

Capitol Tax Partners, LLP
Proposed Section 965 Regulations:
Summary of Differences from Prior Guidance and Comments Rejected or Solicited

Differences from previous guidance on section 965

1. Definition of U.S. shareholder; owner of section 958(a) stock – Special rule for certain controlled domestic partnerships (pp. 28, 128-130)

a. Notice 2018-26

- i. §2.13: A domestic partnership owning 10 percent or more of the voting stock of a SFC directly or indirectly under section 958(a) or constructively under section 958(b) is generally treated as the U.S. shareholder. But see Notice 2010-41, 2010-22 I.R.B. 715 (announcing intent to issue regulations treating certain domestic partnerships as foreign partnerships).
- ii. §3.05(b): Where a domestic partnership that is a U.S. shareholder of a DFIC owns section 958(a) stock (stock owned directly or indirectly through foreign entities), section 965(a) and (c) are applied at the entity level.

b. §1.965-1(e): For purposes of the section 965 regulations, a controlled domestic partnership (CDP) is treated as a foreign partnership for purposes of determining the section 958(a) U.S. shareholder of a specified foreign corporation (SFC) and the section 958(a) stock of the SFC owned by the section 958(a) shareholder if, in general, a U.S. shareholder's CFC is a partner in the partnership.

- i. In other words, a CDP (with a CFC partner) will be treated as an aggregate of its partners and partners will be treated as the owners of the section 958(a) stock in an SFC. This is similar to fact patterns addressed in Notice 2010-41, expanded to cover SFCs.
- ii. A CDP is defined as a domestic partnership controlled by a U.S. shareholder and related persons (within meaning of 267(b) or 707(b)(1)). Control is based on facts and circumstances; deemed control if the U.S. shareholder and related persons own (directly or indirectly) more than 50 percent of the partnership's capital or profits.

2. Accumulated post-1986 deferred foreign income – subpart F in year of E&P measurement date (pp. 34, 132)

- a. §1.965-1(f)(7)(ii): Subpart F income is excluded from the section 965 tax base as previously taxed income under section 965(d)(2)(B) only to the extent it has been accrued by the SFC as of the E&P measurement date. In other words, subpart F income earned by the CFC after November 2, 2017 will only be excluded from the December 31, 2017 measurement date E&P.

3. Cash measurement dates – 52-53 week taxable year (pp. 35-36, 139, 141, 142)

- a. Notice 2018-26, §3.02: Rule in Notice referring to Treas. Reg. §1,441-2(c) not included in proposed regulations for purposes of determining beginning or end of a year.
- b. §1.965-1(f)(24), (25), (30)(iii), and (31): Actual date on which the applicable taxable year begins and ends is taken into account in determining cash measurement dates.

4. Short-term obligations – term upon issuance (pp. 39-40, 145)

- a. Notice 2018-13, §3.04(b): A loan that must be repaid on the demand of the lender (or that must be repaid within one year of such demand) will be treated as a short-term obligation, regardless of the stated term of the instrument.
- b. §1.965-1(f)(43): In response to a comment, proposed regulation clarifies the instrument's term upon issuance is used for purposes of determining whether an obligation is a short-term obligation (other than demand obligations). A short-term obligation is any obligation with a term upon issuance that is less than one year and any loan that must be repaid on the demand of the lender (or that must be repaid within one year of such demand). No ability to prove that a demand loan is not short-term. See comment and reason for rejection #5 below.

5. Pro-rata share – allocation of E&P deficits in proportion to the value of common stock (pp. 40, 141)

- a. §1.965-1(f)(30)(ii): For purposes of determining a shareholder's pro-rata share of a specified E&P deficit, the value of the common stock is determined as of the last day of the last taxable year of the E&P deficit foreign corporation that begins before January 1, 2018.
- b. Not included in prior related guidance (Notice 2018-13, §3.03(a)).
- c. Comments requested on whether to allocate a specified E&P deficit to shareholders of preferred stock, and if so, how. See comment solicited #3, below.

6. Domestic pass-through entities – definition (pp. 43, 137, 139)

- a. Notice 2018-26, §3.05(b): Defines domestic pass-through entity as a pass-through entity that is a U.S. person (as defined in section 7701(a)(30), and defines a pass-through entity as a partnership, S corporation, or any other person to the extent that the income or deductions of such person are included in the income of one or more direct or indirect owners or beneficiaries of the person.
- b. §1.965-1(f)(19), (28): Consistent with Notice; preamble clarifies that a pass-through entity, as defined in Prop. Treas. Reg. §1.965-1(f)(19), does not include a REIT or a RIC.

7. Coordination between Sections 959 and 965 in the inclusion year (pp. 47-48, 152-154)

- a. Notice 2018-7, §3.02(d): Five-steps for determining subpart F inclusions, 965 inclusions, the effect of distributions under 959, and 956 inclusions with respect to deferred foreign income corporations (DFIC): (1) subpart F income of DFIC determined, ignoring section 965(a); (2) pre-2018 distributions from DFIC to another SFC determined under §959; (3) section 965(a) inclusion of the DFIC determined and taken into account; (4) all other distributions from DFIC determined under section 959; (5) section 956 amount with respect to DFIC determined and taken into account.
- b. §1.965-2(b): Follows the sequence in the Notice, but applies more broadly to SFCs, and step (3) includes the determination of (in addition to the section 965 inclusion) the post-1986 E&P (including a deficit) of an SFC and the accumulated post-1986 deferred foreign income of an SFC, and references the rule in §1.965-1(f)(7)(ii) that disregards subpart F income earned after an E&P measurement date for purposes of calculating accumulated post-1986 deferred foreign income as of such measurement date. Also provides rules under step (5) to take into account the section 956 amount under section 959.

- c. §1.965-2(c): The section 965 inclusion amount (translated into functional currency at the spot rate on December 31, 2017) increases section 959(c)(2) PTI and reduces section 959(c)(3) E&P (or increases a section 959(c)(3) deficit).

8. Adjustments to E&P by reason of section 965(b) (pp. 50-52, 155-158)

- a. §1.965-2(d): Provides rules relating to adjustments to E&P of DFICs and E&P deficit foreign corporations by reason of a reduction under section 965(b)(1) and Prop. Treas. Reg. §1.965-1(b)(2) (DFIC's allocable share of US shareholder's aggregate foreign E&P deficit) or under section 965(b)(5) and Prop. Treas. Reg. §1.965-8(b) (U.S. shareholder's applicable share of an affiliated group's unused E&P deficit).

9. Adjustments to basis by reason of section 965(a) and (b) (pp. 52-54, 158-161)

- a. §1.965-2(e): A section 958(a) U.S. shareholder's basis in DFIC stock (or the basis in property, e.g., a foreign partnership interest, through which such stock is owned) is increased under section 961(a) by such U.S. shareholder's section 965(a) inclusion amount with respect to the DFIC. Rules for basis adjustments with respect to a section 962 election are reserved.
- b. §1.965-2(f): In general, no adjustments to basis of stock (or property) are made to take into account the reduction in the section 965(a) inclusion amount with respect to a DFIC as a result of E&P deficit allocation to the DFIC. However, a taxpayer may elect to increase DFIC stock (or property) basis and decrease basis in the stock of E&P deficit foreign corporations (or property). Basis adjustments must be consistently made with respect to all section 958(a) stock of SFCs owned by a section 958(a) U.S. shareholder and related persons. Election must be made by the extended due date for the U.S. shareholder's return for the first tax year to which section 965 applies with respect to a DFIC or E&P deficit foreign corporation. No section 9100 relief is available to file a late election.
- c. Comments requested on the appropriate amount of basis adjustment with respect to a DFIC with respect to which a section 962 election is effective. See solicited comment #4, below.

10. Distributions of section 965 PTI during inclusion year – Gain reduction rule (pp. 54-55, 161-162)

- a. Notice 2018-07, §3.03 and Notice 2018-13, §4: If US shareholder receives a distribution from a DFIC during the section 965 inclusion year attributable to PTI by reason of §965(a), the amount of gain recognized by the US shareholder with respect to the stock of the DFIC under §961(b)(2) is reduced (but not below zero) by the §965(a) inclusion amount. Gain reduction rule also applies to distributions received from a DFIC through a chain of ownership described in §958(a). Similarly, it will apply to the amount that would be recognized under §961(c) by a CFC in the §958(a) ownership chain.
- b. §1.965-2(g): Consistent with rules in the Notices and, in addition, (i) extends application of the gain reduction rule to PTI created by E&P deficit allocations under section 965(b) for a U.S. shareholder that makes the election under Prop. Treas. Reg. §1.965-2(f)(2); and (ii) requires downward stock basis adjustments to the section 958(a) stock (or property) for the amount of gain that would have been recognized.

11. Rules of application for basis adjustments (pp. 55, 162-164)

- a. §1.965-2(h): Provides rules of application common to all basis adjustments described in - 2(e), (f)(2), and (g)(2). Rules address timing and allocation among shares, netting of

basis adjustments and gain recognition to the extent a net downward adjustment would exceed basis, and make clear that the basis adjustments are limited to adjustments to property held by a section 958(a) U.S. shareholder, except in circumstances involving foreign pass-through entities, where the basis adjustment also applies to the foreign pass-through entity's basis in section 958(a) stock (or property).

12. Aggregate foreign cash position – disregard receivables and payables between related SFCs (pp. 55-56, 172)

- a. Notice 2018-07, §3.01(b): All receivables and payables between related SFCs disregarded to the extent of the common ownership of such SFCs by a U.S. shareholder. SFCs are related for this purpose if they are related within the meaning of section 954(d)(3) (substituting SFC for CFC).
- b. §1.965-3(b)(1): Consistent with the Notice, accounts receivable, accounts payable, short-term obligations, and derivative financial instruments between related SFCs (within the meaning of section 954(d)(3)) are disregarded to the extent of the smallest of the section 958(a) U.S. shareholder's ownership percentages of section 958(a) stock of the SFCs owned by the section 958(a) U.S. shareholder on the relevant cash measurement dates.
- c. Consolidated groups: Unclear whether the rule applies to obligations between related SFCs that have different section 958(a) shareholders that are members of the same consolidated group. Use of section 954(d)(3) suggests it does, but rule treating a consolidated group as a single US shareholder only applies for purposes of deficit netting under section 965(b). See Prop. Treas. Reg. §1.965-8(e) (summarized below).

13. Aggregate foreign cash position – disregard of certain assets to prevent double counting (pp. 56-57, 173-174)

- a. Notice 2018-26, §3.05(a): IRS will issue forms or other guidance that will specify required documentation for a US shareholder to demonstrate that the items in section 965(c)(3)(D) of a SFC are taken into account with respect to another SFC.
- b. §1.965-3(b)(2): To disregard assets under this rule, a section 958(a) U.S. shareholder must attach a statement to its return including a description of the asset; the amount by which its pro-rata share of an SFC's cash position is reduced; a detailed explanation of why there would otherwise be double counting; and an explanation of why the rule in -3(b)(1) does not apply (disregard of related party obligations).

14. Recapture of section 965(c) deductions for expatriated entities – expanded scope (pp. 58, 179-180)

- a. §1.965-3(d): Recapture rule in section 965(l) applies to deductions taken into account by an expatriated entity without regard to whether the expatriated entity was itself a U.S. shareholder. This aligns with the expanded scope of availability of section 965(c) deductions (i.e., to a domestic pass-through owner that is not itself a U.S. shareholder).

15. Partnership and S-corporation basis adjustments (pp. 59, 181-182)

- a. §1.965-3(f)(2)(i): In the case of a domestic partnership or S corporation, (i) the aggregate amount of its section 965(a) inclusions net of the aggregate amount of its section 965(c) deductions is treated as a separately stated item of net income solely for purposes of calculating basis under section 705(a) and Treas. Reg. §1.705-1(a) and section 1367(a)(1) and Treas. Reg. §1.1367-1(f); and
- b. §1.965-3(f)(2)(ii): The aggregate amount of its section 965(a) inclusions equal to the amount of its section 965(c) deductions is treated as income exempt from tax solely for purposes of

calculating basis under sections 705(a)(1)(B), 1367(a)(1)(A), and Treas. Reg. §1.1367-1(f).

- c. 3(f)(2)(iii): In the case of an S corporation, the aggregate amount of its section 965(a) inclusions equal to the amount of its section 965(c) deductions is treated as income not exempt from tax solely for purposes of determining whether an adjustment is made to an AAA under section 1362(e)(1)(A) and Treas. Reg. §1.1368-2(a)(2).

16. Treatment under sections 1411 (net investment income tax) and 4940 (private foundations) (pp. 59-60, 182)

- a. §1.965-3(f)(3), (4): Section 965(c) deduction does not reduce the amount of the section 965(a) inclusion that is subject to the taxes imposed by sections 1411 and 4940.

17. Anti-avoidance rules (pp. 60-62, 183-192)

- a. Notice 2018-26, §3.04: Prevention of the reduction of the section 965 tax liability of a US shareholder: Anti-avoidance rules pursuant to authority under sections 965(c)(3)(F) and 965(o).

- i. *Anti-avoidance rule*: Transactions undertaken with a principal purpose of reducing section 965 tax liability. A transaction will be disregarded for purposes of determining a US shareholder's section 965 tax liability if it (i) occurs, in whole or in part, on or after November 2, 2017; (ii) is undertaken with a principal purpose of reducing the US shareholder's section 965 tax liability; and (iii) would, without regard to this rule, reduce the US shareholder's section 965 tax liability. Pass-through owners of domestic pass-through entities treated as US shareholders.

- Reduction in section 965 tax liability:
 - Reduces the US shareholder's section 965(a) inclusion amount with respect to any SFC;
 - Reduces the US shareholder's aggregate foreign cash position; or
 - Increases the amount of foreign taxes of a SFC deemed paid by the US shareholder
- Principal purpose determinations:
 - Facts and circumstances test (including for ordinary course transactions) for cash reduction transactions and E&P reduction transactions.
 - Rebuttable presumption applies to certain transactions (described below) – facts and circumstances must clearly establish that the transaction was not undertaken with a principal purpose.
 - Per se principal purpose applies to certain transactions (described below)
 - Per se not principal purpose applies to certain distributions (described below)

- ii. *Cash reduction transactions*: Any transaction involving (i) transfer of cash, A/R, or cash equivalent assets by a SFC to a US shareholder (or related person); (ii) assumption by SFC of A/P of a US shareholder (or related person), if such

transfer/assumption would reduce the US shareholder's aggregate foreign cash position.

- Facts and circumstances test: Applies to ordinary course of business transactions
 - Rebuttable presumption: Applies to all non-ordinary course transactions other than (i) per se principal purpose transactions; and (ii) per se not principal purpose transactions.
 - Per se principal purpose transactions: A “specified distribution” – a distribution by a SFC if (i) at the time of the distribution, there was a plan or intention for the distribute to transfer, indirectly, cash, A/R, or cash equivalents to any SFC of the US shareholder, or (ii) the distribution is a non pro rata distribution to a foreign person related to the US shareholder.
 - Per se not principal purpose transactions: a distribution, other than a specified distribution, by a SFC to a US shareholder.
- iii. *E&P reduction transactions*: Any transaction between a SFC and any of (i) a US shareholder of such SFC; (ii) another SFC of a US shareholder of such SFC; or (iii) any person related to a US shareholder of such SFC, if such transaction would reduce the post-1986 deferred foreign income or the post-1986 undistributed earnings (as defined in prior law section 902(c)(1)) of such SFC or another SFC of any US shareholder of such SFC.
- Facts and circumstances test: Applies to ordinary course of business transactions.
 - Rebuttable presumption: Applies to all non-ordinary course transactions other than per se principal purpose transactions.
 - Per se principal purpose transactions: A “specified transaction” – a transaction involving one or more of the following: (i) complete liquidation under section 331; (ii) sale or other disposition of stock by a SFC; or (iii) a distribution by a SFC that reduces its E&P under section 312(a)(3) (distribution of property with basis in excess of FMV).
- iv. *Pro rata share transactions*: Any transfer of the stock of a SFC to a US shareholder of such SFC (or a related person) if such transfer would (i) reduce such US shareholder's pro rata share of the SFC's section 965(a) earnings amount (if it is a DFIC); (ii) increase such US shareholder's pro rata share of the SFC's E&P deficit (if it is a deficit foreign corporation); or (iii) reduce such US shareholder's pro rata share of the SFC's cash position.
- Rebuttable presumption: Applies to all transactions other than per se principal purpose transactions.
 - Per se principal purpose transactions: An “internal group transaction” – a pro rata share transaction if immediately before or after the transfer, the transferor and transferee are members of an affiliated group that includes the US shareholder.
 - Example: USP sells stock in CFC to FP (USP's owner) for cash on January 2, 2018 and CFC makes a distribution to FP on January 3, 2018.

CFC has a November 30 year-end and positive E&P on December 31, 2017. USP treats the transaction as a taxable sale and claims a section 245A DRD with respect to the CFC's section 1248 amount. *Result:* The stock sale is an internal group transaction and is disregarded. USP treated as owning the stock of CFC on the last day of CFC's inclusion year (November 30, 2018) and the distribution to FP is disregarded.

- v. *Disregard of certain accounting method changes and entity classification elections:* Disregard any (i) change in method of accounting made for a tax year of a SFC ending in 2017 or 2018 filed on or after November 2, 2017; or (ii) entity classification election filed on or after November 2, 2017, that would reduce a US shareholder's section 965 tax liability. Applies regardless of whether there is a principal purpose of reducing section 965 tax liability.
- b. §1.965-4(b) – (e): Retains all rules in the Notice, with non-substantive terminology change. Under proposed regulations, post-November 1, 2017 transactions are disregarded for purposes of determining the amounts of “all section 965 elements” if “undertaken with a principal purpose of changing the amount of a section 965 element.” In the proposed regulations, “section 965 elements” and “changing the amount of a section 965 element” correspond to the Notice's definition of “reducing section 965 tax liability” (i.e., (i) reduce section 965(a) inclusion amount with respect to an SFC; (ii) reduce aggregate foreign cash position of the US shareholder; (iii) increase amount of foreign income taxes of an SFC deemed paid under section 960 as a result of the section 965(a) inclusion).
- i. *Treatment of domestic pass-through owners as US shareholders:* If a domestic pass-through entity is a US shareholder, then a domestic pass-through owner that is not otherwise a US shareholder is treated as a US shareholder.
- ii. *Other definitional modifications related to pro-rata share transactions:*
- Pro-rata share transaction: Either a pro-rata share reduction transaction or an E&P deficit transaction.
 - Pro-rata share reduction transaction: Transfer of stock of a SFC by a US shareholder (or a related person, including the SFC itself) to a related person if the transfer would reduce the US shareholder's pro-rata share of (i) the section 965(a) earnings amount of the SFC; (ii) the cash position of the SFC; or (iii) both.
 - E&P deficit transaction: A transfer to a US shareholder or a related person of the stock of an E&P deficit corporation by a person relate to the US shareholder (including the E&P deficit corporation itself) if the transfer would increase the US shareholder's pro-rata share of the specified E&P deficit of the E&P deficit foreign corporation.
 - Example provided for pro-rata share transactions.
- c. Comments rejected related to requests for (i) applying a net tax liability reduction test, rather than reduction of section 965 liability; (ii) a de minimis exception; (iii) non-application of rule disregarding accounting method changes where change is from a non-permissible to a permissible; and (iv) applying a principal purpose test to the rule disregarding accounting method changes. See comments and reasons for rejection #6, below.

18. Disregard of certain transactions occurring between E&P measurement dates (pp. 62-64, 192-196)

- a. Notice 2018-07, §3.02(a): Adjustments made to avoid double counting of amounts paid or incurred (including certain dividends) between related SFCs between measurement dates that would otherwise reduce paying SFC's post-1986 E&P as of December 31, 2017. Section 954(d)(3) applies for purposes of determining whether SFCs are related.
- b. §1.965-4(f): Consistent with Notice, and in addition, provides that (i) section 954(d)(3) related test applies immediately before and after the payment; (ii) payor SFC and payee SFC must not have the same "tentative E&P measurement date." Tentative E&P measurement date defined as the "greater of" date (determined without regard to this rule) or, with respect to an E&P deficit foreign corporation (determined without regard to this rule), November 2, 2017. Additional examples provided.
- c. Comments rejected requesting expansion of rule to deductible payments or distributions by a SFC to a US shareholder. See comment and reason for rejection #7, below.

19. Allowance of foreign tax credits – section 965(g) (pp.65-70, 197-200)

- a. §1.965-5(b): No deduction or credit allowed for the applicable percentage of any foreign income taxes paid or accrued by a section 958(a) US shareholder with respect to the amount of the section 965(c) deduction.
 - i. Applies to taxes attributable to a distribution of section 965(a) and section 965(b) PTI (i.e., withholding taxes).
 - ii. Applies to net basis taxes imposed on a US citizen/foreign resident upon receipt of section 965 PTI distributions.
- b. §1.965-5(c): No deduction or credit allowed for the applicable percentage of any foreign income taxes deemed paid or accrued under section 960(a)(1) (with respect to the section 965 inclusion), section 960(a)(3) (distributions of section 965(a) and (b) PTI), and a distributive share of foreign taxes paid or accrued by a partnership.
 - i. *Taxes deemed paid under section 960(a)(3) (pre-2018)*: Such taxes include only the taxes paid or accrued by an upper-tier foreign corporation on a distribution of section 965(a) or (b) PTI from a lower-tier foreign corporation. No credit allowed for taxes that would have been deemed paid under section 960(a)(1) with respect to the portion of section 965(a) earnings reduced by E&P deficit allocations under 1.965-1(b)(2) or -8(b).
 - ii. *Taxes deemed paid under section 960(b) (post-2017)*: Reserved.
 - iii. *Coordination with section 78*: Section 78 applies only to the proportionate amount of taxes deemed paid with respect to the section 965(a) inclusion that is taxable after the section 960(c) deduction. Where a domestic corporation is a domestic pass-through owner, section 78 applies to the owner's share of the proportionate amount of taxes determined at the pass-through entity level.
- c. §1.965-5(d): Applicable percentage follows section 965(g)(2). Applies with respect to a section 958(a) shareholder and its inclusion year. Where a domestic corporation is a domestic pass-through owner, the applicable percentage applied to the owner's share of taxes attributable to the entity's section 965(a) inclusion is determined at the entity level. Thus, as noted in the preamble, a section 958(a) US shareholder may have more than one applicable percentage as a result of more than one inclusion year and owning an interest in a domestic partnership with a section 958(a) inclusion.

20. Computation of foreign income taxes deemed paid (pp. 70-73, 201-202)

- a. §1.965-6(a)-(c): Section 902 applies as if the section 965(a) inclusion (translated into the functional currency of the DFIC using spot rate on 12/31/2017) were a dividend paid by the DFIC (i.e., the section 902 fraction multiplied by the DFIC's post-1986 foreign tax pool).
- b. Section 902 fraction: Numerator is the dividend or section 965(a) inclusion; denominator is post-1986 undistributed earnings (see section 902(a)).
 - i. Fraction equals one where denominator is positive but less than numerator, which could arise where the section 965(a) inclusion is based on the November 2, 2017 measurement date, but post-1986 undistributed earnings is lower because it is determined as of the close of the foreign corporation's taxable year, without diminution by reason of distributions or income inclusions.
 - ii. Fraction equals zero where the denominator is zero or less than zero.
 - iii. Increase in E&P of a deficit foreign corporation under section 965(b)(4)(B) occurs as of the first day of the foreign corporation's first tax year following the year in which section 965 applies. Such increase does not apply for purposes of section 902 for the section 965 year.
- c. Comments rejected for requests that (i) taxpayers be deemed to pay taxes when the denominator of the section 902 fraction is zero or less than zero; and (ii) to the extent that a hovering deficit is treated as reducing post-1986 E&P of a DFIC, related taxes be added to the DFIC's post-1986 foreign income taxes in the inclusion year. See comments and reasons for rejection #8, below.

21. Allocation and apportionment of expenses (pp. 73-74, 202)

- a. §1.965-6(d): Section 965(c) deduction and section 965 PTI do not result in any gross income being treated as exempt, excluded, or eliminated income within the meaning of section 864(e)(3) or §1.861-8T(d). The asset giving rise to section 965(a) inclusion or section 965 PTI (i.e., SFC/CFC stock basis) is not treated as a tax-exempt asset. Preamble notes section 1.861-12T(c)(2)(i)(B) provides that a taxpayer's basis in stock of a CFC does not include section 961 basis adjustments (thereby preventing double counting of PTI in E&P and related section 961 basis increases).
- b. Application of section 904: Preamble notes the proposed regulations do not address the assignment of the section 965(a) inclusion and related taxes to a separate category of income because they have determined application of section 904 is clear. Withholding taxes on a distribution of section 965(a) and (b) PTI will be related to the separate category of income to which the original inclusion was assigned under §1.904-6(b)(2) and (c), Example 7.
- c. Comments requested on what rules may be appropriate, or how existing rules under §1.861-12(c)(2) should be modified, to take into account the application of section 965(b)(4)(A) and (B) (deemed PTI and E&P increases from deficit allocation), and the election under Prop. Treas. Reg. §1.965-2(f)(2) (basis adjustment for deemed E&P from deficit allocation). See solicited comment #5, below.
- d. Comments requested on whether more guidance is necessary with respect to section 904 basketing of the section 965(a) inclusion and related taxes, and whether additional rules are needed for determining the amount of section 904 limitation with respect to distributions of section 965 PTI. See solicited comment #6, below.

22. Net tax liability under section 965 (pp. 77-78, 235-236)

- a. Section 965(h)(6): Net tax liability under section 965 defined as the excess, if any of (i) net income tax for the year of the section 965 inclusion over (ii) net income tax for such year determined without regard to (I) section 965 and (II) any income or deduction properly attributable to a dividend received from any DFIC.
- b. Notice 2018-26, §3.05(c): A domestic pass-through owner is treated as a US shareholder for purposes of determining the net tax liability under § 965(h).
- c. §1.965-7(g)(10): Consistent with statute and Notice, but with respect to the “without” prong:
 - i. Excluded dividends include dividends received directly or through a chain of section 958(a) ownership.
 - ii. Credits attributable to dividends are also excluded. For purposes of calculating FTCs in the “without” prong, disregarded FTCs include (i) deemed paid credits on the section 965(a) inclusion; (ii) deemed paid taxes on a dividend (including on a distribution that would have been a dividend in the absence of section 965); and (iii) withholding taxes on distributions of PTI.

23. Section 965(h) election – installment payments (pp. 78-84, 203-215)

- a. Notice 2018-26, §3.05(b): Where domestic pass-through entity owns section 958(a) stock (stock owned directly or indirectly through foreign entities), sections 965(a) and (c) are applied at the entity level. A domestic pass-through owner is allowed to make the election under section 965(h) that applies to its share of the pass-through entity’s section 965(a) inclusion amount, regardless of whether it is itself a US shareholder of the DFIC. Election applies to all of the pass-through owner’s section 965(a) inclusion amounts.
- b. §1.965-7(b): Consistent with the Notice, any person with a section 965(h) net tax liability (including a section 958(a) US shareholder or a domestic pass-through owner in a domestic pass-through entity that is a section 958(a) US shareholder, but not the domestic pass-through entity itself). Election can be revoked by paying the full amount of the remaining unpaid section 965(h) net tax liability. No section 9100 relief is available to file a late election.
 - i. If a deficiency is assessed on a section 965(h) net tax liability, a taxpayer timely files a return with an increased section 965(h) net tax liability above the amount taken into account for the first installment, or files an amended return increasing the amount of the section 965(h) net tax liability, the deficiency or additional amount will be prorated among installments. Deficiency or additional amount due to negligence, intentional disregard of rules and regulations, or fraud with intent to evade tax is due on notice and demand.
 - ii. If a taxpayer does not pay the correct amount for the first installment and the proration rule above applies, the remaining installments will not be accelerated.
 - iii. *Acceleration events*: Unpaid portion of section 965(h) net tax liability is due if an acceleration event occurs. In addition to acceleration events described in section 965(h)(3), proposed regulations provide that an acceleration event also includes:
 - Any exchange or other disposition of substantially all of the assets of a taxpayer constitutes an acceleration event.

- A person that was not a member of a consolidated group becoming a member of a consolidated group is an acceleration event with respect to the person. Preamble notes that the liquidation of a member of a consolidated group would not constitute an acceleration event.
- When a consolidated group ceases to exist, or otherwise no longer files a consolidated return.

iv. *Transferee exception*: Acceleration provisions do not apply if the requirements in Prop. Treas. Reg. §1.965-7(b)(3)(A) are satisfied.

- c. Comments rejected include request for (i) treating taxpayers as having made an election by default; and (ii) allowing the tax imposed by section 1411 to be paid in installments. See comments and reasons for rejection #9 and #10, below.

24. Section 965(i) election – S corporation shareholders (pp. 84-87, 215-226)

- a. Notice 2018-26, §3.05(b): If an S corporation is an owner of a domestic pass-through entity, an S corporation shareholder can make the section 965(i) election for its share of a section 965(a) inclusion with respect to a DFIC only where the S-corporation is itself a US shareholder of the DFIC.
- b. §1.965-7(c): Consistent with the Notice, an S corporation shareholder can make the section 965(i) election, but is not required to own 958(a) stock of the DFIC (i.e., such stock could be owned by a partnership in which the S corporation is a partner), provided, however, the S corporation is a US shareholder with respect to the DFIC. Proposed regulations implement the reporting requirements in section 965(i)(7); provide procedural rules for making the election; provide rules concerning triggering events described in section 965(i)(2); and provide rules for an S corporation shareholder to obtain IRS consent to make a section 965(h) election in the event of certain triggering events.
- c. Comment rejected seeking guidance to specify that the section 965(i) election does not defer the S corporation's income inclusion and the S corporation's AAA account is increased by the gross amount of the section 965(a) inclusion, because such guidance is unnecessary. See comment and reason for rejection #11, below.

25. Section 965(m) election – REITs (pp. 87-88, 226-228)

- a. §1.965-7(d): Election is revocable only by including in gross income the full amount of the REIT section 965 amounts. No section 9100 relief is available to file a late election.
- b. E&P and basis adjustments: An electing REIT must make SFC E&P and basis adjustments described in Prop. Treas. Reg. §1.965-2 as of the close of each year in which an installment is included in the REIT's gross income.
- c. REIT gross income tests: Restates rule in section 965(m)(1)(A) that section 965(a) inclusions are not taken into account as gross income for purposes of REIT gross income tests under sections 856(c)(2) and (3). This rule applies regardless of whether the REIT is a US shareholder with respect the DFIC.
- d. Comment rejected seeking a similar election for RICs. See comment and reason for rejection #12, below.

26. Section 965(n) election – NOL ring fence (pp. 88-90, 229-230)

- a. Notice 2018-26, §3.05(d): The amount of a NOL for the taxable year will be determined without taking into account as gross income the amount described in section 965(n)(2) (i.e., the section 965(a) inclusion amount and related section 78 gross up). Election will

be treated as made with respect to both the amount of a NOL for the inclusion year and the NOL carryovers or carrybacks for such year.

- b. §1.965-7(e): Consistent with the Notice, the election applies to NOLs for the tax year for which the election is made as well as the NOL carryovers or carrybacks to such taxable year, in their entirety. The election also applies to all components of the consolidated NOL deduction (as defined in §1.1502-21(a)). No section 9100 relief is available to file a late election.
- c. Comment rejected seeking ability to make the section 965(n) election for only a portion of a taxpayer's NOLs. See comment and reason for rejection #13, below.

27. Treatment of consolidated groups as a single US shareholder (pp. 92-94, 239-240)

- a. Notice 2018-07, §3.04: Solely with respect to the calculation of the amount included in gross income by a consolidated group by reason of §965(a), all members of a consolidated group that are US shareholders of one or more SFCs will be treated as a single US shareholder. Example given also states that single US shareholder treatment also applies to determining aggregate foreign cash position into account under §965(c)(1). Stock basis adjustments will be required under Treas. Reg. §1.1502-32 for each member that is a US shareholder to reflect the section 965(a) inclusion and the impact of other member attributes, such as ownership of E&P deficit foreign corporations and SFC cash position.
- b. §1.965-8(e): All members of a consolidated group that are section 958(a) US shareholders of a SFC are treated as a single section 958(a) US shareholder for purposes of section 965(b) and §1.965-1(b)(2) (deficit netting), and all members of a consolidated group are treated as a single person for purposes of sections 965(h) (installment election); (k) (extension of limitation on assessment); and (n) (NOL election).
 - i. Single section 958(a) shareholder treatment does not apply for purposes of determining any member's section 965(a) inclusion, section 965(c) deduction, section 960 deemed paid foreign tax credits, or any other purpose. Preamble notes FTCs must be computed on a separate member basis: "Therefore, a domestic corporation is not deemed to pay any foreign income taxes with respect to a section 965(a) inclusion from a foreign corporation that is not a member of a qualified group with respect to the domestic corporation, even if other members of the domestic corporation's consolidated group qualify to compute deemed paid credits with respect to that foreign corporation. Sections 960(a)(3), 902(b)."
 - ii. However, a consolidated group member's aggregate foreign cash position is determined by multiplying the member's aggregate section 965(a) inclusion amount by the consolidated group's group cash ratio.
 - *Group cash ratio*: Consolidated aggregate foreign cash position divided by the sum of the aggregate section 965(a) inclusion amounts of all consolidated group members.
 - *Consolidated aggregate foreign cash position*: Sum of the amount that would be the aggregate foreign cash position of each consolidated group member that is a section 958(a) shareholder, determined as if not a member of a consolidated group.
- c. §1.965-8(d): See §1.1502-33(d)(1) for adjustments to members' earnings and profits and §1.1502-32(b)(3) for adjustments to members' basis.

28. Affiliated groups – application of section 965(b)(5) (pp. 94-95, 237-239)

- a. §1.965-8(b): Affiliated group netting rule applies after the application of §1.965-1(b) (deficit netting at US shareholder level) where the US shareholder is both an E&P net surplus shareholder and a member of an affiliated group in which not all members are in the same consolidated group. US dollar amount of the section 958(a) US shareholder's pro rata share of a DFIC's 965(a) amount is reduced (but not below zero) by the DFIC's allocable share of the US shareholder's applicable share of the affiliated group's aggregate unused E&P deficit. Examples provided in -8(g).
- i. *Group's aggregate unused E&P deficit*: The sum of the excess aggregate foreign E&P deficit with respect to each E&P net deficit shareholder multiplied by the group ownership percentage of such shareholder (if less than 100%).
 - ii. *US shareholder's applicable share*: The aggregate unused E&P deficit multiplied by the following ratio – US shareholder's aggregate section 965(a) inclusion amount; divided by the sum of all group members' aggregate section 965(a) inclusion amounts (in each case, but for group deficit netting and adjusted for members' group ownership percentage).
 - iii. *DFIC's allocable share*: The E&P net surplus shareholder's applicable share of the group's aggregate unused E&P deficit multiplied by the ratio in §1.965-1(f)(11) – i.e., the section 958(a) US shareholder's pro-rata share of the DFIC's 965(a) earnings amount divided by the aggregate of such amounts with respect to all of such shareholder's DFICs.
 - iv. *Consolidated group as part of affiliated group*: Consolidated group is treated as a single member of the affiliated group for purposes of §1.965-1(b)(2) and -8(b).
- b. §1.965-8(c): Provides rules for when the amount of the affiliated group's aggregate unused E&P deficit exceeds the aggregate section 965(a) inclusion amounts of the group's E&P net deficit shareholders. Each member that is an E&P net deficit shareholder must designate in books and records and a statement setting forth the portion of its excess aggregate foreign E&P deficit that is taken into account by one or more members of the group.

29. Application of section 986(c) – PTI distributions (pp. 95-96, 248-249)

- a. Notice 2018-07, §3.05: Section 986(c) foreign currency gain or loss on distributions of section 965(a) PTI proportionately diminished relative to §965(c) deduction. Ordering rules will be provided to determine portion of PTI distributions related to §965(a) and other subpart F.
- b. Notice 2018-13, §3.05: Section 986(c) gain or loss on distributions of section 959(c)(2) PTI by reason of section 965 will be determined based on change in foreign exchange rates between December 31, 2017 and the date of distribution.
- c. Prop. Treas. Reg. §1.986(c)-1: Consistent with Notices, with clarification that section 986(c) does not apply to distributions of section 965(b) PTI (deemed PTI from deficit netting). Ordering rules for PTI distributions not provided in proposed regulations.

Comments explicitly rejected in the preamble

1. Explanation II.B.2 – Definitions: Post-1986 Earnings and Profits (pp. 31-32)

- a. Comment: Allow taxpayers, such as a foreign corporation that is not a CFC and does not generally track E&P under U.S. tax principles, to use an alternative measurement method for determining its post-1986 earnings and profits and cash position, such as audited financial statements.
- b. Reason for rejection: Treasury and IRS appreciate that obtaining accurate information for U.S. federal income tax purposes may present administrative challenges, particularly in the case of United States shareholders that do not have a majority interest in a specified foreign corporation. However, this challenge is not unique to this context; there are numerous longstanding provisions in the Code where minority shareholders of foreign corporations must determine E&P consistent with section 312 where no alternative measurement method is provided. Additionally, minority shareholders who are nonetheless United States shareholders of CFCs must know the E&P of the CFC in order to apply the rules under subpart F. Accordingly, Treasury and IRS determined that it would not be appropriate for the proposed regulations to provide alternative methods for determining a corporation's E&P or cash position.

2. Explanation II.B.3 – Definitions: E&P Deficit Foreign Corporation (p. 33)

- a. Comment: Previously taxed E&P should be disregarded in determining a specified E&P deficit of an E&P deficit foreign corporation.
- b. Reason for rejection: Previously taxed E&P are a type of E&P. No express exclusion of previously taxed E&P is provided in section 965(d)(3) for purposes of determining post-1986 earnings and profits. In contrast, the term accumulated post-1986 deferred foreign income, as defined in section 965(d)(2), explicitly excludes previously taxed E&P. Accordingly, the proposed regulations provide that previously taxed E&P is not excluded in determining the existence and amount of a specified E&P deficit, which is defined in reference to post-1986 earnings and profits and not in reference to accumulated post-1986 deferred foreign income.

3. Explanation II.B.5 – Definitions: Cash Measurement Dates (p. 36)

- a. Comment: Request guidance on the measurement of cash when a section 381 transaction occurs during the last year of a specified foreign corporation that begins before January 1, 2018.
- b. Reason for rejection: Treasury and IRS defined cash measurement date in the notices and largely adopted the definition in the proposed regulations. Treasury and IRS determined that these rules provide appropriate guidance, and therefore additional rules are not necessary (citing Explanation Part V.A.2 for a discussion of the rules for disregarding certain assets to prevent double-counting under section 965(c)(3)(D) and Explanation Part VI.A for a discussion of the anti-avoidance rule in proposed §1.965-4(b), which could apply, for example, to liquidations that reduce a section 958(a) U.S. shareholder's aggregate foreign cash position).

4. Explanation II.B.7 – Definitions: Accounts Receivable and Accounts Payable (p. 39)

- a. Comment: Request modifications to the definition of accounts payable for purposes of determining a specified foreign corporation's cash position, including that accounts payable be defined to include payables related to the licensing of intellectual property,

payables to employees in the ordinary course of business, and payables arising from property described in section 1221(a)(2).

- b. Reason for rejection: The term “accounts payable” is not defined in the statute, and Treasury and IRS determined that the definition in the proposed regulations is consistent with the ordinary meaning of accounts payable. Therefore no change is made in the proposed regulations to the definition of accounts payable.

5. Explanation II.B.8 – Definitions: Short-Term Obligations (p. 40)

- a. Comment: Request that taxpayers be able to prove, based on facts and circumstances, that a demand loan should not be treated as a short-term obligation.
- b. Reason for rejection: Treasury and IRS determined that any facts-and-circumstances test would not be administrable, particularly to the extent that the test required a determination of a taxpayer’s subjective intent with respect to the payment of the loan.

6. Explanation VI.A – Disregard of Certain Transactions: Anti-avoidance rules (pp. 61-62)

- a. Comment: Request that the anti-avoidance rule not apply to the extent a reduction in tax liability by reason of section 965 is offset by an equal amount of tax increase pursuant to a different Code provision.
- b. Reason for rejection: The Conference Report reflects an intent for Treasury and IRS to address all strategies for avoiding a section 965(a) inclusion, without regard to the effect on overall tax liability. Furthermore, it would be difficult for IRS to determine whether a particular increase in tax liability for non-section 965 reasons is related to the reduction in the taxpayer’s section 965(a) inclusion. Finally, the anti-avoidance rule generally does not apply without a principal purpose of changing the amount of a section 965 element. Depending on the facts and circumstances, transactions that do not reduce overall tax liability may not meet the principal purpose test described in proposed §1.965-4(b)(1).
- c. Comment: Request a de minimis exception for the anti-avoidance rule.
- d. Reason for rejection: Treasury and IRS determined that any reduction in tax imposed by reason of section 965 through tax avoidance strategies occurring after November 2, 2017, is inconsistent with congressional intent and should not be respected.
- e. Comment: Request that the rule disregarding changes to methods of accounting not apply when the change is from an impermissible to a permissible method, and that a principal purpose test should apply.
- f. Reason for rejection: Proposed §1.965-4(c)(1) does not affect a taxpayer’s ability to change its method of accounting, including to change to a permissible method. Instead, the rule disregarding an accounting method change is relevant only for the limited purpose of determining the amount of a taxpayer’s section 965 elements. The choice of a November 2, 2017, measurement date reflects an intent to impose a transition tax on a snapshot of earnings as of a date that coincides with the introduction of the Act in Congress, and reflects a general policy of disregarding taxpayer actions occurring after November 2, 2017, that reduce the taxpayer’s liability imposed by reason of section 965, even if such future actions are otherwise respected under the Code. Such actions can include changes in accounting methods, whether to methods that are permissible or impermissible and regardless of the principal purpose for such change. A rule disregarding such changes is also consistent with the Conference Report, which reflects a clear intent for Treasury and IRS to exercise their authority under section 965(o) to

disregard accounting method changes that reduce a taxpayer's tax liability under section 965.

7. Explanation VI.B – Disregard of certain transactions occurring between E&P measurement dates (pp. 63-64)

- a. Comment: Request that rules disregarding transactions occurring between specified foreign corporations be expanded to cover other transactions that could lead to double counting and double non-counting in the computation of post-1986 earnings and profits of a specified foreign corporation, including: (i) deductible payments by a specified foreign corporation to a United States shareholder or to a partnership owned by the United States shareholder; and (ii) distributions by specified foreign corporations to a United States shareholder.
- b. Reason for rejection: Treasury and IRS determined that the concerns regarding issues of double counting and double non-counting in the computation of post-1986 earnings and profits of a specified foreign corporation relate to transactions occurring between specified foreign corporations rather than between a specified foreign corporation and a United States shareholder. Payments by a specified foreign corporation to a United States shareholder only affect the post-1986 earnings and profits of a single specified foreign corporation, and thus do not result in double counting in determining a United States shareholder's section 965(a) inclusion amount. Additionally, payments by a specified foreign corporation to a United States shareholder can have attendant U.S. tax effects that do not occur with respect to payments between specified foreign corporations and that would need to be considered if such payments were disregarded. For example, a distribution from a specified foreign corporation to its United States shareholder may permit the United States shareholder to take into account foreign tax credits under section 902 and avoid the limitation under section 965(g)(1) that would apply if the underlying foreign taxes had been deemed paid with respect to the United States shareholder's section 965(a) inclusion amount.

8. Explanation VII.C.1 – Foreign Tax Credits: Computation of foreign income taxes deemed paid – General Rule and Exception (p. 71)

- a. Comment: Request that taxpayers be deemed to pay taxes when the denominator of the section 902 fraction is zero or less than zero, either by treating the DFIC as having post-1986 undistributed earnings equal to the DFIC's post-1986 foreign income taxes, or by determining the DFIC's post-1986 undistributed earnings as of the measurement date used to determine its section 965(a) earnings amount.
- b. Reason for rejection: Treasury and IRS determined that the Act was not intended to alter the application of sections 902 and 960 with respect to section 965. Thus, the proposed regulations confirm that when the denominator of the section 902 fraction is zero or less than zero, no taxes are deemed paid with respect to the section 965(a) inclusion (citing proposed §1.965-6(c)(2)).
- c. Comment: Recommend that, to the extent that a hovering deficit is treated as reducing the post-1986 earnings and profits of a DFIC, those taxes should be added to the DFIC's post-1986 foreign income taxes in the inclusion year with respect to the DFIC.
- d. Reason for rejection: Treasury and IRS determined that the existing rules adequately address this issue. The proposed regulations do not provide special rules for foreign income taxes that are related to hovering deficits; as a result, the rules in §1.367(b)-7 continue to apply with respect to such foreign income taxes.

9. Explanation VIII.C.3 – Section 965(h) election: Election Mechanics (p. 83)

- a. Comment: Request that taxpayers with section 965(a) inclusions be treated as having made a section 965(h) election by default.
- b. Reason for rejection: The statute provides for an affirmative election, and the proposed regulations provide an extended period in which to make it.

10. Explanation VIII.C.4 – Section 965(h) election: Application to Non-Chapter 1 Taxes (p. 84)

- a. Comment: Request that Treasury and IRS provide that tax imposed under section 1411 on section 965(a) inclusions be payable in installments under section 965(h).
- b. Reason for rejection: Because the definition of net income tax in section 965(h)(6)(B) refers to credits allowed under subparts A, B, and D of part IV of subchapter A of chapter 1 of subtitle A of the Code, Treasury and IRS determined that section 965(h) applies only with respect to tax imposed under subchapter A of chapter 1 of subtitle A of the Code. Accordingly, elections may not be made under section 965(h) to pay tax imposed under other subchapters or chapters in eight installments.

11. Explanation VIII.D.3 – Section 965(i) election (p. 87)

- a. Comment: Request guidance specifying that if an S corporation shareholder makes a section 965(i) election, the S corporation's income inclusion is not deferred, and the S corporation's AAA should be increased by the gross amount (and not the net amount after the application of the section 965(c) deduction).
- b. Reason for rejection: Because, by its terms, a section 965(i) election affects only the timing of assessment and payment of an S corporation shareholder's section 965(a) net tax liability and not the timing or amount of the section 965(a) inclusion of either the S corporation or the S corporation shareholder, Treasury and IRS determined that it is not necessary that the proposed regulations provide this additional guidance (citing Explanation V.D).

12. Explanation VIII.E – Section 965(m) election (p. 88)

- a. Comment: Request that, in addition to REITs, RICs also be allowed to make a similar election to include any amount required to be taken into account under section 951(a)(1) by reason of section 965 in eight installments.
- b. Reason for rejection: The statute provides the election solely for REITs.

13. Explanation VIII.F.1– Section 965(n) election: Scope of election (p. 89)

- a. Comment: Request clarification regarding whether taxpayers could make the section 965(n) election for only a portion of their NOLs.
- b. Reason for rejection: Treasury and IRS determined that the election was intended to apply to the NOL amount in its entirety. Accordingly, the proposed regulations provide that if a section 965(n) election is made for a taxable year, the election applies to NOLs for the taxable year for which the election is made as well as the NOL carryovers or carrybacks to such taxable year, each in their entirety.

14. Explanation VIII.G – Election to use alternative method for calculation of post-1986 earnings and profits (p. 92)

- a. Comment: Request that individuals be permitted to calculate post-1986 earnings and profits by prorating E&P for the November 2, 2017, measurement date based on year-end numbers.

- b. Reason for rejection: Allowing individuals to use year-end numbers and prorate to November 2, 2017, would allow taxpayers to base their post-1986 earnings and profits for both dates on the E&P as of a single date, contrary to the intent of the two E&P measurement dates in the statute.

15. Explanation XI.B.2 – Reporting and Filing: Extensions (pp. 98-99)

- a. Comment: Request an extension of time for reporting and paying section 965-related amounts and an extension of time for making the section 965(h) election.
- b. Reason for rejection: The statute provides for an extended time to file returns reporting section 965-related amounts and to make applicable elections. In addition, with the section 965(h) election, the statute provides a method for taxpayers to delay payment of the total net tax liability under section 965. Furthermore, the proposed regulations provide that a taxpayer eligible to make a section 965(h) election may make the election on its timely-filed return taking into account extensions, if any, or any additional time that would have been granted if the person had made an extension request. In addition, the proposed regulations provide that for a person who is a specified individual (as defined in proposed §1.965-7(g)(9)) for the year within which an installment payment would be required to be made who makes a section 965(h) election and who otherwise receives an extension of time to file and pay under §1.6081-5(a)(5) or (6), the due date for an installment payment will be the fifteenth day of the sixth month following the close of the prior taxable year, regardless of whether the person was a specified individual for the year of the person’s section 965(a) inclusion (citing proposed §1.965-7(b)(1)(iii)(B)). Moreover, IRS has announced relief from additions to tax (and related acceleration events under section 965(h)(3)) for certain individual filers that do not timely pay their first installment of tax due with respect to the 2017 tax year under section 965(h).

16. Explanation XI.C.1 – Individuals: In General (pp. 99-100)

- a. Comment: Request guidance exempting individuals from the application of section 965.
- b. Reason for rejection: Because the statute and legislative history are clear that section 965 was intended to apply to all United States shareholders, including individuals, Treasury and IRS have determined that providing the requested relief is not appropriate.

17. Explanation XI.C.2 – Individuals: Rates on Tax on Section 965(a) inclusions (p. 100)

- a. Comment: Request that guidance be provided changing the application of the participation exemption to individuals
- b. Reason for rejection: Congress anticipated the participation exemption when calculated for individuals may not be 8 percent and 15.5 percent. Individuals may make an election under section 962 to have the tax imposed under chapter 1 on amounts that are included in the individual’s gross income under section 951(a) with respect to a foreign corporation with respect to which it is a United States shareholder be equal to the tax that would be imposed under section 11 if the amounts were received by a domestic corporation.

18. Explanation XI.D.1 – Determination of aggregate foreign cash position: Liquidity-Based Exceptions (pp. 101-103)

- a. Comment: Request guidance modifying the definition of a specified foreign corporation’s cash position or the calculation of a United States shareholder’s aggregate foreign cash position. For example, guidance excluding certain assets from a specified foreign

corporation's cash position, or otherwise providing special rules with respect to those assets, including (i) cash used, or intended to be used, to fund foreign acquisitions; (ii) blocked, restricted, or segregated cash; (iii) cash used, or to be used, to pay third-party payables within a specified period (for example, 12 months after a cash measurement date); (iv) obligations with respect to which there was an inclusion under section 956; (v) cash held in a fiduciary or trust capacity; (vi) cash held or attributable to an entity that is engaged in a regulated industry, such as life insurance; and (vii) cash pledged against defined liabilities as well as potential or contingent liabilities. In addition, request exceptions for commodities representing inventory or supplies and stock of a publicly traded company in which the specified foreign corporation holds at least 10 percent of the stock, each of which is personal property of a type that is actively traded and for which there is an established financial market, and thus included in the cash position of a specified foreign corporation.

- b. Reason for rejection: Comments are premised on the view that an asset that otherwise would be included in the cash position of a specified foreign corporation should be excluded to the extent that the asset cannot be otherwise employed; that is, if the asset is not sufficiently "liquid." Although the legislative history describing a specified foreign corporation's cash position refers to earnings that are "liquid," neither the legislative history nor the statute indicates that the cash position of a specified foreign corporation should be determined by reference to an analysis of whether any particular asset should be considered a liquid asset. Instead, as the Conference Report notes, the statute includes a specific list of assets that are included in the cash position of a specified foreign corporation. Treasury and IRS determined that the definition of cash position in section 965(c)(3)(B) is the best indication of what Congress believed was a liquid asset. Depending on the facts, any particular asset may be required to be used for a specific purpose, or a taxpayer may intend to retain the asset for a lengthy period of time. However, Treasury and IRS determined that it would not be administrable to create individual regulatory exceptions to the statute in the absence of a statutory standard for liquidity because it would likely require introducing a facts-and-circumstances test that analyzes the liquidity of every asset, which would be difficult to administer. Furthermore, while some assets that would otherwise be treated as cash-equivalent assets could be excluded from a specified foreign corporation's cash position for being insufficiently liquid, other assets that are not treated as cash-equivalent assets but are liquid would need to be included in a specified foreign corporation's cash position. Accordingly, the proposed regulations do not introduce new regulatory exceptions to the definition of cash position.

19. Explanation XI.D.2 – Determination of aggregate foreign cash position: Other Modifications Requested to Statutory Rules (pp. 103-04)

- a. Comment: Request modifications to the rules regarding the calculation of a specified foreign corporation's cash position or a United States shareholder's aggregate foreign cash position, including request that (i) accounts payable be allowed to offset both accounts receivable and other components of a specified foreign corporation's cash position; (ii) the pro rata share of cash held through a pass-through entity be limited to the amount of cash that a specified foreign corporation would have been entitled to on liquidation of the pass-through entity; (iii) the cash position be reduced by section 301(c) cash distributions by the specified foreign corporation when using the average of the aggregate cash positions on the first two cash measurement dates; and (iv) the cash position be reduced by undistributed previously taxed E&P.

- b. Reason for rejection: Treasury and IRS determined that the statute is unambiguous as to how, in each of these circumstances, a specified foreign corporation's cash position or a United States shareholder's aggregate foreign cash position should be determined, such that it is unnecessary to provide guidance or to revise the operation of the statute by regulation under these circumstances.

20. Explanation XI.D.3 – Determination of aggregate foreign cash position: Notional Cash Pooling Arrangements (p. 104)

- a. Comment: Request that the proposed regulations provide that notional cash pooling arrangements are treated as creating intercompany receivables for purposes of section 965.
- b. Reason for rejection: The determination of whether transactions in a notional cash pooling arrangement are treated as occurring among participants in the arrangement, or between the participants and a third party, depends on the application of federal income tax principles (comparing to Rev. Rul. 87-89, 1987-2 C.B. 195).

21. Explanation XI.D.4 – Determination of aggregate foreign cash position: Non-Corporate Entities under Section 965(c)(3)(E) (p. 104)

- a. Comment: Request clarification regarding whether section 965(c)(3)(E), which treats a non-corporate entity held by a specified foreign corporation as a specified foreign corporation (if it would otherwise be a specified foreign corporation if it was a foreign corporation) for purposes of taking into account its cash position, applies to an entity that is disregarded as an entity separate from its owner for U.S. federal income tax purposes (“disregarded entity”).
- b. Reason for rejection: Treasury and IRS determined that it is clear under existing law that the assets of a disregarded entity are considered as held directly by the disregarded entity's owner, such that the rule in section 965(c)(3)(E) does not apply with respect to disregarded entities, and no specific rules addressing the application of section 965(c)(3)(E) are necessary.

22. Explanation XI.E – Blocked foreign income (p. 105)

- a. Comment: Request that the proposed regulations provide rules with respect to income subject to certain exchange controls or other foreign legal restrictions. Generally, section 964(b) and §1.964-2 (the blocked foreign income rules) provide that no part of the E&P of a CFC are included in the CFC's E&P for purposes of sections 952 and 956 if it is established to the satisfaction of the Secretary that the E&P could not have been distributed by the CFC to United States shareholders that own the stock of the CFC due to currency or other foreign legal restrictions. Section 965(a) inclusion amounts are not, however, limited by section 952, such that the blocked foreign income rules do not affect the determination of such amounts. Comments request that the proposed regulations adopt rules similar to the blocked foreign income rules for purposes of section 965 by reducing the post-1986 earnings and profits of a specified foreign corporation by an amount equal to any amounts subject to restrictions on distributions by a specified foreign corporation.
- b. Reason for rejection: Treasury and IRS determined that it is not appropriate to provide rules similar to the blocked foreign income rules for purposes of computing post-1986 earnings and profits. Section 965(d)(3) expressly provides that the term post-1986 earnings and profits means E&P “computed in accordance with section 964(a) and 986,”

giving rise to a clear inference that the principles of section 964(b) should not be given effect in computing post-1986 earnings and profits.

Comments explicitly solicited in the preamble

1. **Explanation II.B.2 – Definitions: Post-1986 Earnings and Profits (p. 31)**
 - a. Whether additional rules are needed to address the treatment of hovering deficits that reduce post-1986 earnings and profits of a DFIC, for example when the hovering deficit creates a specified E&P deficit.
2. **Explanation II.B.3 – Definitions: E&P Deficit Foreign Corporation (pp. 33-34)**
 - a. Rules with respect to the definitions of post-1986 earnings and profits, accumulated post-1986 deferred foreign income, and specified E&P deficit.
3. **Explanation II.B.9 – Definitions: Pro Rata Share (p. 40)**
 - a. Whether there are circumstances in which a specified E&P deficit should be allocated to shareholders of an E&P deficit foreign corporation's preferred stock and, if so, how to allocate as between shareholders of common stock and shareholders of preferred stock as well as among shareholders of preferred stock
4. **Explanation IV.C.1 – Adjustments to Basis by Reason of Section 965(a) (p. 52)**
 - a. Appropriate amount of a basis adjustment with respect to a DFIC with respect to which a section 962 election is effective.
5. **Explanation VII.D – Foreign Tax Credits: Allocation and Apportionment of Expenses (p. 75)**
 - a. What rules may be appropriate, including whether the rules under § 1.861-12(c)(2) (regarding basis adjustment for stock in nonaffiliated 10 percent corporations) should be modified, in recognition that (1) the application of section 965(b)(4)(A) and (B) may warrant the issuance of special rules for the determination of adjusted basis; and (2) a different rule may be needed if a taxpayer has made an election under proposed § 1.965-2(f)(2) to adjust its basis to reflect the use of a specified E&P deficit.
6. **Explanation VII.E – Foreign Tax Credits: Application of section 904 (p. 76)**
 - a. Whether more guidance is necessary with respect to the assignment of the section 965(a) inclusion and the related taxes to a separate category or categories of income.
 - b. Whether additional rules are needed for determining the amount of the increase in the section 904 limitation with respect to distributions of section 965(a) previously taxed earnings and profits and section 965(b) previously taxed earnings and profits, taking into account the section 965(c) deduction and the disallowed foreign taxes under section 965(g).
7. **Explanation XI.D.1– Determination of aggregate foreign cash position: Liquidity-Based Exceptions (p. 103)**
 - a. Rules with respect to the definition of a cash position of a specified foreign corporation.