with a hovering deficit available to the extent of current E&P of the SFC with the hovering deficit
- ▶ Taking only actual Section 956 inclusions into account in the “without” calculation when calculating the net tax liability for purposes of the Section 965(h) installment election

This Alert discusses these provisions and other changes between the Proposed and Final Regulations in detail. (For discussion of the Proposed Regulations, see EY Global Tax Alert, [US Treasury Department releases proposed Section 965 regulations](#), dated 6 August 2018.

Additionally, this Alert discusses certain provisions relevant to the transition tax in The Joint Committee on Taxation general explanation of the *Tax Cuts and Jobs Act* (the [Bluebook](#)) and the draft technical corrections bill released by Kevin Brady, then Chairman of the Ways and Means Committee, on 2 January 2019 (the [Discussion Draft](#)).

Detailed discussion

Section 965

Section 965(a) generally provides that the subpart F income of an SFC (i.e., a controlled foreign corporation (CFC) and any other foreign corporation with a 10% corporate US shareholder) in its last tax year beginning before 1 January 2018 (inclusion year) increases by the greater of its accumulated post-1986 deferred foreign income determined on 2 November 2017, and 31 December 2017 (Section 965(a) earnings amount and inclusion dates, respectively). An SFC that has accumulated post-1986 deferred foreign income is referred to as a deferred foreign income corporation or a DFIC.

An SFC's accumulated post-1986 deferred foreign income equals its post-1986 E&P on a measurement date reduced by any E&P attributable to (a) income that is effectively connected with the conduct of a trade or business in the

United States (ECI) and subject to tax under the Code, or (b) E&P that, if distributed, would be excluded from the gross income of a US shareholder under the Section 959 exclusion for PTI. Generally, an SFC's post-1986 E&P equals E&P accumulated in years ending after 31 December 1986, but only during periods in which the foreign corporation was an SFC, and by diminution for dividends made during the inclusion year to other SFCs.

Reduction in inclusion for the foreign E&P deficits. Under Section 965(b), if a US shareholder owns at least one DFIC and at least one E&P deficit foreign corporation, then the amount of the Section 965(a) earnings that would otherwise be included in the US shareholder's income under Section 951(a) is reduced by the amount of the US shareholder's aggregate foreign E&P deficit (the reduced amount is the Section 965(a) inclusion amount and results in a Section 965(a) inclusion). An E&P deficit foreign corporation is, with respect to a US shareholder, an SFC with respect to which, as of 2 November 2017, (1) the SFC had a deficit in post-1986 E&P; (2) the corporation was an SFC; and (3) the shareholder was a US shareholder of the corporation. The deficit in post-1986 E&P as of 2 November 2017, of an E&P deficit foreign corporation is a specified E&P deficit. The US shareholder's aggregate foreign E&P deficit is the total of its pro rata share of specified E&P deficits of its E&P deficit foreign corporations. The last tax year of an E&P deficit foreign corporation that begins before 1 January 2018, is also referred to as the inclusion year discussed previously.

Section 965(c) deduction. Under Section 965(c), a US shareholder is entitled to a deduction that is intended to reduce the applicable tax rate on the Section 965(a) inclusion amount to 15.5% on a portion of the inclusion amount and 8% on the remainder. More specifically, the 15.5% tax rate applies to the portion of the Section 965(a) inclusion amount equal to a US shareholder's aggregate foreign cash position, and the 8% tax rate applies to the remaining amount. Aggregate foreign cash position means the greater of the US shareholder's aggregate pro rata share of the cash position of its SFCs determined on the last day of the SFCs' inclusion year, or the average of the US shareholder's pro rata share of the cash position of its SFCs determined in the two years ending immediately before 2 November 2017. For the purposes of this calculation, an SFC's cash position consists of:

- ▶ Cash
- ▶ Net accounts receivable

- ▶ The fair market value of:
 - Personal property that is of a type that is actively traded and for which there is an established financial market
 - Commercial paper, certificates of deposit and certain government securities
 - Foreign currency
 - Obligations with a term less than a year
 - Derivative financial instruments other than bona fide hedges

Liability payable over eight years. In general, taxpayers may elect to pay the net tax liability resulting from the Section 965(a) inclusion amount in installments (Section 965 net tax liability). The Section 965 net tax liability is determined based on the taxpayer's net income tax for the tax year in which a Section 965(a) inclusion amount is recognized over the taxpayer's net tax liability for that tax year, but determined without regard to Section 965 and any income or deduction properly attributable to dividends received by that US shareholder from a DFIC.

The Proposed Regulations and Notice 2018-78

Following the issuance of the Proposed Regulations, [Notice 2018-78](#) was issued on 1 October 2018, and announced certain amendments to the rules included in the Proposed Regulations. The Notice announced that the Final Regulations would:

- ▶ Include a transition rule extending the due date and providing limited revocability for the basis election under Prop. Reg. Section 1.965-2(f)(2)
- ▶ Provide a rule treating consolidated groups as a single US shareholder for certain purposes in calculating the aggregate foreign cash position
- ▶ Provide filing relief for taxpayers impacted by Hurricane Florence

For additional discussion of Notice 2018-78, see EY Global Tax Alert, [US IRS announces changes to Section 965 transition tax rules affecting basis election deadline, aggregate foreign cash position, and relief in connection with Hurricane Florence](#), dated 3 October 2018.

The Final Regulations

The Final Regulations adopt substantially all the provisions of Proposed Regulations, with some modifications. The following discussion describes the changes made to the Proposed Regulations in the Final Regulations. This discussion follows the organization of the Final Regulations.

Treas. Reg. Section 1.965-1: Overview, general rules, and definitions

Treatment of E&P subject to Section 956 inclusions – new example. The Preamble to the Final Regulations stated that the definition of accumulated post-1986 deferred foreign income does not exclude E&P that would be included in income of a US shareholder under Sections 951(a)(1)(B) and 956 (i.e., a Section 956 inclusion), notwithstanding comments requesting an exception. A new example illustrates this point and the same E&P generates a Section 956 inclusion for a CFC's period ending 30 November 2017, and is accounted for as accumulated post-1986 deferred foreign income on the 2 November 2017 E&P measurement date.

Exclusion of certain commodities from an SFC's cash position. The Final Regulations do not consider a commodity described in Section 1221(a)(1) (inventory) or Section 1221(a)(8) (supplies) in the hands of an SFC (a Specified Commodity) to be "personal property which is of a type that is actively traded and for which there is an established market," and consequently are excluded from an SFC's cash position. The exception does not apply to dealers or traders in commodities. Additionally, any forward contracts and short positions with respect to Specified Commodities are excluded from the definition of a derivative financial instrument, and thus excluded from an SFC's cash position.

Aggregate hedging transaction. The fair market value cash-equivalent asset hedging transaction, which is a bona-fide hedging transaction on a cash-equivalent asset, is also included in an SFC's cash position. For a bona-fide hedge on both cash-equivalent and non-cash equivalent assets (an aggregate hedging transaction), the amount of the aggregate hedging transaction that is a cash-equivalent asset is determined based on the proportionate value of the cash equivalent and non-cash equivalent assets being hedged.

Determination of pro rata share of Section 965(a) earnings amount. Under the Final Regulations, the pro rata share of the Section 965(a) inclusion amount is determined on the last date of the inclusion year on which the foreign corporation was an SFC. The pro rata share of the Section 965(a) inclusion from an SFC is not reduced based on the number of days during the inclusion year that the foreign corporation in an SFC.

Determination of pro rata share of specified E&P deficit. For purposes of determining a US shareholder's pro rata share of a specified E&P deficit, the Proposed Regulations allocated the specified E&P deficit among the shareholders of the SFC's common stock in proportion to the value of the

common stock held by those shareholders. Under the Final Regulations, a specified deficit that would be allocated to common stock with no liquidation value is first allocated to the most junior class of equity with a positive liquidation value to the extent of liquidation value. If there is no stock with positive liquidation value, then the specified deficit is allocated to common stock using any reasonable method.

Application of attribution rules for purposes of determining SFC status. The Proposed Regulations provided a special attribution rule for the purposes of determining whether a foreign corporation is an SFC. Under this rule, stock owned by a partner would not be considered owned by a partnership if the partner owns less than 5% of the interests in the partnership's capital and profits. The Final Regulations raises the threshold from "less than 5%" to "less than 10%" and extends this special attribution rule to trusts.

Application of the controlled domestic partnership rule. Certain controlled domestic partnerships (CDP) are treated as foreign partnerships for purposes of Section 965. This special rule applies if:

- ▶ The CDP is otherwise a US shareholder of an SFC
- ▶ The SFC would continue to be an SFC if the CDP (and any other CDPs in the chain of ownership of the SFC) were foreign
- ▶ At least one US shareholder of the SFC would be treated as a US shareholder of the SFC and would be treated as owning (directly or indirectly) the stock owned (directly or indirectly) by the CDP through another foreign corporation that is a direct or indirect partner in the CDP

Under the Proposed Regulations, a CDP is a US partnership controlled by a US shareholder and related persons. The Final Regulations revise this definition so that a CDP is no longer defined only with respect to the US shareholder, and is clearly treated as a foreign partnership for all partners, assuming the requisite conditions are satisfied. The Final Regulations also treat a CDP that is treated as a foreign partnership as a foreign pass-through entity for purposes of the basis-shifting election to address insufficient basis on future distributions of Section 965(b) PTI created under Section 965(b)(4)(A).

Treas. Reg. Section 1.965-2: Adjustments to E&P and basis

Ordering rule. The Proposed Regulations provided a five-step process to determine the coordination of Sections 951, 956, 959, and 965 (the Ordering Rule). Under the Proposed

Regulations, the Ordering Rule only applied to an SFC's inclusion year. The Final Regulations extend the application of the Ordering Rule to also include tax years of an SFC in which an E&P measurement date occurs (which would be the same in the same of a calendar year but could be different in a fiscal year).

The Final Regulations also revise step 1 of the Ordering Rule to require Section 1248 amounts to be determined at the same time as the determination of amounts included under Subpart F. Consequently, Section 1248 amounts are determined before, and may reduce, a buyer's Section 965(a) inclusion. Also, the E&P consequences of a distribution between SFCs that is disregarded under Reg. Section 1.965-4 are redetermined after the adjustments for Section 965(a) inclusion in step 4. Accordingly, the revised five-step process is as follows:

- ▶ An SFC's actual Subpart F income and Section 1248 amounts for its inclusion year are determined.
- ▶ The treatment of any distributions made by the SFC to another SFC before 1 January 2018, is determined under Section 959.
- ▶ The SFC's Section 965(a) inclusion amount is determined.
- ▶ The treatment of all other distributions made by the SFC during its inclusion year (other than those determined under step 2) is determined under Section 959. The E&P consequences of a distribution between SFCs that is disregarded under Treas. Reg. Section 1.965-4 are redetermined after the adjustments for Section 965(a) inclusion in this step.
- ▶ An amount is determined under Section 956 with respect to the SFC and its US shareholders.

Lastly, the Final Regulations adjust the rules for determining the ordering of foreign income taxes deemed paid with respect to an inclusion or distribution. The Final Regulations apply Section 902 with respect to any distributions from an SFC to another SFC before 1 January 2018 (other than those disregarded under the anti-abuse rules) before applying Section 960 with respect to Section 965(a) inclusions, Section 956 inclusions, and all other distributions.

Adjustments to DFIC E&P. Under the Proposed Regulations, a DFIC's PTI increased by the DFIC's Section 965(a) inclusion amount that was not included in a US shareholder's gross income due to the deficit offset rules of Section 965(b) (referred to as Section 965(b) PTI). The Final Regulations clarify Section 965(b) PTI is created even if the US shareholder has no Section 965(a) inclusion.

The Final Regulations also clarify that Section 965(b) PTI is treated as E&P included under Section 951 for purposes of Section 1248(d)(1). Thus, Section 965(b) PTI is excluded from a foreign corporation's E&P for the purposes of Section 1248 with respect to any US shareholder.

Basis adjustment election. In general, the Proposed Regulations provided that no adjustment is made to the basis of stock (or other property) with respect to a DFIC to account for any Section 965(b) PTI. As a result, a distribution of Section 965(b) PTI by the DFIC could, in certain circumstances, result in gain recognition under Section 961(b)(2). To address this issue, a US shareholder could elect to make the following basis adjustments (basis adjustment election):

- ▶ The US shareholder's basis in the stock of each DFIC (or applicable property with respect to the DFIC) increased by the US dollar amount of the Section 965(b) PTI with respect to that US shareholder.
- ▶ The US shareholder's basis in the stock of an E&P deficit foreign corporation (or applicable property with respect to such foreign corporation) decreased by the US shareholder's pro rata share of the foreign corporation's specified E&P taken into account by the US shareholder under Section 965(b). To the extent that the amount of this reduction exceeded the US shareholder's adjusted basis in the stock or applicable property, the US shareholder had to recognize gain in the amount of such excess.

A US shareholder and all related persons must make the basis adjustment election, and the election applies to all DFICs and E&P deficit foreign corporations.

The Final Regulations modify the potentially negative impact of the basis adjustment election by allowing taxpayers to limit the amount of the basis adjustment, both upward and downward, permitting taxpayers to avoid gain. Also, the Final Regulations provide that an individual US shareholder who made a Section 962 election in the year the individual recognized a Section 965 inclusion may adjust the basis of the individual's SFCs as permitted under the basis adjustment election.

The basis adjustment election must be made with the US shareholder's first return that includes a Section 965(a) inclusion and cannot be revoked. Consistent with Notice 2018-78, to alleviate the burden of making a binding basis election before the Proposed Regulations were finalized, the Final Regulations include two rules addressing the timing and revocability of the election. Taxpayers whose income tax return is due before the date that is 90 days before the

date that the Final Regulations are published must make the basis election no later than 90 days after the publication of the Final Regulations. In addition, the Final Regulations allow taxpayers that made a basis election before the Final Regulations were issued to revoke that election no later than 90 days after the publication date of the Final Regulations.

Gain reduction rule and translation rates. If a US shareholder receives a distribution of Section 965(a) or 965(b) PTI from a DFIC during the inclusion year, then the amount of gain otherwise recognized by the US shareholder with respect to the stock of the DFIC under Section 961(b)(2) will be reduced (but not below zero) by the amount of the Section 965 PTI. The Final Regulations provide that the translation rate to be used with respect to Section 965(b) PTI for purposes of the gain reduction rule is the spot rate on 31 December 2017.

Treas. Reg. Section 1.965-3: Section 965(c) deductions

Non-corporate entity. A non-corporate entity is treated as an SFC of a US shareholder for the purposes of determining the US shareholder aggregate foreign cash position if (1) any interest in such non-corporate entity is held by an SFC of such US shareholder and (2) such non-corporate entity would be an SFC of such US shareholder if such non-corporate entity were a foreign corporation. Under the Final Regulations, the US shareholder's pro-rata share of the non-corporate entity's cash position is limited to the share of the non-corporate entity held indirectly through an SFC.

Treas. Reg. Section 1.965-4: Anti-avoidance rules and specified payments

Background on anti-avoidance rules. The anti-avoidance rules first introduced in Notice 2018-26 and updated in the Proposed Regulations were retained in the Final Regulations with some modifications. Under the anti-avoidance rules, certain transactions, entity-classification elections and changes in method of accounting are disregarded for purposes of determining a US shareholder's Section 965 tax liability.

Transactions occurring on or after 2 November 2017 are disregarded if they would change a Section 965 element and are undertaken with a principal purpose of changing the amount of a Section 965 element of a US shareholder. Special rules provide presumptions and per se treatment. The transactions that are presumed to be done with a principle purpose of changing the amount of a Section 965 element are a cash reduction transaction, an E&P reduction transaction, and a pro-rata share transition.

A change to a Section 965 element means: (1) reduction to the US shareholder's Section 965(a) inclusion amount with respect to any SFC; (2) reduction to the US shareholder's aggregate foreign cash position; or (3) an increase to the amount of foreign income taxes of an SFC deemed paid by the US shareholder under Section 960 as a result of a Section 965(a) inclusion.

Entity classifications made after on or after 2 November 2017, are disregarded if they would change a Section 965 element. For discussion of the updated rule on disregarding certain and accounting-method changes for purposes of determining a US shareholder's Section 965 tax liability, see the discussion in the next section.

Change in method of accounting. The Final Regulations disregard any change in method of accounting made for an SFC's tax year ending in 2017 or 2018 for purposes of determining the Section 965 elements if it would otherwise decrease the Section 965(a) inclusion amount with respect to the SFC, decrease the US shareholders aggregate foreign cash position, or increase the amount of taxes deemed paid from the SFC *other than by reason of an increase in the Section 965(a) inclusion amount.* Such changes are disregarded regardless of whether the change in method of accounting is made with a principal purpose of changing the amount of the Section 965 element. Under the Proposed Regulations, an increase to the amount of taxes deemed paid from the SFC by reason of increasing the Section 965(a) inclusion amount would have caused a change in the method of accounting to be disregarded. The final rule will result in most, if not all, taxpayer-unfavorable method changes (i.e., those with positive Section 481(a) adjustments that result in an increase in the Section 965(a) inclusion amount) being treated as regarded for Section 965 purposes.

SFC liquidations. Special rules apply to liquidations that result from a retroactive entity classification and are disregarded for the purposes of determining the Section 965 elements. The rule determines the date treated as the last day of the SFC's tax year for the purposes of determining the Section 965 elements. Per the Final Regulations, the date treated as the last day of the SFC's tax year is: (1) 30 November 2017, for a US shareholder that must include in income the all E&P amount with respect to the SFC's stock; or (2) the date the election was made, for all other US shareholders.

Incorporation transactions. Under the Final Regulations, a transfer of SFC stock from a US shareholder to a domestic corporation, including an S corporation, is excluded from the

anti-avoidance rules and is not disregarded for the purposes of determining the US shareholder's Section 965 elements, provided certain requirements are met. The requirements are: (1) the Section 965(a) inclusion amount with respect to the transferred SFC stock is not reduced, and (2) the transferor and transferee's aggregate foreign cash positions must include the pro-rata share of the SFC's cash position for all cash measurement dates.

SFC to US distributions. Like the Proposed Regulations, the Final Regulations treat a cash reduction transaction that is a distribution of cash, accounts receivable, or cash equivalent assets by an SFC to its US shareholder per se as not undertaken with a principal purpose of changing the amount of a Section 965 element of the US shareholder if the distribution is not a specified distribution. A "specified distribution" is treated per se as undertaken with a principal purpose of changing the amount of a Section 965 element, and means a distribution by an SFC to a US shareholder if: (1) the distributee planned or intended, at the time of the distribution, to transfer, directly or indirectly, cash, accounts receivable, or cash equivalent assets to any SFC of such US shareholder, or (2) the distribution is a non-pro-rata distribution to a foreign person that is related to such US shareholder.

In the Final Regulations, there is not considered to be a plan or intention for the US shareholder to transfer cash, accounts payable, or cash-equivalent assets to any SFC of the US shareholder if the transfer is made by the US shareholder under a legal obligation entered before 2 November 2017.

Disregard of certain transactions occurring between E&P measurement dates. For purposes of determining post-1986 E&P as of 31 December 2017, the Final Regulations disregard all payments between related SFCs that are made after 2 November 2017 and on or before 31 December 2017, and reduce the post-1986 E&P of the SFC payor as of 31 December 2017 (specified payments). Under the Proposed Regulations, the specified payment definition also required the two SFCs to have different tentative E&P measurement dates. The Final Regulations permit a US shareholder to elect-out of this rule, provided the US shareholder and all related US shareholders do so consistently with respect to each SFC.

Reg. Sections 1.965-5 and -6: Foreign tax credit guidance

Background. Section 965(g)(1) and (3), respectively, disallow a credit under Section 901 and deduction for the applicable percentage of any foreign income "taxes paid or accrued (or

treated as paid or accrued)" with respect to any amount for which a Section 965(c) deduction is allowed. The applicable percentage is the sum of two percentages: (1) the US shareholder's aggregate Section 965(a) inclusion amount equal to its aggregate foreign cash position (allocated to that period) over the total Section 965(a) inclusion amount times 77.1%, plus (2) the US shareholder's aggregate Section 965(a) inclusion amount exceeding its aggregate foreign cash position (allocated to that period) over the total Section 965(a) inclusion amount times 55.7%.

Applicable percentage. The Final Regulations state that, if a Section 958(a) US shareholder does not have an aggregate Section 965(a) inclusion amount (e.g., its pro rata shares of accumulated post-1986 deferred foreign income were entirely offset by its pro rata shares of specified E&P deficits), then its applicable percentage with respect foreign taxes paid on the distribution Section 965(b) PTI is 55.7%.

For a US shareholder with more than one Section 965(a) inclusion year, the Final Regulations clarify that the applicable percentage that applies to foreign income taxes imposed on distributions of Section 965 PTI is determined based on the US shareholder's year in which the DFIC's Section 965(a) inclusion amount was recognized (i.e., the year in which the Section 965 PTI arose).

Regarding foreign taxes paid by a domestic pass-through owner through its investment in a domestic pass-through entity, the Final Regulations clarify that the applicable percentage of the domestic pass-through entity applies to such foreign taxes paid.

Hovering deficits. The Final Regulations adopt a new beneficial rule for taxes that are associated with a hovering deficit. Under the Final Regulations, to the extent the hovering deficit of a DFIC would have been absorbed by E&P accrued during the tax year but for a Section 965(a) inclusion, taxes that relate to the hovering deficit are taken into account for purposes of determining the DFIC's post-1986 foreign income taxes. The hovering deficit offset is treated as occurring as of the last day of the DFIC's inclusion year.

Reg. Sections 1.965-7: Elections and payment of Section 965 transition tax

In addition to these two changes, the Final Regulations include several updates on requirements for certain elections under Section 965 and the triggering events under Section 965(h) and (i).

Section 965 net tax liability. As noted, a taxpayer may elect to pay its Section 965 net tax liability in installments over eight years, subject to certain acceleration events. In determining the amount of the Section 965 net tax liability, the Final Regulations provide that only actual Section 965 inclusions are taken into account in the "without" calculation when calculating the net tax liability.

Transfer agreement due date. If an election was made to pay the Section 965 net tax liability in installments under Section 965(h) or to defer the payment of the liability for a shareholder in an S corporation under Section 965(i), listed events will accelerate the due date of the Section 965 net tax liability or trigger the end of the deferral (acceleration or triggering events). For certain acceleration or triggering events, an exception may apply, provided a transfer agreement is executed and filed with the IRS within 30 days of the acceleration or triggering event. Per the Final Regulations, for an acceleration or triggering event occurring on or before 31 December 2018, the transfer agreement must be filed by 31 January 2019. The Final Regulations also include other qualifications for transfer agreements not detailed here.

Reg. Sections 1.965-8: Affiliated groups, including those that file consolidated returns

Aggregate foreign cash position of a consolidated group. For purposes of calculating the Section 965(c) deduction, including determining the aggregate foreign cash position, the Final Regulations treat a consolidated group as a single US shareholder. The Proposed Regulations required each member of a consolidated group to determine its own aggregate foreign cash position, which was used to determine the Section 965(c) deduction of each member of the consolidated group.

Bluebook and draft technical corrections

The Bluebook noted that several rules included in the Final Regulations may require a technical correction, many of which were included in the Discussion Draft. The following highlights two issues included in the Bluebook or Discussion Draft not addressed the Final Regulations.

Section 958(b)(4) repeal limited to de-CFC transaction by a foreign parent. The repeal of Section 958(b)(4) permits stock of a foreign corporation owned by a foreign person to be attributed and considered constructively owned by a US subsidiary of the foreign person for purposes of determining the SFC or CFC status of the foreign corporation and US

shareholder status of any US person. The Final Regulations do not limit or otherwise modify the repeal other than with regard to a less-than-10% partner, as previously noted.

The Bluebook (citing to the Conference Report) indicates, however, that congressional intent for the repeal of Section 958(b)(4) is to render ineffective certain transactions among related persons that are used as a means of avoiding the subpart F provisions. Specifically, the Bluebook highlights “de-control” transactions by which a new foreign parent (or non-CFC foreign affiliate) may transfer property to a CFC in exchange for ownership of 50% or more of the stock of the CFC to convert the CFC to a non-CFC. While the intent of the repeal of Section 958(b)(4) may have been to target such transactions that de-CFC the status of an existing CFC, the far-reaching consequences confer CFC status upon foreign corporations (including those that were never a CFC before the *Tax Cuts and Jobs Act*) as a result of the repeal of Section 958(b)(4) for all purposes of the Code. The Bluebook accordingly notes that a technical correction to the *Tax Cuts and Jobs Act* and its repeal of Section 958(b)(4) may be necessary to reflect this apparently narrower intent of Congress.

Consistent with the Bluebook explanation, the Discussion Draft proposes to introduce a set of provisions that would retroactively reinstate Section 958(b)(4) and provide a different regime that would separately impose Section 965 (and the Section 951A GILTI regime) on a US shareholder and foreign corporation that are both are controlled by the same foreign person.

Transition period earnings. The Discussion Draft would also add a provision to target earnings generated by a CFC after 31 December 2017, during the CFC’s inclusion year (the Transition Period). The rule would only apply US shareholders that are domestic corporations. This rule would require the US shareholder to increase its Subpart F income by the amount of “extraordinary earnings” and treat the Subpart F inclusion in the same manner as a Section 965(a) inclusion. Thus, a Section 965(c) deduction would be allowed and the foreign

taxes paid (or deemed paid) with respect to the inclusion allowed as a credit or deduction would be reduced. For this purpose, extraordinary earnings means, with respect to any CFC, the amount of E&P accrued during the Transition Period and attributable to dispositions made outside of the ordinary course of the CFC’s activities and to a related person.

Implications

Most taxpayers will need to determine the effects of the revisions made from the Proposed Regulations to the Final Regulations on their Section 965 net tax liability. In some cases, these revisions will materially affect a taxpayer’s Section 965 net tax liability. As with the Proposed Regulations, the rules provided in the Final Regulations are retroactive and apply to a foreign corporation’s last tax year that begins before 1 January 2018 and to a US shareholder’s tax year in which or with which the foreign corporation’s year ends.

In the near term, taxpayers that have elected to pay in installments or defer payment of Section 965 net tax liability and have had acceleration or triggering events occurring on or before 31 December 2018, should finalize and file any requisite transfer agreement by 31 January 2019. Also, US shareholders of SFCs with Section 965(b) PTI should consider whether to make or revoke, if already made, the basis adjustment election within 90 days following the date the Final Regulations are published in the Federal Register.

Further, fiscal-year taxpayers that have yet to file their 2017 tax return should consider whether it may be appropriate to file an unfavorable change in method of accounting for the 2017 tax year given final rules that no longer disregard such change for the purposes of determining the Section 965 elements. Taxpayers that already filed their 2017 tax return and decided to defer taxpayer-unfavorable changes in method of accounting to the 2018 tax year should consider the effects of the audit protection rules under Section 8.02(5) of Revenue Procedure 2015-13.

Endnote

1. All “Section” references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.

For additional information with respect to this Alert, please contact the following:

Ernst & Young LLP, International Tax Services, US

- ▶ Jose Murillo, *Washington, DC* jose.murillo@ey.com
- ▶ Craig Hillier, *Boston* craig.hillier@ey.com
- ▶ Martin Milner, *Washington, DC* martin.milner@ey.com
- ▶ Trey Whitten, *Washington, DC* trey.whitten1@ey.com

Ernst & Young LLP, National Tax Quantitative Services, US

- ▶ Susan Graiss, *Washington, DC* susan.graiss@ey.com
- ▶ Tim Powell, *Washington, DC* tim.powell@ey.com

International Tax Services

Global ITS Leader, **Jeffrey Michalak**, *Detroit*

ITS Director, Americas, **Craig Hillier**, *Boston*

ITS Markets Leader, Americas, **Stephen O'Neil**, *New York*

National ITS Leader, **Jose Murillo**, *Washington*

ITS Regional Contacts, Ernst & Young LLP (US)

Central
Colleen Warner, *Chicago*

Northeast
Jonny Lindroos, *McLean, VA*

Southeast
Scott Shell, *Charlotte, NC*

Southwest
Amy Ritchie, *Austin*

West
Sadler Nelson, *San Jose, CA*

Financial Services
Chris J Housman, *New York*

Canada - Ernst & Young LLP (Canada)
Albert Anelli, *Montreal*

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