October 31, 2018

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Re: Proposed Guidance Regarding the Transition Tax Under Section 965 and Related Provisions (REG-104226-18)

Dear Ms. Perkins and Ms. Cate:

The American Institute of CPAs (AICPA) submits the following comments and recommendations regarding the proposed guidance released on August 9, 2018 regarding section 965 as amended by Pub. L. No. 115-97, commonly referred to as the Tax Cuts and Jobs Act (TCJA).

Specifically, the AICPA recommends that the Department of the Treasury (“Treasury”) and the Internal Revenue Service (IRS):

1) Clarify that previously taxed earnings (PTI) under section 965(b)(4)(A) are deemed included in section 951 for purposes of applying section 1248(d).

2) Clarify that the portion of a section 965 inclusion liability attributable to section 956 is eligible for the appropriate reduced rate of tax as a consequence of the deduction provided for in section 965(c).

3) Provide taxpayers with additional flexibility when making the basis adjustment election under Prop. Reg. § 1.965-2(f) by including the ability to make partial basis adjustments, elect adjustments on an entity-by-entity basis and modify the proposed consistency provision on related persons.

4) Provide guidance as to the ordering of distributions of PTI between section 965(a) PTI and section 965(b) PTI for the purposes of applying section 959(c) and section 986(c).

5) Provide relief to taxpayers that make or have made late elections under the proposed section 965 regulations and clarify the procedure for obtaining such relief.

1 Unless otherwise indicated, hereinafter, all section references are to the Internal Revenue Code of 1986, as amended, or to Treasury Regulations promulgated thereunder.
6) Provide that United States (U.S.) shareholders that are members of the same consolidated group are treated as a single U.S. shareholder for all purposes with respect to section 965.

7) Clarify that the PTI amount created under section 965(b)(4)(A) is not taken into account under section 864(e)(4)(D) for purposes of allocating and apportioning interest expense.

8) Exercise the authority under section 965(o) to provide relief from the income inclusion to certain affected taxpayers. Specifically, provide guidance excluding a foreign corporation that is considered a controlled foreign corporation (CFC) solely as a result of the “downward attribution” rules of section 318(a)(3) from the definition of an specified foreign corporation (SFC) for any U.S. shareholder not considered a related party (within the meaning of section 954(d)(3)) with respect to the domestic corporation to which ownership was attributed.

9) Provide a carve-out for certain “triggering events” of an S corporation under 965(i) such as where the S corporation and relevant shareholders maintain direct or indirect ownership of the transferred assets (e.g., tax-free transfers).

10) Clarify the application of ordering rules regarding subsequent distributions of section 965 inclusion amounts by a taxpayer that made a section 962 election for the section 965 inclusion year.

11) Provide guidance to help prevent unintended consequences resulting from the requirement in the proposed regulations that certain specified payments are disregarded for section 965 purposes.

12) Provide guidance on the interaction of the anti-abuse rules stating that certain transactions and elections are disregarded for purposes of section 965.

13) Correct a drafting error in Prop. Reg. § 1.965-7(c)(2)(i).

14) Provide guidance on the interaction between a section 962 election and a section 965(i) election, including clarifying that an eligible taxpayer may make a section 962 election for a section 965 tax liability for which they intend to defer inclusion under section 965(i).

15) Provide guidance on which taxpayer(s) must sign the section 965 statement and elections attached to a married filing joint individual income tax return.
The AICPA is the world’s largest member association representing the accounting profession, with more than 431,000 members in 137 countries and territories, and a history of serving the public interest since 1887. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America’s largest businesses.

We appreciate your consideration of these comments and welcome the opportunity to discuss these issues further. Please contact Philip Pasmanik, Chair, AICPA International Taxation Technical Resource Panel, at (212) 686-7160, ext. 156 or Philip.Pasmanik@hertzpherson.com; Jonathan Horn, Senior Manager – AICPA Tax Policy & Advocacy, at (202) 434-9204 or Jonathan.Horn@aicpa-cima.com; or me at (408) 924-3508 or Annette.Nellen@sjsu.edu.

Respectfully submitted,

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Chair, AICPA Tax Executive Committee

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1. Treatment of Section 965(b) Previously Taxed Earnings

RECOMMENDATION

The American Institute of CPAs (AICPA) recommends that the Department of the Treasury (“Treasury”) and the Internal Revenue Service (IRS) clarify that previously taxed earnings (PTI) under section 965(b)(4)(A) are deemed included in section 951 for purposes of applying section 1248(d).

ANALYSIS

Section 1248(d) provides that for purposes of section 1248, certain amounts are excluded from the earnings and profits (E&P) of a foreign corporation. One such exclusion is for E&P of a foreign corporation attributable to any amount previously included in the gross income of a United States (U.S.) person under section 951, with respect to the stock sold or exchanged. This exclusion applies only to the extent the inclusion of such amount did not result in an exclusion of an amount from gross income under section 959.

With respect to any U.S. shareholder of a deferred foreign income corporation (DFIC), an amount equal to such U.S. shareholder’s reduction under section 965(b)(1) that is allocated to such DFIC under section 965(b) is treated as included in the gross income of the U.S. shareholder under section 951(a) (“section 965(b) PTI”) for purposes of applying section 959 in any taxable year beginning with the taxable year described in section 965(a). The statutory language limits the section 965(b) PTI application to section 959. However, the Preamble to the section 965 proposed regulations states that, in the context of the indirect credibility of section 959(b) PTI under section 960, “section 965(b) previously taxed earnings and profits are treated as having been included in a U.S. shareholder’s income under section 951(a).”

We are concerned that a pure technical reading of the current statute could lead to the conclusion that upon an event wherein a portion of the E&P of a foreign corporation contains section 965(b) PTI (e.g., sections 1248, 964(e), and 367), such amount is not excluded from inclusion in gross income by reason of section 1248(d). This interpretation is based on a strict reading of the first clause of section 965(b)(4)(A) which states “for purposes of applying section 959.” As a result, it appears that the section 965(b) PTI is included as an applicable dividend amount. This outcome would not only contradict the underlying general principle that PTI is not subject to further tax, it is also inconsistent with section 959(d), which provides that a distribution under section 959(a) is not treated as a dividend. Such a distribution is also ineligible for the section 245A dividend received deduction.
In order to properly align the treatment of PTI under section 965(b)(4)(A), the AICPA recommends considering section 965(b) PTI as previously included under section 951 for purposes of applying section 1248(d). Otherwise, the E&P is potentially subject to double taxation.

2. **Interaction of Section 965(h) with Section 956 Items**

**RECOMMENDATION**

The AICPA recommends that Treasury and the IRS clarify that the portion of a section 965 inclusion liability attributable to section 956 is eligible for the appropriate reduced rate of tax as a consequence of the deduction provided for in section 965(c).

**ANALYSIS**

Section 965(h) allows a U.S. shareholder of a DFIC to elect to pay the net tax liability under section 965 in eight annual installments. For this purpose, section 965(h)(6) defines “net tax liability” as the excess (if any) of (i) such taxpayer’s net income tax for the taxable year in which an amount is included in the gross income of such U.S. shareholder under section 951(a)(1) by reason of section 965, over; (ii) such taxpayer’s net income tax for such taxable year, determined without regard to section 965 and without regard to any income or deduction properly attributable to a dividend received by such U.S. shareholder from any deferred foreign income corporation.

Proposed Reg. § 1.965-2(b) includes ordering rules with respect to the application of section 965. Specifically, this rule provides that a shareholder’s section 965(a) inclusion under section 951(a)(1)(A) is taken into account before a shareholder’s section 956 inclusion under section 951(a)(1)(B).

In situations where a taxpayer is considered to have an investment in U.S. property within the meaning of section 956 in a section 965 inclusion year, it appears that for purposes of section 965(h) the above definition of net tax liability would exclude amounts attributable to section 956. Specifically, as mentioned above, section 965(h)(6)(A)(i) first requires the taxpayer to take into account the regular tax liability (reduced by applicable credits) under section 951(a)(1) by reason of section 965 (“gross section 965 tax liability”). Next, under section 965(h)(6)(A)(ii), the taxpayer’s regular tax liability (reduced by applicable credits) excluding any section 965 amounts is determined (“non-section 965 tax liability”). The non-section 965 tax liability appears to include tax liability amounts attributable to section 956. The gross section 965 tax liability is reduced by the non-section 965 tax liability to arrive at the net tax liability for purposes of section 965(h). Therefore, by removing tax liability amounts attributable to section 956 from the gross section 965 tax liability, the net tax liability under section 965(h) would not include section 956 tax liability amounts.

However, in accordance with the proposed ordering rule, such exclusion should only apply for purposes of determining the amount eligible for the installment method under section 965(h). Proposed Reg. § 1.965-2(b) requires that a shareholder take into account their section 965(a) inclusion under section 951(a)(1)(A) before their section 956 inclusion under section 951(a)(1)(B). The result is that the relevant E&P attributable to section 956 is captured under section 965 and
subject to taxation in the section 965 inclusion year at the appropriate rate(s) provided in section
965(c).

Example 1

A calendar year DFIC has $100 of accumulated post-1986 deferred foreign income under
section 965, an aggregate cash position of $100 and foreign tax credits of $30 related to
the earnings. The 100 percent U.S. shareholder has no other income in the inclusion year.

The calculation of the 965(h) amount is as follows:

965(a) amount = $100.00
965(c) amount = $55.71
965(g) amount = ($16.71)
Foreign Tax Credits (FTCs) / Section 78 amount = $13.29

“With” Calculation
Taxable income = $57.58
U.S. tax @ 35% = $20.15
FTCs = ($13.29)
Net tax liability = $6.86

“Without” Calculation
Taxable income = $0
U.S. tax @ 35% = $0
FTCs = $0
Net tax liability = $0

965(h) amount = $6.86

Example 2

Assume the same facts as in Example 1, except that the DFIC also has $100 attributable to
a section 956 investment of earnings in U.S. property.

The calculation of the 965(h) amount is as follows:

965(a) amount = $100.00
965(c) amount = $55.71
965(g) amount = ($16.71)
Foreign Tax Credits (FTCs) / Section 78 amount = $13.29
“With” Calculation  
Taxable income = $57.58  
U.S. tax @ 35% = $20.15  
FTCs = ($13.29)  
Net tax liability = $6.86

“Without” Calculation  
Taxable income = $100.00  
U.S. tax @ 35% = $35.00  
FTCs = ($30.00)  
Net tax liability = $5.00

965(h) amount = $1.86

As a result of the ordering rules in the proposed regulations, in both examples the entire $100 of income is taxed at the section 965 equivalent rate of 15.5 percent. However, when a section 956 investment exists, only a reduced portion of the tax amount is eligible for installment payment treatment under section 965(h).

Accordingly, the AICPA recommends that the IRS confirm that the net tax liability eligible for the election under section 965(h) does not include any section 965 inclusion amounts attributable to section 956, and that those amounts are still taxed at the appropriate lower rates provided for under section 965(c).


RECOMMENDATION

The AICPA recommends that Treasury and the IRS provide taxpayers additional flexibility when making the basis adjustment election under Prop. Reg. § 1.965-2(f) by including the ability to make partial basis adjustments, elect adjustments on an entity-by-entity basis and modify the proposed consistency provision on related persons.

ANALYSIS

As currently drafted, Prop. Reg. § 1.965-2(f)(2) sets forth an election (the “basis adjustment election”) permitting a section 958(a) U.S. shareholder to make adjustments to its section 961 basis in the section 958(a) stock of (or in applicable property with respect to) a DFIC as well as an E&P deficit foreign corporation. The election is available when a DFIC is allocated a deficit from an E&P deficit foreign corporation. Under this election, the section 958(a) U.S. shareholder increases its section 961 basis in the DFIC stock or applicable property and makes a reduction to its section 961 basis in the stock of the E&P deficit foreign corporation or applicable property in the amount of the section 965(b) PTI.

The basis adjustment election is intended to facilitate the tax-free repatriation of section 965(b) PTI in years following the inclusion year. Therefore, a distribution of PTI by a first tier DFIC
would, absent an increase in the stock basis of the DFIC, result in section 961(b)(2) gain to the extent the distribution to a U.S. shareholder exceeds the U.S. shareholder’s otherwise existing basis in the DFIC’s stock.

Additionally, with respect to distributions of section 965(b) PTI by a DFIC to a section 958(a) U.S. shareholder during the inclusion year, the proposed regulations extend the application of the “gain reduction rule” of Prop. Reg. § 1.965-2(g)(1) to such distributions if the taxpayer has made the basis adjustment election. Thus, the amount of gain otherwise recognized by the U.S. shareholder is also reduced by the amount of the DFIC’s section 965(b) PTI. Proposed Reg. § 1.965-2(g)(2) requires a reduction of the basis in the stock of (or applicable property with respect to) the DFIC by the amount of gain that would have been recognized absent the gain reduction rule. This basis reduction ensures that the gain otherwise recognized under section 961(b)(2) is reflected in the DFIC’s basis. However, the gain reduction rule does not modify the potential gain that may result from the reduction in basis of an E&P deficit foreign corporation resulting from a basis adjustment election. Thus, if the reduction required by such an election exceeds the basis in such E&P deficit foreign corporation, then gain is recognized to the extent of the excess.

The proposed basis adjustment election rules require making any basis adjustments as an all-or-nothing adjustment. The proposed regulations do not allow taxpayers flexibility in determining the amount of basis adjustments that they want to make. As a result, taxpayers may have to choose between not repatriating their section 965(b) PTI for reinvestment in the U.S. or incurring an unanticipated tax on the gain regardless of whether they make a basis adjustment election. This result appears to contradict a goal of the basis adjustment election rules to encourage the repatriation of PTI to the U.S. for investment. This goal is achieved by allowing U.S. shareholders to limit their section 961(b)(2) gain on distributions of section 965(b) PTI that did not previously increase stock basis pursuant to section 961(a). This policy goal is better achieved by allowing taxpayers the ability to make partial basis adjustments that would not require reducing the basis of an E&P deficit foreign corporation below zero, triggering gain recognition.

We recommend that the final section 965 regulations allow taxpayers to specify the amount of basis adjustments made with respect to their DFICs and E&P deficit corporations and forego the all-or-nothing approach. To encourage repatriation of PTI without subjecting such distributions to additional U.S. taxation, the final regulations should only require basis adjustments to the extent necessary to facilitate such repatriations.

The proposed regulations also require making the basis adjustment election with respect to all DFICs and E&P deficit foreign corporations for which a taxpayer is a section 958(a) U.S. shareholder. Further, each person related to the taxpayer that is a section 958(a) U.S. shareholder, even in the case of completely different DFICs, must also make the election for all their DFICs and E&P deficit foreign corporations.

We suggest allowing taxpayers to make the basis adjustment election on an entity-by-entity basis with respect to their DFICs and E&P deficit foreign corporations to provide greater flexibility and facilitate the repatriation and investment of their section 965(b) PTI.
We further recommend that Treasury modify the consistency rule. As drafted, the consistency rule is overly broad and does not appear to serve a reasonable purpose as an anti-abuse provision. A modified provision limiting the consistency requirement to a basis adjustment election made by related persons involving specified foreign corporations in which they share common ownership is a fair and equitable solution.

4. Ordering Rules for Section 965(a) and Section 965(b) PTI

RECOMMENDATION

The AICPA recommends that Treasury and the IRS provide guidance as to the ordering of distributions of PTI between section 965(a) PTI and section 965(b) PTI for the purpose of applying section 959(c) and section 986(c).

ANALYSIS

Proposed Reg. § 1.986(c)-1 provides rules for determining the amount of foreign currency gain or loss recognized with respect to distributions of section 965(a) PTI. The proposed regulations also provide that section 986(c) does not apply with respect to distributions of section 965(b) PTI. However, the proposed regulations provide no guidance on the ordering or allocation of distributions of PTI between “historic” section 959(c)(1) and 959(c)(2) PTI, section 965(a) PTI and section 965(b) PTI. Taxpayers currently have no guidance to help them determine which bucket of PTI current distributions are drawn from, as well as whether and when distributions of PTI result in section 986(c) gain/loss.

To clarify the ordering of distributions of PTI and the computation of section 986(c) gain/loss, the AICPA recommends that Treasury and the IRS issue regulations under section 959 specifying that distributions of PTI received by a U.S. shareholder are ordered as follows:

- First attributable to “historic” sections 959(c)(1) and 959(c)(2) PTI,
- Second to section 965(a) PTI and
- Third to section 965(b) PTI.

Such an approach would provide consistency and clarity for taxpayers in calculating section 986(c) gain/loss and section 961(b)(2) gain.

5. Relief for Late Elections under Section 965 and Proposed Section 965 Regulations

RECOMMENDATION

The AICPA recommends that Treasury and the IRS provide relief to taxpayers that make or have made late elections under the proposed section 965 regulations and clarify the procedure for obtaining such relief.
ANALYSIS

Section 965 provides certain elections that taxpayers can make with respect to its application. Specifically, the following elections are available under section 965:

- Pay a section 965 net tax liability in eight annual installments;

- Defer a section 965 tax liability until a triggering event occurs and pay the section 965 net tax liability in eight annual installments when such triggering event occurs in the case of a U.S. shareholder of an S corporation;

- Pay a section 965 net tax liability in five annual installments with respect to a Real Estate Investment Trust (REIT); and

- Apply net operating losses (NOLs) for purposes of section 965.

The proposed regulations generally provide guidance with respect to eligibility, timing, and procedural rules for the elections available under section 965. In addition to these “statutory elections,” the proposed regulations also provide taxpayers with two additional “regulatory elections” as follows:

- Use an alternative method for purposes of calculating post-1986 E&P; and

- Make certain basis adjustments described in Prop. Reg. § 1.965-2(f)(2) resulting from the application of section 965(b).

Taxpayers are generally required to make the statutory and regulatory elections described in section 965 and the proposed regulations no later than the due date (with extensions) of the return for the relevant taxable year. On October 1, 2018, the IRS issued Notice 2018-78 that states that the basis adjustment election described in Prop. Reg. § 1.965-2(f)(2) is timely if made within 90 days of the release of the final regulations. The AICPA appreciates this action by the IRS. However, the proposed regulations explicitly state that late-election relief is not available under Treas. Reg. § 301.9100-2 or -3 (“9100 relief”) for any of the elections listed above.

Since section 9100 relief is disallowed and taxpayers do not have alternative means for obtaining relief for late elections under the proposed regulations, unintended and inequitable consequences could result. For example, if a U.S. shareholder of an S corporation had reasonable cause for a failure to timely file an extension for their calendar year 2017 U.S. income tax return and wanted to make the election under section 965(i) on a late-filed return, the failure to file the extension invalidates the section 965(i) election under the proposed regulations. Further, the taxpayer is prohibited from obtaining section 9100 relief under the proposed regulations and it appears that the IRS will not allow the taxpayer to demonstrate reasonable cause for the failure to make a timely election.

The severe treatment of taxpayers with respect to elections under the proposed regulations appears inconsistent with legislative intent. Neither the legislative history of section 965 nor the Preamble
to the proposed section 965 regulations suggests that taxpayers who have otherwise taken appropriate steps to comply with the Internal Revenue Code (IRC or “Code”) and regulations promulgated thereunder are ineligible for relief under reasonable cause standards.

IRS discretion to grant section 9100 relief for statutory elections is limited in scope. However, the broad regulatory authority granted the IRS in section 965(o) to issue “such regulations or other guidance as may be necessary or appropriate to carry out the provisions of this section” provides the ability to provide relief under Treas. Reg. § 301.9100-2. We urge the IRS to address the potential harsh consequences to taxpayers by providing in the final regulations that relief is available under Treas. Reg. § 301.9100-2 for all statutory elections under section 965. Alternatively, we urge the IRS to include language in the final regulations that provides a clear process for taxpayers to obtain late-election relief for all of the section 965 statutory elections using common penalty relief standards (e.g., reasonable cause).

In addition, we urge the IRS to provide in the final regulations that relief is available under Treas. Reg. § 301.9100-2 or Treas. Reg. § 301.9100-3 for the regulatory elections under section 965. In the alternative, we urge the IRS to include language in the final regulations that provides a clear process for taxpayers to obtain late-election relief for all the section 965 regulatory elections using common penalty relief standards such as reasonable cause.

6. Consolidated Group Treatment

RECOMMENDATION

The AICPA recommends that Treasury and the IRS provide that U.S. shareholders that are members of the same consolidated group are treated as a single U.S. shareholder for all purposes with respect to section 965.

ANALYSIS

The proposed section 965 regulations provide rules for the application of section 965 with respect to affiliated groups and consolidated groups. Under Prop. Reg. § 1.965-8(e), U.S. shareholders that are members of a consolidated group are treated as “a single section 958(a) U.S. shareholder for purposes of section 965(b) and §1.965-1(b)(2)” as well as “for purposes of paragraphs (h), (k), and (n) of section 965 and §1.965-7.” Members of a consolidated group are not treated as a single U.S. shareholder for any other purpose, including for purposes of determining a member’s section 965(a) inclusion or foreign income taxes deemed paid under sections 902 and 960 with respect to a section 965(a) inclusion.2

Notice 2018-78 provides a slight expansion of this treatment by providing that members of a consolidated group are treated as a single section 958(a) U.S. shareholder for purposes of Prop. Reg. § 1.965-3(b). However, this expanded treatment applies only for purposes of Prop. Reg. § 1.965-3(b) with respect to disregarding certain assets for purposes of determining aggregate foreign cash position. For all other purposes other than those specifically enumerated in Prop.

2 However, a consolidated group member calculates its section 965(c) deduction by applying the consolidated group’s overall group cash ratio, as defined by Treas. Reg. § 1.965-8(f)(8). See Prop. Treas. Reg. § 1.965-8(e)(3).
Reg. § 1.965-8(e), members of a consolidated group are not treated as a single U.S. shareholder for purposes of section 965.

The treatment of members of a consolidated group as a single U.S. shareholder for some purposes but not others results in the potential for confusion in proper application of the rules and inconsistent treatment of taxpayers who are members of consolidated groups.

Consider the following example:

**Example 3**

USP is the parent of the U.S. consolidated group that includes U.S. Sub 1 and U.S. Sub 2. U.S. Sub 1 owns 100 percent of the section 958(a) stock of CFC 1 and is a section 958(a) U.S. shareholder of CFC 1 for purposes of section 965. Additionally, U.S. Sub 2 owns 60 percent of the section 958(a) stock of CFC 2 and is a section 958(a) U.S. shareholder of CFC 2 for purposes of section 965. CFC 1 owns the remaining 40 percent of CFC 2 stock. Each of USP, U.S. Sub 1, U.S. Sub 2, CFC 1, and CFC 2 have calendar year-ends for U.S. tax purposes. On December 1, 2017, CFC 2 makes a $100 redemptory distribution to CFC 1 under section 302, resulting in a dividend to CFC 1 under section 301. CFC 2 has no paid or accrued foreign income taxes. CFC 1 has accumulated post-1986 E&P on November 2, 2017 and December 31, 2017 of $50 and $300, respectively. CFC 2 has accumulated post-1986 E&P on November 2, 2017 and December 31, 2017 of $100 and $250, respectively.

The $100 redemptory distribution from CFC 2 to CFC 1 results in a reduction of the post-1986 E&P of CFC 2 and is disregarded under Prop. Reg. § 1.965-4(b) as it would reduce the section 965(a) inclusion amount of U.S. Sub 2. For purposes of Prop. Reg. § 1.965-4, U.S. Sub 1 and U.S. Sub 2 are not treated as a single U.S. shareholder pursuant to Prop. Reg. § 1.965-8(e). By application of the rules in Prop. Reg. § 1.965-4(b), the $100 redemptory distribution is disregarded only with respect to the payor (i.e., CFC 2) for purposes of determining the section 965 elements of the U.S. shareholder. The result is the inclusion of the same $100 in both U.S. Sub 1’s and U.S. Sub 2’s section 965(a) inclusion amounts.

However, if U.S. Sub 1 and U.S. Sub 2 were treated as a single U.S. shareholder, the $100 redemptory distribution is not treated as disregarded under Prop. Reg. § 1.965-4(b) as there is no reduction in the section 965(a) inclusion of a U.S. shareholder. As a result, the $100 is properly treated as a section 965(a) inclusion amount only once.

To prevent similar unintended and unfavorable results for taxpayers, we recommend that the final section 965 regulations provide that U.S. shareholders that are members of a consolidated group are treated as a single U.S. shareholder for all purposes with respect to section 965.
7. Interest Expense Apportionment Issues with Section 965 and Section 864(e)

RECOMMENDATION

The AICPA recommends that Treasury and the IRS clarify that the PTI amount created under section 965(b)(4)(A) is not taken into account under section 864(e)(4)(D) for purposes of allocating and apportioning interest expense.

ANALYSIS

Generally, section 904(a) limits the foreign tax credit to the amount of U.S. tax (determined without regard to foreign tax credits) on taxable income from foreign sources. Foreign source taxable income is gross income from non-U.S. sources, less deductions allocated and apportioned to that gross income. Since “money is fungible,” the regulations generally attribute interest expense to all of a taxpayer’s activities and property (including debt for which the taxpayer is liable). Interest deductions are generally apportioned among all gross income in proportion to the values of the assets used by the taxpayer in generating the income. Interest expense allocated to foreign source income effectively reduces the amount of foreign source income for purposes of determining the foreign tax credit limitation under section 904, which results in a reduction of the amount of foreign tax credits available.

The mechanism used to calculate a U.S. shareholder’s inclusion under section 965 includes “netting” rules that allow deficit E&P of one SFC to offset the E&P of another SFC. One aspect of these rules requires a DFIC to treat E&P that is offset by negative E&P of another SFC, for purposes of applying section 959, as PTI (“section 965(b) PTI”). This PTI is expected to increase the adjusted basis of the stock of the DFIC under the interest expense apportionment rules. It is not appropriate for the section 965(b) PTI to attract interest expense.

The Preamble to the proposed section 965 regulations acknowledges the potential for the adjustments to E&P and PTI under section 965(b)(4) to distort interest expense apportionment. Specifically, the Preamble states “As a result of the enactment of section 965, the Treasury Department and the IRS recognize that the application of section 965(b)(4)(A) and (B) may warrant the issuance of special rules for the determination of adjusted basis. ... The Treasury Department and the IRS request comments on what rules may be appropriate, including whether the rules under §1.861-12(c)(2) should be modified.”

Generally, allocation and apportionment of interest expense is determined using the adjusted basis of assets. In determining the adjusted basis of corporate stock for this purpose, section 864(e)(4)(D) provides that the E&P of a corporation is adjusted “to take into account any earnings and profits included in gross income under section 951 or under any other provision of this title,” and the basis in the stock of the corporation is adjusted accordingly. Regulations issued pursuant to section 861 determine these basis adjustments by requiring that basis in a nonaffiliated 10 percent owned corporation, such as a CFC, is increased or decreased (not below zero) by its E&P or deficit in E&P respectively. The section 861 regulations further explain that income previously
taxed under section 951 (“section 959 PTI”) is included in E&P and taken into account when making basis adjustments for interest expense apportionment purposes. Section 965(b) allows a U.S. shareholder of a DFIC to reduce its pro-rata share of the Subpart F income of each DFIC by the U.S. shareholder's “aggregate foreign E&P deficit” of its “E&P deficit foreign corporations.” An E&P deficit foreign corporation is any specified foreign corporation with respect to the U.S. shareholder as of November 9, 2017 that has a deficit in post-1986 E&P. Under section 965(b)(4)(A), for purposes of applying the section 959 PTI rules in a taxable year beginning after December 31, 2017, the amount of the aggregate foreign E&P deficit of a U.S. shareholder allocated to a DFIC is treated as section 959 PTI (i.e., as if such U.S. shareholder had a section 951(a) inclusion equal to the amount of the deficit allocated to the DFIC). The corollary rule in section 965(b)(4)(B) requires that the U.S. shareholder's pro rata share of the E&P of any specified E&P deficit foreign corporation is increased by the amount of the E&P deficit taken into account by such shareholder under section 965(b)(4)(A). Effectively, the deficit in E&P of the E&P deficit foreign corporation is converted to section 959 PTI of the DFIC.

The section 959 PTI created by section 965(b)(4)(A) would cause the DFIC to increase its basis for interest expense apportionment purposes under the section 861 regulations. Without the ability to utilize the corresponding E&P deficit of the E&P deficit foreign corporation, the section 964(b)(4)(A) rule causes an apportionment of interest expense to the DFIC due to the increase in section 959 PTI.

Example 4

A U.S. shareholder wholly owns a CFC (CFC1). CFC1 owns 100 percent of a CFC with zero stock basis and E&P of $100 (DFIC). CFC1 also owns 100 percent of another CFC with zero stock basis and an E&P deficit of $100 (“E&P deficit foreign corporation”). Under section 965(b), the positive and negative E&P amounts offset each other, resulting in a section 965 inclusion of zero to the U.S. shareholder. Section 965(b)(4)(A) requires treating the $100 of positive E&P as section 959 PTI of the DFIC, while under section 965(b)(4)(B) the E&P deficit foreign corporation will increase its E&P amount to zero.

Absent further guidance from Treasury, section 864(e)(4)(D) and the section 861 regulations will require the U.S. shareholder to take the $100 of PTI of the DFIC into account in adjusting the basis of the stock of the DFIC for interest expense apportionment purposes. Accordingly, basis in the DFIC increases to $100, while basis of the E&P deficit foreign corporation is zero. As a result of the basis adjustments, the $100 of adjusted basis in the stock of the DFIC will attract interest expense solely due to the operation of the section 965(b)(4) rules. This interest expense would reduce foreign source income, which would also reduce the amount of foreign tax credits allowable under section 904.

8. Guidance under Section 965 Related to the Repeal of Section 958(b)(4) Attribution Rules

RECOMMENDATION

The AICPA recommends that Treasury and the IRS exercise their authority under section 965(o) to provide relief from the income inclusion to certain affected taxpayers. Specifically, we
recommend providing guidance excluding a foreign corporation that is considered a CFC solely as a result of the “downward attribution” rules of section 318(a)(3), from the definition of an SFC for any U.S. shareholder not considered a related party (within the meaning of section 954(d)(3)) with respect to the domestic corporation to which ownership was attributed.

ANALYSIS

The repeal of section 958(b)(4) creates “downward attribution” under section 318(a)(3) from a foreign person to a U.S. person. Due to the downward attribution, certain foreign corporations are treated as CFCs. Accordingly, a non-corporate U.S. shareholder could unexpectedly own an interest in an SFC as defined in section 965, resulting in an income inclusion to the U.S. shareholder of a portion of the corporation’s accumulated post-1986 deferred foreign income. The repeal of section 958(b)(4) applies retroactively to a foreign corporation’s last taxable year beginning before January 1, 2018 and each subsequent taxable year, resulting in an income inclusion on the U.S. shareholder’s 2017 tax return. It also applies to taxable years of U.S. shareholders in which or with which the taxable years of those foreign corporations’ end.

The AICPA believes that the income inclusion to the U.S. shareholder is inconsistent with the intent of section 965 and the repeal of section 958(b)(4). According to page 633 of the Joint Explanatory Statement of the Committee of the Conference (Conference Report) for the TCJA relating to the repeal of section 958(b)(4), “the Senate Finance Committee explanation states that the provision is not intended to cause a foreign corporation to be treated as a controlled foreign corporation with respect to a U.S. shareholder as a result of attribution of ownership under section 318(a)(3) to a U.S. person that is not a related person (within the meaning of section 954(d)(3)) to such U.S. shareholder as a result of the repeal of section 958(b)(4).” The Report further states that the “conference agreement follows the Senate amendment.”

The Conference Report also provides that “in adopting this provision, the conferees intend to render ineffective certain transactions that are used to as a means of avoiding the subpart F provisions. One such transaction involves effectuating “de-control” of a foreign subsidiary, by taking advantage of the section 958(b)(4) rule that effectively turns off the constructive stock ownership rules of 318(a)(3) when to do otherwise would result in a U.S. person being treated as owning stock owned by a foreign person. Such a transaction converts former CFCs to non-CFCs, despite continuous ownership by U.S. shareholders.”

The Preamble states that Treasury and the IRS believe that guidance under section 958(b)(4) is beyond the scope of these proposed regulations. We disagree and think that the grant of authority in section 965(o), which provides that the “Secretary shall prescribe such regulations or other guidance as may be necessary or appropriate to carry out the provisions of this section” (emphasis added), allows Treasury and the IRS to implement our recommended targeted relief regarding the section 965 income inclusion.
9. Triggering Events for S-Corporations under Section 965(i)

RECOMMENDATION

The AICPA recommends that Treasury and the IRS provide a carve out for certain “triggering events” of an S corporation under 965(i) such as tax-free transfers where the S corporation and relevant shareholders maintain direct or indirect ownership of the transferred assets.

ANALYSIS

Section 965(i)(2)(A)(ii) provides that a triggering event includes “A liquidation or sale of substantially all the assets of such S corporation (including in a title 11 or similar case), a cessation of business by such S corporation, such S corporation ceases to exist, or any similar circumstance.” Proposed Reg. § 1.965-7(c)(3)(ii)(B) expands the definition of a triggering event to include “… a liquidation, sale, exchange, or other disposition of substantially all of the assets of the S-Corporation...” (emphasis added). We suggest that the expanded definition covers a broader range of transactions than that contemplated by the statute. The items enumerated in the statute are directed at a reduction in interest in the businesses/assets of the S corporation directly or indirectly. The regulations take a broader approach and would apply to situations where the statutory language does not appear to have been intended.

For example, a contribution of all the assets of an S corporation to a partnership for a 90 percent interest in a partnership would qualify as a triggering event under the proposed regulations. Similarly, an F reorganization of a CFC, the stock of which represents “substantially all” of the assets of the S corporation, would qualify as a triggering event under the proposed regulations. These types of transactions (along with other tax-free transfers such as section 351 transfers) are not “similar circumstances” as the other triggering events listed in section 965(i)(2)(A)(ii). These transactions are not representative of transactions where the S corporation shareholders have disassociated themselves from the activities of the S corporation. Therefore, final regulations should except from the definition of a triggering event any tax-free transfers of the assets of an S corporation where the S corporation and the relevant shareholder continues to own a direct or indirect interest in the assets.

10. Impact of Section 962 Election on Section 965 Distribution Ordering Rules

RECOMMENDATION

The AICPA recommends that Treasury and the IRS clarify the application of ordering rules regarding subsequent distributions of section 965 inclusion amounts by a taxpayer who made a section 962 election for the section 965 inclusion year.

ANALYSIS

The proposed regulations provide certain guidance on ordering rules for subsequent distributions of section 965 amounts. Individual taxpayers may choose to make a section 962 election for their
section 965 inclusion amounts to benefit from the lower tax rates available to corporations for that income.

Guidance is requested on coordinating the ordering and E&P pool calculations with respect to section 965 distributions following a section 962 election. Guidance is also requested on the proper treatment of any section 956, investments in U.S. property in subsequent years as a result of section 965 inclusions for which a section 962 election was made.

11. Unintended Consequences from Disregard of Certain Specified Payments

RECOMMENDATION

The AICPA recommends that Treasury and the IRS provide guidance to help prevent unintended consequences resulting from the requirement in the proposed regulations that certain specified payments are disregarded for section 965 purposes.

ANALYSIS

Under the proposed regulations, certain specified payments are generally disregarded solely for purposes of section 965. This treatment may lead to unintended results that are taxpayer unfavorable. For example, CFC1 makes a payment on November 30th to CFC2. If the CFC’s have different measurement dates, the payment is disregarded for purposes of section 965. However, it appears that the foreign tax credit associated with the specified payment will still transfer from CFC1 to CFC2. As a result, the taxpayer could have an inappropriately reduced foreign tax credit pool when the E&P is subject to tax under section 965. The AICPA suggests that a coordination rule is provided in such situations to ensure that the taxpayer’s ability to use foreign tax credits or other tax attributes is not diminished by the section 965 disregard of certain specified payments.

12. Unintended Results from Anti-Abuse Rules under 965(c)(3)(F) and Prop. Reg. § 1.965-4

RECOMMENDATION

The AICPA recommends that Treasury and the IRS provide guidance on the interaction of the anti-abuse rules stating that certain transactions and elections are disregarded for purposes of section 965.

ANALYSIS

Proposed Reg. § 1.965-4 sets forth rules that disregard certain transactions for purposes of section 965 if they are considered abusive. In practice, these rules could produce distorted results in certain situations if transactions and their impact on tax related items are disregarded solely for purposes of section 965. For example, a December 31st year-end C corporation with a November 30th year-end CFC files a check-the-box election to change from the classification of a first tier CFC in order that it is treated as fiscally transparent. If this election is made on November 15th, it appears that there is a liquidation and an inclusion of all the E&P in the U.S. corporation’s year 1 return. When preparing the year 2 return, it appears the taxpayer would have to ignore the check-the-box election
under Prop. Reg. § 1.965-4 rules. Because the anti-abuse rules require a taxpayer to disregard the election, it appears that a second E&P inclusion could result under the current rules since the November 2nd and December 31st measurement date balances are calculated without considering the election. Treasury and the IRS should provide a safe harbor or other guidance to prevent double counting of income and other unintended consequences for taxpayers in these situations.

13. Correction of Drafting Error

RECOMMENDATION

The AICPA recommends that Treasury and the IRS correct a drafting error in Prop. Reg. § 1.965-7(c)(2)(i).

ANALYSIS

Prop. Reg. § 1.965-7(c)(2)(i) states:

“Each shareholder with a section 965(i) net tax liability with respect to an S corporation may make the 965(i) election with respect to such S corporation, provided that, with respect to the shareholder, none of the triggering events described in paragraph (c)(3)(ii) of this section have occurred before the election is made. Notwithstanding the preceding sentence, a shareholder that would be able to make the 965(i) election but for the occurrence of an event described in paragraph (c)(3)(ii) of this section may make the section 965(i) election if an exception described in paragraph (c)(3)(ii) of this section applies” (Emphasis added).

However, paragraph (c)(3)(ii) does not contain any exceptions.

It appears that the last sentence in Prop. Reg. § 1.965-7(c)(2)(i) allowing a shareholder of an S corporation to make the section 965(i) election should read “if an exception described in paragraph (c)(3)(iv) of this section applies” (Emphasis added).

14. Interaction of the Section 962 Election and Section 965(i) Election

RECOMMENDATION

The AICPA recommends that Treasury and the IRS issue guidance on the interaction between a section 962 election and a section 965(i) election, including clarifying that an eligible taxpayer may make a section 962 election for a section 965 tax liability for which they intend to defer inclusion under section 965(i).

ANALYSIS

The section 965(i) election does not delay inclusion of income, merely the assessment and payment of the appropriate amount of tax. A taxpayer is required to make a section 962 election for the
inclusion year to ensure the liability is calculated using the appropriate reduced rate of tax. Guidance is requested as to how the section 962 election affects the tax deferred by the section 965(i) election and whether making the election would result in the treatment of distributions occurring before a triggering event as dividends pursuant to section 962.

15. Signature on a Married Filing Jointly Individual Income Tax Return

RECOMMENDATION

The AICPA recommends that Treasury and the IRS provide guidance on which taxpayer(s) must sign the section 965 statement and elections attached to a married filing joint income tax return.

ANALYSIS

There is no guidance available regarding who must sign the section 965 statement for a married filing joint individual income tax return. Presumably, both spouses’ signatures are required. As an alternative, in cases where ownership of the relevant SFCs is clearly held by one spouse, only that individual is required to sign any statements or elections.