



International Tax ADVISORY ■

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Finally! Final Regulations Published for Section 965 Transition Tax

On February 4, 2019, the Treasury issued final regulations ([T.D. 9846](#)) implementing the transition tax enacted by the Tax Cuts and Jobs Act (TCJA). These are the first regulations implementing the TCJA to be finalized. They generally adopt the proposed regulations released on August 9, 2018. However, several changes have been made to provide further clarity to the proposed regulations.

Section 965 Generally

New Section 965 requires all U.S. shareholders (as defined in Section 951(a)(1)) to include in income their share of the accumulated post-1986 deferred foreign earnings of all “deferred foreign income corporations” (DFICs). DFICs include controlled foreign corporations (CFCs) and any foreign corporation in which at least one domestic corporation is a U.S. shareholder. The amount deemed repatriated is the greater of the deferred foreign earnings as of November 2, 2017, or December 31, 2017. The repatriation inclusion should have been made for the last taxable year of the DFIC beginning before January 1, 2018—e.g., in 2017 for a calendar-year DFIC. In some cases, a U.S. shareholder may have had a Section 965 inclusion in two years—e.g., a calendar-year U.S. shareholder that owns calendar-year and non-calendar-year DFICs.

Section 965 allows a deduction resulting in an effective tax rate of 15.5% to the extent the inclusion is held by the DFIC in cash or cash equivalents and an 8% rate to earnings held in illiquid assets. Previously taxed income (PTI) reduces the amount subject to inclusion, and deficit-netting rules may significantly reduce the repatriation inclusion. Taxpayers may apply net operating losses (or preserve them) and claim a foreign tax credit.

Under Section 965(h), taxpayers can elect to pay any resulting liability in back-loaded installments over eight years. If an “acceleration event” occurs (e.g., a liquidation, sale, exchange, or other disposition of substantially all the assets of the electing taxpayer), the unpaid portion of all remaining installments is generally due on the date of that event, subject to exceptions for corporate acquisition events. Additionally, elections can be

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made under Section 965(i) (for a shareholder of an S corporation) and Section 965(m) (for a REIT) to defer payment of the resulting liability following a “triggering event” (e.g., a liquidation, sale, or other disposition of substantially all the assets of the S corporation or REIT).

Some Key Takeaways

De minimis threshold preventing downward attribution to certain partnerships and trusts

Some favorable changes were made to the attribution rules for determining the status of a foreign corporation as a specified foreign corporation. The purpose of this de minimis threshold is to limit the administrative and compliance burdens related to determining whether a foreign corporation is a specified foreign corporation solely by reason of downward attribution of its stock.

The final regulations increased the de minimis threshold preventing downward attribution to partnerships from partners that own less than 5% to partners that own less than 10%. This change came about after the government received several comments requesting an increased threshold. The government determined that a 10% threshold would strike the appropriate balance between mitigating administrative and compliance burdens and accurately identifying which foreign corporations are specified foreign corporations.

Additionally, the government was persuaded by a comment to the proposed regulations that requested the de minimis threshold be extended to trusts, since similar compliance burdens are present. As such, the final regulations extend the de minimis threshold to trusts.

Exception from the anti-abuse rules for certain incorporation transactions

The anti-abuse rules relate to transactions undertaken with a principal purpose of changing a Section 965 element of a U.S. shareholder and certain changes in method of accounting and entity classification elections. Transactions subject to these anti-abuse rules are disregarded for purposes of determining the amounts of all Section 965 elements of a U.S. shareholder.

Comments to the proposed regulations requested a number of exceptions from the anti-abuse rules, including for certain incorporation transactions. In response to these comments, the final regulations provide an exception from the anti-abuse rules for certain domestic incorporation transactions. Under this exception, the anti-abuse rules do not apply to disregard domestic incorporations (including through “check-the-box” elections) that resulted in a transfer of a specified foreign corporation, provided that the Section 965(a) amount does not decrease and that the aggregate foreign cash position of both the transferor and the transferee is determined as if each had held the transferred stock of the specified foreign corporation owned by the other on each of the cash measurement dates.

Transfer agreements

A transferee and transferor can enter into a transfer agreement to avoid the acceleration of an otherwise deferred Section 965 tax liability following an acceleration event or triggering event. Under a transfer agreement, the transferee agrees to assume the liability of the transferor for any unpaid installment payments. Generally, transfer agreements must be filed within 30 days of the acceleration event or triggering event.

The final regulations provide that for acceleration events or triggering events that occurred on or before February 5, 2019, the transfer agreement will be considered timely filed if it is filed by March 7, 2019.

The final regulations require that a transfer agreement include a statement about whether the ratio of the total indebtedness of the transferee to the sum of its money and all other assets reduced (but not below zero) by such total indebtedness (the “leverage ratio”) exceeds three to one. The final regulations provide little guidance on how to calculate the leverage ratio. If the leverage ratio does exceed three to one, the preamble to the final regulations states that the IRS may use this statement to determine the accuracy of the transferee’s representation that it is able to make the remaining payments that it is assuming. A senior counsel with the IRS explained that this debt-to-equity ratio is “just another data point” to determine whether the IRS should consider following up on the transferee’s ability to pay the liability. The IRS could reject a transfer agreement if it determines that the taxpayer’s leverage ratio statement was incorrect.

Notably, the final regulations do not carve out tax-free reorganizations or exchanges from the definition of what constitutes a disposition of substantially all the taxpayer’s assets for purposes of determining whether an accelerating event or triggering event has occurred. The preamble to the final regulations indicates that this omission was intentional—the government determined that any disposition of substantially all the assets of the person making the Section 965(h) election, the S corporation, or the REIT, including in a tax-free reorganization or an exchange described in Section 351 or 721, poses a risk to the IRS’s ability to collect the full amount of the tax liability under Section 965.

Basis adjustment election

Under the proposed regulations, a taxpayer may elect to increase the basis in the stock of a DFIC by an amount equal to its Section 965(b) previously taxed earnings, with a corresponding reduction to basis in the stock of E&P deficit foreign corporations. The final regulations allow taxpayers to elect to make only an upward basis adjustment to the extent of available basis in the E&P deficit foreign corporation’s stock or applicable property (the “to-the-extent rule”). The final regulations also allow taxpayers to make the full adjustments that would have been required under the proposed regulations, rather than applying the to-the-extent rule, and recognize gain.

The final regulations provide that if a taxpayer made this election on or before February 5, 2019, it will be revocable before May 6, 2019. The election can be revoked by attaching a statement to an amended return filed no later than May 6, 2019.

Next Steps

Despite containing limited changes from the proposed regulations, the final regulations provide taxpayers with much-needed certainty. The final regulations provide for several elections that require timely action to be taken. Additionally, they contain rules that may have an impact on returns that have already been filed. Taxpayers should think about whether previously filed returns are impacted by the final regulations and whether any adjustments need to be made.

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