KPMG report: Final regulations relating to "transition tax" under section 965

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Introduction

The U.S. Treasury Department and IRS on Tuesday, January 15, 2019, released final regulations relating to the "transition tax" under section 965.

Read the text of the **final regulations** [PDF 1.19 MB] (305 pages) as published on the IRS webpage. Because of the partial shutdown of the federal government, it is uncertain when these final regulations will be published in the Federal Register.

This report provides initial impressions and observations about these final regulations.

Applicability dates

The final regulations retain the applicability dates included in the proposed regulations. Thus, the final regulations generally apply beginning with a foreign corporation's inclusion year and, with respect to a U.S. person, beginning with the tax year in which or with which the foreign corporation's inclusion year ends.

KPMG observation

As a result of these retroactive effective dates, and in light of the fact that all timely tax returns for calendar year 2017 (the first inclusion year for most taxpayers) have now been filed, consideration must be given to the impact of rules contained in these final regulations that may not have (and in some cases could not possibly have) been reflected on those returns.

KPMG observation

As discussed more fully below, the final regulations make changes from prior guidance as to the prescribed content of statements and agreements necessary to preserve deferral in certain transactions that would otherwise accelerate or trigger deferred installment payments under section 965(h). The final regulations extend the due date for such statements and agreements (generally required within 30 days of the acceleration or triggering event) to January 31, 2019, if they would otherwise be due earlier. On its face, it is unclear whether this extension is meant to indicate that filings which have already been made in accordance with the earlier guidance must be updated by January 31, or whether the extension applies only to filings which have not otherwise been made at all. However, the preamble to the proposed regulations did contain language stating that taxpayers may choose to apply the provisions of the proposed regulations governing statements, elections and agreements "in their entirety to all tax years as if they were final regulations." This suggests that taxpayers who have fully complied with the requirements of the proposed regulations need not update their filings. For taxpayers who have any doubt as to whether their prior filings in fact fully complied with the proposed regulations, it may be appropriate

to proceed with an abundance of caution and update their filings if at all possible.

Background

Treasury and the IRS on August 9, 2018, published proposed regulations (REG-104226-18) that answered a number of technical and structural questions relating to section 965. Read **TaxNewsFlash** for KPMG's report that examines the proposed regulations.

Although Treasury and the IRS received a number of comments from taxpayers about these proposed regulations, the final regulations generally do not adopt these comments but retain the basic approach and structure of the proposed regulations.

KPMG observation

In the preamble to the final regulations, Treasury and the IRS in several instances indicated that they had limited ability to adopt taxpayer comments that they determined to be contrary to the clear language in section 965 and the legislative history. In other contexts, Treasury and the IRS have taken more liberty in interpreting the relevant statute and legislative history to achieve a desired result. For example, in Notice 2019-01, Treasury and the IRS announced their intent to use their authority in section 965(o) to override the historical ordering rules for previously taxed earnings and profits ("PTEP") in the case of distributions of section 965 PTEP. In addition, in the proposed regulations under section 951A, Treasury and the IRS broadly interpreted their grant of authority under section 951A(d)(4) to adopt anti-abuse rules addressing transactions beyond those discussed in the statutory text or contemporaneous legislative history.

While the overall changes to the proposed regulations are limited, the final regulations make helpful changes in several key areas, including:

- A new exclusion from the definition of "cash position" for commodities held as inventory
- Updates to the basis adjustment rules to permit a taxpayer to choose the amount of the upward and downward basis adjustments in the stock of its deferred foreign income corporation ("DFIC") and E&P deficit foreign corporation ("EPDFC"), respectively
- Rules to coordinate foreign taxes under sections 902 and 960 for distributions occurring in the taxable year of the section 965 inclusion

In addition, the final regulations provide much needed guidance to resolve issues around double counting of cash and E&P. A fuller discussion of these topics, along with others, is included in the following discussion.

Impact on previously filed returns and other imminent considerations

As noted above, the final regulations contain rules that may have an impact on returns that have already been filed. In addition, a number of elections provided for in the final regulations require timely action to be taken. For example, it appears that taxpayers wishing to file "transfer agreements" relating to

succeeding to the deferred section 965(h) liability—for example, upon the acquisition of a Target U.S. consolidated group—for acceleration events that occurred during 2018 have only through the end of January 2019 to file the agreements. The final regulations also include additional requirements for these agreements beyond those set forth in the proposed regulations. Second, taxpayers wishing to elect or alter a previously made election with respect to adjusting stock basis for section 965(b) PTEP must do so within 90 days of the final regulations being published in the Federal Register.

Furthermore, to the extent that a taxpayer's previously filed return is based on an understanding of the application of section 965 that would be changed by the final regulations, the taxpayer must now consider how to proceed. In particular, the IRS's requirement that a taxpayer file a Form 965 and host of associated schedules with its 2018 tax return—if the taxpayer had a section 965 inclusion in 2017 *or* 2018—may result in taxpayers having to adjust their previously reported amounts in making the 2018 disclosures. Although not yet entirely clear, it appears that taxpayers may be able to make go-forward adjustments to their remaining section 965(h) installments through self-assessing any section 965-related underpayment on the 2018 return.

Cash assets

The final regulations provide guidance on what is and mostly what is not excluded from the cash position of a specified foreign corporation ("SFC").

- **Commodities exclusion:** In response to comments on the proposed regulations, the final regulations exclude the fair market value of commodities held by an SFC as stock in trade included in inventory or as property held primarily for sale to customers or consumed by the SFC in the ordinary course of the SFC's trade or business (together, "specified commodities") from the SFC's cash position as of a cash measurement date. This rule does not apply to the extent that the SFC is a dealer or trader in commodities. Absent this change, the fair market value of commodities (e.g., oil, lumber, coffee beans, lead) held by an SFC likely would have been treated as a cash asset because commodities are personal property of a type that is actively traded and for which there is an established financial market. As a further consequence, derivative financial instruments (notional principal contracts, options, forwards, futures, and short positions) that are *bona fide* hedging transactions with respect to specified commodities now also would not be taken into account in computing an SFC's cash position as of a measuring date.

- **Forward contracts:** As a result of a change to portions of the definition of derivative financial instrument, forward contracts with respect to specified commodities (whether the SFC has a long or short position in such contract) that are not *bona fide* hedging transactions but that could have been identified as a hedging transaction within the meaning of § 1.1221-2(b) (for example, a transaction entered into in the normal course of the SFC's trade or business to manage price risks with respect to a commodity) with respect to one or more specified commodities held by the SFC also are excluded from the cash position of an SFC as of a measuring date.

KPMG observation

The scope of this exclusion is unclear. Taxpayers often hedge net risk involving, for example, price risk on both inventories on hand for future sale and supplies to be acquired in the future. It is hard to believe that the exception in the final regulations would not be intended to cover one or more

forward contracts over commodities entered into for such a purpose. Indeed, it seems reasonable to conclude that the exception would have been intended to cover a commodities contract entered into solely to hedge the cost of future supplies that have not yet been purchased. However, the literal language of the proposed regulations refers only to a hedge of "commodities held" by the SFC. One hopes that the government will interpret this language consistent with a reasonable understanding of the underlying intent rather than based on a narrow reading of the literal words.

- **Additional exclusions not provided:** Treasury and the IRS received numerous comments requesting additional exclusions from the definition of cash position, including exclusions for the following:
    - Illiquid cash (such as cash subject to local regulatory restrictions or obligated to be paid to a third party)
    - Cash related to PTEP generated by a section 956 inclusion
    - Certain publicly traded stock (such as stock of a publicly traded corporation controlled by the SFC)

  Treasury and IRS declined to exclude such assets from the definition of cash position given what they view as the unambiguous language of the statute, and based upon administration concerns. Additionally, comments requested an expansion of the definition of accounts payable to include, for example, payables related to employees from the purchase of depreciable property and from the licensing of intellectual property. Such an expanded definition likely would cause a reduction in an SFC's cash position because an SFC may reduce (but not below zero) its accounts receivable by the amount of its accounts payable. Treasury and the IRS declined to expand the definition beyond the GAAP definition of accounts payable, which excludes the items described in the comments from the definition of accounts payable.

KPMG observation

It is difficult to see how an exclusion for the types of property described in the comments would be any more ambiguous or difficult to administer than the commodities exception. For example, as is the case with commodities, publicly traded stock in a controlled corporation is closely tied to actual business operations. In addition, publicly traded stock in a controlled corporation does not appear to present any additional administrative concerns that would not be present with commodities as the eligibility of each would need to undergo some level of review.

Double counting of cash

Comments requested that accounts payable held by SFCs of a U.S. shareholder may be used to reduce accounts receivable held by a separate SFC of the U.S. shareholder. If adopted, such a provision would have reduced the increase in cash position because of ordinary course transactions between third parties and other SFCs exemplified in proposed § 1.965-3(b)(3), Example 4. In that example, one CFC of the U.S. shareholder ("CFC1") purchases goods from a third party on credit, a second CFC of the U.S. shareholder ("CFC2") purchases such goods from CFC1 on credit, and CFC2 sells such goods to a third party on credit. As a result of the SFC-to-SFC cash disregard rule, the payable / receivable between CFC1 and CFC2 would be disregarded for purposes of measuring the cash position of CFC1 and CFC2; however, the third-party payable owed by CFC1 and the third-party receivable held by CFC2 would not be

disregarded, could not be netted absent the change requested by the commenter, and would result in an increase in the cash position of CFC2. Such comment was not adopted, and the final regulations retain the example in proposed § 1.965-3(b)(3), Example 4.

Another comment requested that proposed § 1.965-3(b)(2) (which allows a reduction of an SFC's cash position upon demonstration of double counting) be expanded to include all of the cash assets described in section 965(c)(3)(B). As in the proposed regulations, the final regulations limit the application of such rule to net accounts receivable, actively traded property, and short-term obligations. Helpfully, however, the final regulations make clear that proposed § 1.965-3(b)(2) applies to disregard such assets included in the cash position even if the cash would be included in the cash position of an SFC on different measuring dates. Such could be the case when an SFC liquidates into another SFC.

Double counting of E&P

Comments identified two situations in which the E&P of an SFC with a U.S. tax year ending November 30 may be included by a U.S. shareholder twice:

(i) The SFC is a CFC that has an investment in U.S. property for its tax year ending November 30, 2017, that causes its U.S. shareholder to have inclusion pursuant to sections 956 and 951(a)(1)(B) with respect to such year; and

(ii) The SFC makes a dividend distribution to its U.S. shareholder between November 2, 2017, and December 1, 2017.

In both situations, the issue is resolved based upon whether PTEP (in (i) generated because of the section 956 inclusion and in (ii) generated because of the section 965 inclusion) may be used to reduce the SFC's post-1986 E&P as of November 2.

Section 965(d)(2)(B) provides that post-1986 E&P of a CFC is reduced by E&P that, if distributed, would be excluded from the gross income of a U.S. shareholder under section 959. In neither case would the E&P representing the section 956 inclusion or the dividend distribution be E&P that would be excluded from the U.S. shareholder's gross income under section 959.

With respect to (i), the amount included as a section 956 inclusion would not be treated as PTEP if such amount were distributed to the U.S. shareholder during the CFC's tax year ending November 30, 2017, because of the application of section 959(f) and, instead, such amounts would be treated as a distribution of untaxed E&P described in section 959(c)(3) if distributed; thus, such PTEP may not be used to reduce post-1986 E&P as of November 2, 2017. With respect to (ii), the distribution to the U.S. shareholder does not reduce the post-1986 E&P under the anti-diminution rule of section 965(d)(3)(B), and is not a distribution of PTEP because the PTEP created as a result of section 965 arises in the SFC tax year ending November 30, 2018.

Distribution ordering rules

The proposed regulations, following upon rules first announced in Notice 2018-07, contained a five-step ordering process for determining the treatment of E&P and distributions among "regular" subpart F income, distributions between SFCs, section 965(a) subpart F Inclusions, other distributions (including to U.S. shareholders), and section 956 inclusions. These rules indicate that they apply specifically for

purposes of section 959 (that is, for when the E&P would be included vs. excluded from gross income by the U.S. shareholders) and, by silent inference, not for section 902 pooling or section 960 purposes.

The final regulations clarify this apparent disconnect by providing that section 960 is applied before section 902 (meaning credits must generally first be associated with regular or 965 subpart F Inclusions), but that effect is given for section 902 pooling purposes to distributions between SFCs that occur prior to the November 2, 2017 measurement date. SFC-to-SFC distributions between the November 2, 2017 and December 31, 2017 measurement dates are re-determined to be distributions of PTEP and, thus, have no effect on the distributing or recipient SFCs' section 902 pools, meaning they do not correlatively change the deemed paid credits associated with the section 965(a) inclusion. The final regulations also set forth an ordering rule for the allocation of the section 902 pools to the various credits, which generally follows the ordering rules for distributions.

KPMG observation

The proposed regulations' implementation of the ordering rules, and the potential to "de-link" the section 902 earnings and taxes from the "location" of the section 965(a) earnings, was perhaps the most difficult aspect of the proposed regulations to navigate and quantify. The changes in the final regulations, in particular the redetermination of distributions between measurement dates as being out of PTEP despite those distributions ordinarily first being determined in the step prior to the section 965 consequences, significantly reduce the uncertainty caused by the proposed regulations.

Taxpayers should be mindful that non-dividend reductions to an SFC's section 902 pool occurring between the measurement dates, such as deductions for interest and for services, can still lead to the SFC's section 902 E&P pool varying (perhaps meaningfully) from the final section 965(a) earnings amount.

Basis adjustment election

As mentioned above, the final regulations retain the key policy decisions made in the proposed regulations. Notably, this includes the rule that a U.S. shareholder's receipt of section 965(b) PTEP requires a basis reduction to the distributing corporation's stock even though the section 965(b) PTEP was created without a preceding commensurate increase in basis. Also retained was the concept that a taxpayer should be entitled to increase its CFC stock basis for section 965(b) PTEP only to the extent that there is a reduction in basis with respect to the stock in an EPDFC. The final regulations, however, do ameliorate the "all or nothing" aspect of the proposed regulations by allowing taxpayers to elect, as an alternative to "full" section 965(b) PTEP basis increase and E&P deficit stock reduction (even if that resulted in immediate capital gain), to instead make only partial increase and decrease adjustments for basis and section 965(b) PTEP.

As first announced in Notice 2018-78, taxpayers have a 90-day window after the final regulations are published in the Federal Register to make, or amend a previously made, basis adjustment election.

Anti-avoidance and disregard rules

The proposed regulations, following upon rules first announced in Notice 2018-26, contained far-reaching anti-avoidance rules that targeted taxpayer transactions that reduce the taxpayer's pro rata share of section 965(a) earnings or foreign cash position, or would increase the taxpayer's share of an E&P deficit. Sometimes such transactions would be automatically disregarded under *per se* rules while in other cases a rebuttable presumption applied. The proposed regulations also automatically disregarded the effect of accounting method changes that changed certain section 965 "elements" as well as the effect of check-the-box elections, without regard to the section 965 avoidance motivation of the taxpayer or the permissibility of the prior accounting method. Notably, the proposed regulations did not provide further guidance on the implications of ignoring accounting method or check-the-box elections for section 965, but not other interrelated, purposes.

The final regulations broadly adopt the proposed regulations in this area, despite receiving (and rejecting) a host of comments related to the "-4 rules." The final regulations do however make several meaningful changes, including:

- An ordinary course exception for when distributions of cash from an SFC to a U.S. shareholder would be disregarded (that is, added back) in determining the SFC's cash position, when the U.S. shareholder had a legal obligation prior to November 2, 2017, to re-contribute the cash back to SFC;
- Confirming that a transfer of SFC stock to a domestic corporation (including an S corporation to facilitate a section 965(i) election) will not be a prohibited pro rata share reduction transfer, as long as the overall section 965(a) earnings amount and cash position succeeded to by the domestic corporation transferee are such attributes of the transferors;
- Giving section 965 effect to accounting method changes that increase the deemed paid foreign tax credit "element" solely by reason of the increase in section 965(a) earnings arising from the (unfavorable) section 481(a) adjustment; and
- Simplifying the treatment of SFCs that liquidated through check-the-box elections by deeming the SFC's tax year to close and thus precluding the need to, for example, take into account transactions occurring up through when the SFC's U.S. tax year would otherwise end.

KPMG observation

The accounting method rule change resolves one of the thorniest issues in this part of the proposed regulations; taxpayers that wanted to self-correct previously impermissible methods faced material uncertainty as to whether unfavorable changes would be given effect for section 965, and what the overall result would be if they were ignored. Unfortunately, the window for taxpayers to make these changes effective for their 2017 year has now passed. Taxpayers considering accounting method changes now must also consider the IRS's still-current policy in Rev. Proc. 2015-13 on (lack of) audit protection for when a method change follows a prior year that included a "spiked" increase in deemed paid foreign tax credits, as well as the potential treatment of the four-year spread of section 481(a) adjustments as GILTI tested income going forward.

Lastly, the final regulations also modify the anti-double counting rules in § 1.965-4(f) so that they no longer limit their application to when the "tentative testing date" of the SFCs is different and to provide an election to simply ignore the -4(f) rules, the effect of which is that the taxpayer would accept some amount of double-counting for related-party payments as the price of administrative ease.

Changes with respect to the calculation of foreign tax credits attributable to a section 965 inclusion

Consistent with the proposed regulations, the final regulations provide for a "haircut" of foreign taxes paid or deemed paid when such taxes are properly attributable to a section 965(a) inclusion or a distribution of section 965(a) or 965(b) PTEP. The amount of the "haircut" is equal to the applicable percentage, as provided in § 1.965-5(d).

The final regulations make a number of clarifications with respect to the application of this haircut. The final regulations provide that the haircut applies to all creditable foreign income taxes properly attributable to a section 965(a) inclusion or a distribution of the related PTEP, including gross basis withholding taxes. Further, when a U.S. shareholder did not have a section 965(a) inclusion because its pro rata share of specified deficits exceeded its pro rata share of deferred foreign income, it was unclear under the proposed regulations whether any taxes paid with respect to a distribution of section 965(b) PTEP were creditable without haircut because the formula for calculating the applicable percentage created a "divide by zero" result. However, the final regulations resolve this issue by providing that, in such instance, foreign taxes attributable to a section 965(b) PTEP distribution are subject to the haircut and that the applicable percentage in such a case is 0.557.

Additionally, the final regulations maintain the position laid out in the proposed regulations that no credit is allowed under section 960(a)(3) or any other section with respect to taxes that would have been deemed paid under section 960 with respect to a section 965(a) earnings amount had such earnings amount not been reduced by an allocable deficit.

The final regulations also provide some ability for taxpayers to access foreign tax credits associated with hovering deficits. Under this rule, to the extent a hovering deficit would have been absorbed by current year earnings (that were instead included under section 965(a)), taxes that relate to the portion of the hovering deficit that would have been so absorbed are taken into account in determining post-1986 foreign income taxes.

Certain changes with respect to elections and payments

Taxpayers may make an election under section 965(h) to pay their section 965(a) liability in installments. Additionally, elections can be made under sections 965(i) (with respect to a shareholder of an S corporation) and 965(m) (with respect to a REIT) to defer payment of the section 965(a) liability. However certain acceleration events (with respect to elections made under sections 965(h) and 965(m)) and triggering events (with respect to elections made under section 965(i)) may result in the taxpayer's section 965(a) liability becoming due immediately. Under the final regulations, a disposition of substantially all of the taxpayer's assets constitutes such an acceleration event or triggering event, as applicable. The final regulations do not carve out tax-free reorganizations or exchanges (such as those described in section 351 or 721) from the definition of what constitutes a disposition of substantially all of the taxpayer's assets; the discussion in the preamble to the final regulations indicates that the absence of such an exception is intentional.

The results of certain acceleration events (with respect to an election under section 965(h)) or triggering events (with respect to an election under section 965(i)) can be avoided by entry into a transfer agreement by the transferor and transferee of the transferor's assets pursuant to which the transferee agrees to be liable for the any remaining section 965 liability of the transferor. Generally, such transfer agreement must be filed within 30 days of the acceleration event or triggering event. However, for acceleration events or triggering events that occurred on or before December 31, 2018, the final regulations provide that the transfer agreement will be considered timely filed if it is filed by January 31, 2019.

The final regulations require that a transfer agreement include a statement as to whether the leverage ratio of the section 965(h) transferee exceeds three to one. In the event that it does, the IRS may use this statement in determining the accuracy of the transferee's representation that it is able to make the remaining payments so assumed and, if it is determined that the representation is incorrect, the transfer agreement may be rejected.

Another acceleration event with respect to a section 965(h) election is the IRS's assessment of a penalty for the failure to make an installment payment when due.

Increased installments due to deficiency or timely filed or amended return

Absent negligence, intentional disregard of rules and regulations, or fraud, a deficiency assessed with respect to a taxpayer's section 965(h) net tax liability generally is allocated across installments, with any portion allocated to payments already made due upon notice and demand. Further, under the final regulations, when a taxpayer increases the amount of its section 965(h) net tax liability on a return or amended return after the payment of one or more initial installment payments, any amount of the additional tax liability that is allocated to the previously made installments is due with the filing of the return reporting such additional liability.

Finally, in order to apply the elections made under sections 965(h) and 965(i) to defer payments of a taxpayer's liability under section 965, the taxpayer's total net tax liability under section 965 must be determined. Such liability generally is calculated using a "with" and a "without" approach. In calculating the "without" prong, the final regulations provide that, like dividends, inclusions under section 956 are not taken into account in computing the taxpayer's hypothetical tax liability.

Affiliated group rules

The proposed regulations generally treated members of an affiliated group as separate persons for purposes of section 965. The proposed regulations provided limited exceptions to this general rule that treated members of a U.S. consolidated group as a single person for certain purposes. Specifically, the proposed regulations treated all members of a U.S. consolidated group that are section 958(a) U.S. shareholders of an SFC as a single section 958(a) U.S. shareholder (the "consolidated section 958(a) U.S. shareholder rule") for purposes of taking into account specified deficits, and treated all members of a U.S. consolidated group as a single person for purposes of the section 965 election provisions (e.g., the installment payment and net operating loss elections). Subsequent to publishing the proposed regulations, Treasury and the IRS issued Notice 2018-78, which announced that the final regulations

would take into account the consolidated section 958(a) U.S. shareholder rule for purposes of applying the rules in proposed § 1.965-3(b); these rules addressed situations in which the cash position of an SFC was double counted in determining the aggregate foreign cash position of a section 958(a) U.S. shareholder.

The final regulations retain the affiliated group rules included in the proposed regulations. The final regulations also include an expanded version of the rule announced in Notice 2018-78 that takes into account the consolidated section 958(a) U.S. shareholder rule for purposes of applying § 1.965-3 in its entirety, not just the cash position double-counting rules in paragraph (b). Treasury and the IRS expanded the rule announced in Notice 2018-78 in response to comments that the rule did not eliminate the potential for an aggregate foreign cash position overstatement (e.g., the stock of an SFC was transferred among U.S. consolidated group members between cash measurement dates). Thus, the expansion of the rule announced in Notice 2018-78 is a taxpayer-favorable change, albeit one that applies in limited situations.

No late election relief

Section 965 includes statutory due dates for making section 965(h) elections, section 965(i) elections, section 965(m) elections, and section 965(n) elections.

In addition, the final regulations include two additional elections, §§ 1.965-2(f)(2) and 1.965-7(f), and prescribe due dates for making these regulatory elections. The final regulations indicate that relief is not available under §§ 301.9100-2 and 301.9100-3 if these elections are not timely filed.

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