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The End of Eternity: Anomalies in Transition to Territoriality

by Libin Zhang and Joshua A. Rabinovits

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In this report, Zhang and Rabinovits examine some effects of section 965, with attention to individual taxpayers and the interactions of section 965 with the alternative minimum tax, the section 962 election, foreign tax credit limitations, and other code provisions.

An earlier version of this report was presented by Zhang on March 5.

Table of Contents

I. Introduction 621
II. Worldwide and Territorial Tax Regimes 621
III. Deemed Repatriation of Deferred Income 622
A. Section 965(a) Income 622
B. Section 965(c) Deduction 627
C. Section 965(g) Limitation on FTC 633
D. Section 965(h) Election to Defer Tax . .635
E. Section 965(i) Election for S Corporation 637
F. Section 1411 Tax. 638
G. Stock Tax Basis Adjustment 639
H. Section 965(n) NOL Election 639
IV. Conclusion 640

I. Introduction

The Tax Cuts and Jobs Act (P.L. 115-97) represents the most significant update to the Internal Revenue Code since the Tax Reform Act of 1986. A major change is the transition of the United States from a worldwide tax system to a partially territorial tax system.

One issue that Congress had to address in switching to a territorial system was how to treat a foreign corporation's previously earned income. Section 14103 of the TCJA enacted section 965, titled, "Treatment of Deferred Foreign Income Upon Transition to Participating Exemption System of Taxation." The new provision is far-reaching and has surprising effects, particularly for individual taxpayers, who do not benefit from the new territorial tax system.

II. Worldwide and Territorial Tax Regimes

A U.S. taxpayer investing abroad through a foreign corporation is subject to U.S. tax under sections 951 through 965, in subchapter N, Part III, subpart F, of the code. Under the pre-TCJA subpart F rules, a U.S. shareholder of a corporation that was a controlled foreign corporation for an uninterrupted period of at least 30 days was subject to U.S. tax on the shareholder's pro rata share of the CFC's subpart F income, which is generally categories of passive income or other income. Under the pre-TCJA section 951(b), a U.S. shareholder was defined as a U.S. person that owns 10 percent or more of the foreign corporation's voting stock. A CFC was defined in section 957(a) as a foreign corporation owned more than 50 percent, by vote or value, by U.S. shareholders.

Subpart F income was generally included in the gross income of a U.S. shareholder under section 951(a)(1) as of the last day of the CFC's tax year. For example, if a CFC has a tax year that runs from December 1, 2017, through November 30, 2018, under section 898(c)(2), the CFC's subpart F income is included in the gross income of its U.S. shareholders as of November 30, 2018.

The subpart F income was typically not subject to U.S. tax a second time. Section 959(a) provided that a foreign corporation's distribution to its U.S. shareholder was excluded from the U.S. shareholder's gross income to the extent of the shareholder's previously taxed income (PTI) under section 959(c)(1) and (2) — that is, prior subpart F income.

A U.S. shareholder of a CFC that earned only non-subpart F income could defer U.S. tax on that income until it was repatriated to the United States, if ever. Also, a U.S. shareholder usually was not subject to current U.S. tax for any income earned by a non-CFC foreign corporation. When that income was repatriated from the foreign corporation to the U.S. shareholder, the income was usually taxed as a dividend under prior law.

Section 14101 of the TCJA enacted new section 245A, which provides that a domestic corporation that is a U.S. shareholder of a "specified 10-percent owned foreign corporation" is entitled to a 100 percent dividends received deduction (DRD) for the foreign-source portion of a dividend from that foreign corporation in 2018 and later, if specified holding period requirements are met. A specified 10-percent owned foreign corporation is a foreign corporation in which the domestic corporation is a U.S. shareholder under section 951(b). Section 951(b) was amended by section 14215 of the TCJA to mean a U.S. person that has a 10 percent interest, by vote or value, in a foreign corporation in 2018 and later.

If the 100 percent DRD were to apply to all of a foreign corporation's distributed earnings, the result could be a windfall for the corporate shareholders of a foreign corporation with previously earned foreign income that was never repatriated to the United States and will never be taxed by the United States. The TCJA enacted section 965 to subject that deferred foreign income to some U.S. tax currently.

III. Deemed Repatriation of Deferred Income

A. Section 965(a) Income

Section 965(a) provides that in the last tax year of a deferred foreign income corporation (DFIC) beginning before 2018, the DFIC's subpart F income is increased by the greater of the accumulated post-1986 deferred foreign income of that corporation determined as of November 2, 2017, or December 31, 2017. A DFIC is any specified foreign corporation (SFC) of which the taxpayer is a U.S. shareholder, if the SFC has positive accumulated post-1986 deferred foreign income.

Section 965(e) provides that an SFC means, for a U.S. shareholder, a foreign corporation that is either a CFC or is a foreign corporation in which a domestic corporation is a U.S. shareholder. Section 965 uses the pre-TCJA definition of a U.S. shareholder, which means a U.S. person that holds 10 percent or more of the voting stock of the foreign corporation. An SFC is therefore any foreign corporation that either is owned 10 percent or more by vote by a domestic corporation or is owned more than 50 percent by vote or value by corporate or individual U.S. shareholders.

A foreign corporation is not an SFC merely because it is owned 10 percent by an S corporation. Section 1373(a)(1) provides that an S corporation is treated as a partnership for purposes of subpart F, including new section 965.

A foreign corporation can be an SFC by being owned 10 percent by a domestic C corporation, in which case the foreign corporation is also an SFC for all the other corporate and noncorporate U.S. shareholders. For example, a foreign corporation that is owned 10 percent by a U.S. citizen, 10 percent by a domestic C corporation, 10 percent by an S corporation, and 70 percent by foreign persons, is an SFC because a domestic C corporation owns 10 percent of it. The U.S. citizen, the S corporation, and the C corporation are all U.S. shareholders of an SFC and subject to section 965.

Section 958(b) provides stock attribution rules, based on section 318, for determining whether a U.S. person is a U.S. shareholder or whether a foreign corporation is a CFC. Section 958(b)(4) was amended by the TCJA with expanded downward attribution, effective for a foreign corporation's last tax year beginning in 2017 and later years. That amendment affects section 965.

The constructive attribution rules may cause a foreign corporation to be a DFIC based on the other assets of its shareholders and related parties. For example, an individual shareholder, whether foreign or a U.S. citizen, may own 50 percent of a domestic C corporation's stock and 10 percent of a foreign corporation's stock. Section 318(a)(3)(C) treats a C corporation as constructively owning any stock owned by a 50-percent-or-greater shareholder, so the domestic C corporation constructively owns 10 percent of the foreign corporation's stock. Because the foreign corporation has a constructive 10 percent corporate U.S. shareholder, it is an SFC, which causes section 965 to apply to its individual U.S. shareholders. The result is the same if the domestic C corporation's stock instead is 50 percent owned by the individual's foreign grandparent. The individual shareholder's 10 percent of the foreign corporation is constructively owned by the grandparent because of section 318(a)(1)(A), and the stock is further constructively owned by the domestic C corporation.[1]

Accumulated post-1986 deferred foreign income under section 965(d)(2) and (3) consists of the DFIC's earnings and profits during the period beginning after 1986 in which it was an SFC until either November 2, 2017 (the date the TCJA was introduced as a bill in the House), or December 31, 2017, whichever results in the greater E&P, but excluding E&P that is effectively connected with the conduct of a U.S. trade or business and is subject to U.S. tax.[2] For CFCs, accumulated post-1986 deferred foreign income also excludes amounts that would be excluded from a U.S. shareholder's gross income under section 959 if distributed by the CFC — that is, PTI that was subpart F income. If the CFC has other shareholders that are not U.S. shareholders, those shareholders are not subject to subpart F and section 959, but their pro rata share of the CFC's subpart F income should also be excluded from the CFC's accumulated post-1986 deferred foreign income. Section 959(d)(2)(B) authorizes regulations to exclude those amounts.

Section 959 applies to all foreign corporations, not just CFCs, that distribute PTI to U.S. shareholders. A U.S. shareholder may have subpart F income from a CFC that gave rise to PTI, and the foreign corporation ceases to be a CFC in a later year, such as through the issuance of new stock to foreign shareholders. As long as the U.S. shareholder is still a U.S. shareholder — that is, owns 10 percent or more of the voting stock of the foreign corporation — distributions from the foreign corporation to the U.S. shareholder are tax free to the extent of the PTI. However, the U.S. shareholder's PTI of that non-CFC foreign corporation is not excluded from accumulated post-1986 deferred foreign income under section 965(d)(2)(B), which applies only to CFCs. Because the income was previously taxed under subpart F and should not be taxed again under section 965(a), a technical correction should cause section 965(2)(B) to apply to non-CFCs that may make distributions excluded from gross income under section 959.

Dividend distributions made in the SFC's last tax year beginning before 2018 — that is, the year that gives rise to section 965(a) income — are generally disregarded in calculating E&P under section 965(d)(3). The TCJA effectively made a retroactive change to the treatment of a DFIC's distributions made earlier in 2017, which may be converted from dividends to tax-free distributions of PTI. The retroactive nature of the change creates issues if some stock in the DFIC was sold (or redeemed) in 2017, with potential double inclusion of the section 965(a) income by both the old (or redeemed) shareholders and the new (or remaining) shareholders.[3] The retroactive effect is more limited for an SFC that is a fiscal-year taxpayer. For example, if the SFC has a tax year from December 1, 2017, through November 30, 2018, dividend distributions made on or before

[1] Notice 2018-26, 2018-16 IRB 480, provides that in determining SFC status, section 318(a)(3)(A) partner-to-partnership downward attribution will be limited generally to partners who own 5 percent or more of the partnership's interests. The notice does not contain limitations on other attribution rules.

[2] A foreign corporation's status as an SFC in 1987 through 2017 depends on its ownership and the constructive ownership rules for those years, such as former section 958(b)(4) preventing foreign-to-U.S. downward attribution before 2017.

[3] *See* New York State Bar Association Tax Section, "Report on Section 965," Rept. No. 1388, at 5-7 (Feb. 6, 2018).

November 30, 2017, would reduce the SFC's accumulated post-1986 deferred foreign income.

For an SFC that is a CFC, the increase in the CFC's subpart F income results in additional gross income to its U.S. shareholders under the general subpart F income rules of section 951. For non-CFC SFCs, the subpart F rules are expanded to apply to their U.S. shareholders, but only for section 965(a) income. Section 965(e)(2) provides that a non-CFC SFC is treated as a CFC under sections 951 and 961 (tax basis in stock) solely to take into account section 965(a) income of the SFC. Section 965(f) provides that the determination of the U.S. shareholder's pro rata share of section 965(a) income from a non-CFC SFC is made under rules similar to section 951(a)(2), by treating the section 965(a) income as subpart F income and by treating the SFC as a CFC.

In short, section 965(a) requires a DFIC's U.S. shareholder to generally include in gross income its pro rata share of the income in the foreign corporation that was not previously subject to U.S. tax as of December 31, 2017, with no allowance for 2017 distributions or for any reduction in E&P that the foreign corporation may have achieved between November 2, 2017, and December 31, 2017. The section 965(a) income is included in the U.S. shareholder's gross income under the subpart F rules. For example, if a DFIC has a tax year that runs from December 1, 2017, through November 30, 2018, its subpart F income is included in the gross income of its U.S. shareholders as of November 30, 2018. A U.S. shareholder that is a calendar-year taxpayer would include the gross income in 2018.[4]

Section 965 imposes a U.S. tax on the realized gains of an SFC from 1987 through 2017 that were included in E&P. E&P does not include unrealized gains. A U.S. shareholder that is a domestic C corporation will not pay U.S. tax on the unrealized gain because of the 100 percent section 245A DRD for gains realized and distributed by the foreign corporation in 2018 or later.[5] An SFC should avoid selling any appreciated assets in 2017 (for a calendar-year taxpayer) or its 2017-2018 tax year (for a fiscal-year taxpayer).

1. E&P deficits.

If a taxpayer is a U.S. shareholder of an E&P deficit foreign corporation — that is, an SFC that has a deficit in post-1986 E&P as of November 2, 2017 (not December 31, 2017) — the U.S. shareholder's aggregate E&P deficit from the E&P deficit foreign corporations is generally allocated under section 965(b)(2) among the U.S. shareholder's DFICs (that is, SFCs with accumulated post-1986 deferred foreign income). The taxpayer's section 965(a) income from each DFIC is reduced under section 965(b)(1) by the E&P deficit allocated to that DFIC. The reduction is illustrated by the following example, taken from the conference report.[6]

Example 1: A domestic C corporation is a U.S. shareholder in four SFCs, of which two are E&P deficit foreign corporations and two are DFICs. The foreign corporations have the following accumulated post-1986 deferred foreign income or foreign E&P deficits:

Table 1

SFC	Percentage Owned	Post-1986 E&P or Deficit	Shareholder's Pro Rata Share
A	60%	($1,000)	($600)
B	10%	($200)	($20)
C	70%	$2,000	$1,400
D	100%	$1,000	$1,000

- The U.S. shareholder's aggregate E&P deficit from E&P deficit foreign corporations is $620, and accumulated post-1986 deferred foreign income from DFICs is $2,400.
- The E&P deficit allocable to Corp. C is $362 (that is, $620 x $1,400/$2,400), and the E&P

[4]Rev. Proc. 2018-17, 2018-9 IRB 384, provides that an SFC using a calendar tax year may not have automatic IRS approval, under Rev. Proc. 2002-39, 2002-1 C.B. 1046, or Rev. Proc. 2006-45, 2006-2 C.B. 851, to change its 2017 tax year to a fiscal year if it has one or more U.S. shareholders that would have section 965(a) income from any SFC.

[5]Unless the gain is subpart F income or other currently taxed income (such as global intangible low-taxed income).

[6]H.R. Rep. No. 115-466, at 608 (Dec. 15, 2017) (Conf. Rep.).

deficit allocable to Corp. D is $258 (that is, $620 x $1,000/$2,400).
- The U.S. shareholder has $1,780 of net E&P from DFICs that is section 965(a) income, with $1,038 from Corp. C and $742 from Corp. D.

The U.S. shareholder's section 965(a) income, like other subpart F income, is section 959(c)(2) PTI, which may be distributed by the DFIC to the U.S. shareholder without further U.S. tax. Section 965(b)(4)(A) provides that the portion of the aggregate E&P deficit allocated to the DFIC is also PTI. Thus, the U.S. shareholder may receive a tax-free distribution of $1,400 of PTI from Corp. C.

Section 965(b)(4)(B) provides the converse to section 965(b)(4)(A)'s additional PTI. The U.S. shareholder increases its pro rata share of Corp. A's E&P by $600, from a $600 deficit to zero E&P. Section 965(b)(4)(B) further provides that the increase in E&P is attributable to the same activity to which the E&P deficit was attributable under section 952, in computing a CFC's subpart F income.

For an E&P deficit foreign corporation that is a CFC, section 952(c)(1)(B) provides that the CFC's subpart F income from a qualified activity may be reduced by prior "qualified deficits" in E&P from the same qualified activity. The allowed qualified deficits are generally:
- post-1982 deficits from any foreign base company sales income activity;
- post-1962 deficits from any foreign base company services income activity;
- post-1962 deficits from any section 953 insurance income activity or foreign personal holding company income activity of a section 952(c)(1)(B)(v) qualified insurance company; and
- post-1987 deficits from any foreign personal holding company income activity of a section 952(c)(1)(B)(vi) qualified financial institution.

For those qualified activities, the increase in E&P effectively eliminates the qualified deficit, which may result in the E&P deficit foreign corporation having more future subpart F income from the activity.

For a CFC's nonqualified activities, such as a foreign personal holding company income activity for a non-insurance and non-financial company, the elimination of the deficit has no effect under section 952(c)(1)(B) because the deficit could not have reduced subpart F income previously.

Aside from the section 952 consequences for qualified activities, an E&P increase would generally be beneficial for a CFC with a corporate U.S. shareholder, since any distributions out of future E&P could be tax free with the section 245A deduction and no stock basis reduction. The E&P increase is similarly beneficial for any corporate U.S. shareholder of a non-CFC E&P deficit foreign corporation, which is never affected by section 952. The increase in E&P is not as beneficial for noncorporate U.S. shareholders, who become more likely to receive taxable dividends instead of non-dividend return of capital distributions in the future.

Section 965(b)(4)(B) provides that the E&P deficit foreign corporation's E&P is increased, without specifying that the increased amount is an item of current E&P. A CFC may have previously made investments in U.S. property that would have given rise to income under section 956, except that the section 956 income was generally limited by section 956(a)(2) to the U.S. shareholder's pro rata share of the CFC's current E&P and prior years' accumulated E&P. The section 965(b)(4)(B) increase in E&P should not be considered an addition to the CFC's current E&P that would give rise to section 956 income. Section 965(b)(4)(B) does increase the CFC's accumulated E&P and may have a section 956 effect in a later year. Similarly, if a CFC is subject to the limitation in section 952(c)(1)(A), which provides that a CFC's overall subpart F income is limited to the CFC's E&P for the tax year, section 964(b)(4)(B) does not appear to increase that corporate-level limit and increase the E&P deficit foreign corporation's subpart F income for that tax year.

Section 965(b)(5) provides netting rules for a corporate U.S. shareholder to generally reduce its section 951(a) income by the E&P deficit of a corporate U.S. shareholder in the same affiliated group. If the Corp. A and Corp. B stock in Example 1 are owned by one corporate U.S. shareholder (the E&P net deficit shareholder), and the Corp. C and Corp. D stock are owned by another corporate U.S. shareholder (the E&P net surplus shareholder) in the same affiliated group, the E&P net surplus shareholder has $2,400 of section 965(a) income reduced by up to all of the $620 E&P deficit from the E&P net deficit shareholder, with adjustments for ownership by nonmembers of the affiliated group. Section 965(b)(5) does not apply if the two corporate shareholders are not in a section 1504 affiliated group, such as if a partnership or real estate investment trust is between the two corporate shareholders, in which case the E&P net surplus shareholder would have the full $2,400 of section 965(a) income.

A deficit in E&P of an E&P deficit foreign corporation is defined in section 965(b)(3)(C) as a "deficit in post-1986 E&P," without any specific exclusions, in contrast to a DFIC's accumulated post-1986 deferred foreign income generally excluding PTI and U.S. trade or business income. It is unclear why an E&P deficit foreign corporation's U.S. earnings and deficits should affect section 965(a) income. An E&P deficit foreign corporation may still have PTI, which could have been distributed tax-free to a U.S. shareholder to increase the overall E&P deficit. The lack of an exclusion for PTI penalizes a CFC that did not distribute its PTI for nontax reasons and consequently has a smaller deficit in E&P for section 965 purposes. A better policy is for an E&P deficit to be calculated with the same two exclusions as accumulated post-1986 deferred foreign income.

2. Individual U.S. shareholders.

Section 965(a) applies to any U.S. shareholder of a DFIC, whether that shareholder is an individual or a corporation. In contrast, section 245A provides a 100 percent DRD only for a domestic C corporation, which may seem unfair to individual shareholders.

If the foreign corporation is a CFC, the legislative intent may have been to view the CFC unfavorably as a means to defer the U.S. tax of the majority U.S. shareholders, and that deferral should end regardless of whether a shareholder may claim the section 245A DRD beginning in 2018.

A non-CFC foreign corporation was not controlled by its U.S. shareholders and was not presumed to be an instrument of U.S. tax deferral. However, a non-CFC foreign corporation's corporate U.S. shareholder may claim the section 245A DRD beginning in 2018, and it was considered appropriate to require the corporate U.S. shareholder to recognize section 965(a) income to prevent deferred foreign income from becoming tax-free income. But once a non-CFC foreign corporation is an SFC because of a corporate U.S. shareholder, section 965 may have been unintentionally overbroad in applying to all of the non-CFC SFC's other U.S. shareholders, including individual shareholders, particularly if the SFC status is due only to constructive ownership.

Congress may have been concerned that exempting individual U.S. shareholders from section 965 might lead to the individuals later contributing their SFC stock to a domestic C corporation, which could then receive the deferred foreign income tax-free with a section 245A DRD. Other antiabuse rules could have addressed that concern, such as by modifying the nonrecognition rules of sections 351 and 368. Further, a potential conversion of 1987-to-2017 deferred foreign income into tax-free income continues to exist for an individual who owns up to 50 percent of the stock of a foreign corporation that happens to not be an SFC.

Congress may also have been concerned that a narrower approach would not raise $338.8 billion of federal tax revenue in 2018 to 2027.[7]

3. RICs and REITs as U.S. shareholders.

A regulated investment company and a REIT are subject to section 965(a) without any future section 245A DRD.

A RIC may pass through its dividend income from domestic C corporations to the RIC's corporate shareholders under section 854(b)(1) for the corporate shareholders to claim the section 243 DRD, but there is no similar passthrough for the 100 percent section 245A DRD. Since the corporate shareholder must own 10 percent or more of the stock of the foreign corporation to qualify for the 100 percent section 245A DRD, it may have been considered administratively

[7] Joint Committee on Taxation, "Estimated Budget Effects of the Conference Agreement for H.R. 1, the 'Tax Cuts and Jobs Act,'" JCX-67-17, at 6 (Dec. 18, 2017).

difficult to look through the RIC to determine that ownership.

A REIT cannot pass through the character of its dividend income to its corporate shareholders for them to claim any DRD, even though a REIT can pass through qualified dividends to individual U.S. shareholders under section 857(c)(2).

Section 965(m) acknowledges the different nature of REITs to a limited extent. The section 965(a) income is not considered gross income under the section 856(c)(2) and (3) REIT income tests, and the REIT may elect to include the section 965(a) income in taxable income over eight years. No similar benefit is provided for RICs, which must recognize the section 965(a) income as RIC income upfront, thereby increasing their section 852(b)(1) taxable income and section 852(a)(1) distribution requirement. Section 851(b) provides that subpart F income is qualifying income for the RIC's section 851(b)(2) 90 percent gross income test only to the extent that there is also a distribution out of the E&P attributable to the subpart F income, which was reiterated in prop. reg. section 1.851-2(b)(2).

4. Pre-1987 E&P.

It is unclear why only the post-1986 E&P of a foreign corporation gives rise to section 965(a) income. TRA 1986 made major changes to FTCs and other international tax provisions, but a foreign corporation's undistributed E&P was already tax-deferred at that time, and subpart F itself was enacted earlier by the Revenue Act of 1962.

There is no similar post-1986 limitation in the 100 percent section 245A DRD, which applies to substantially all of a foreign corporation's foreign-source E&P, in contrast to the House bill's version of section 245A, which applied only to post-1986 E&P. A foreign corporation's undistributed E&P from before 1986 may avoid U.S. tax permanently when distributed to corporate U.S. shareholders.

B. Section 965(c) Deduction

Section 965(c) provides a deduction from the section 965(a) income in an amount equal to the sum of two amounts: (1) a 15.5 percent rate equivalent percentage on the section 965(a) income to the extent of the U.S. shareholder's "aggregate foreign cash position," and (2) an 8 percent rate equivalent percentage on the remaining section 965(a) income.

The goal of the section 965(c) deduction is to cause the section 965(a) income to be taxed at either an 8 percent U.S. tax rate (for illiquid assets) or a 15.5 percent U.S. tax rate (for liquid assets), after considering different potential U.S. corporate tax rates. The conference report explained:

> By stating the permitted deduction in the form of a tax rate equivalent percentage, the provision ensures that all pre-effective date accumulated post-1986 deferred foreign income is subject to either [an 8 percent or 15.5 percent] rate of tax, depending on the underlying assets as of the measurement date, without regard to the corporate tax rate that may be in effect at the time of the inclusion. For example, corporate taxpayers that use a fiscal year as the taxable year may report the increased subpart F income in a taxable year for which a reduced corporate tax rate would otherwise apply (on a pro-rated basis under section 15), but the allowable deduction would be reduced such that the rate of U.S. tax on the income inclusion would be [8 or 15.5] percent.[8]

A reason for the higher U.S. tax rate for liquid assets may be that the SFC could more easily dispose of those assets and make distributions for the U.S. shareholders to pay their U.S. tax. Congress may also have viewed any SFC that accumulated liquid assets as less deserving of a tax rate discount.

The section 965(c) deduction formula results in an 8 percent or 15.5 percent rate of U.S. tax when the taxpayer is a domestic C corporation, but not an individual.

Example 2: A domestic C corporation is a U.S. shareholder that owns 100 percent of a CFC. The domestic C corporation has $200 of section 965(a) income in 2017 because of the accumulated post-1986 deferred foreign income of the CFC. Half of the section 965(a) income is subject to the 8

[8] Conf. Rep. at 609.

percent rate equivalent percentage, and half is subject to the 15.5 percent rate equivalent percentage. The domestic C corporation determines its federal corporate tax on the section 965(a) income as follows:

Table 2

	8% Rate Equivalent Percentage	15.5% Rate Equivalent Percentage
Section 965(a) income	$100	$100
Section 965(c) deduction	($77.14) [(35% - 8%)/35% x $100]	($55.71) [(35% - 15.5%)/35% x $100]
Taxable income	**$22.86**	**$44.29**
Corporate tax at 35%	$8	$15.50
Effective U.S. tax rate	**8%**	**15.5%**

Example 3: Same facts as Example 2, except that the $200 of section 965(a) income is from a CFC with a tax year ending November 30, 2018, so that the domestic C corporation shareholder is subject to a 21 percent federal corporate tax rate in 2018 for the section 965(a) income. The domestic C corporation determines its federal corporate tax on the section 965(a) income as follows:

Table 3

	8% Rate Equivalent Percentage	15.5% Rate Equivalent Percentage
Section 965(a) income	$100	$100
Section 965(c) deduction	($61.90) [(21% - 8%)/21% x $100]	($26.19) [(21% - 15.5%)/21% x $100]
Taxable income	**$38.10**	**$73.81**
Corporate tax at 21%	$8	$15.50
Effective U.S. tax rate	**8%**	**15.5%**

Example 4: The same facts as Example 2 except that the U.S. shareholder is an individual who is subject to a 39.6 percent federal individual income tax rate in 2017. The individual determines his U.S. tax for the section 965(a) income as follows:

Table 4

	8% Rate Equivalent Percentage	15.5% Rate Equivalent Percentage
Section 965(a) income	$100	$100
Section 965(c) deduction	($77.14) [(35% - 8%)/35% x $100]	($55.71) [(35% - 15.5%)/35% x $100]
Taxable income	**$22.86**	**$44.29**
U.S. tax at 39.6%	$9.05	$17.54
Effective U.S. tax rate	**9.05%**	**17.54%**

Example 5: The same facts as Example 2, except that because of the CFC having a tax year ending on November 30, 2018, the section 965(a) income is included in the individual U.S. shareholder's 2018 tax year, during which individuals are subject to a 37 percent rate of U.S. tax and C corporations are subject to a 21 percent rate of U.S. tax:

Table 5

	8% Rate Equivalent Percentage	15.5% Rate Equivalent Percentage
Section 965(a) income	$100	$100
Section 965(c) deduction	($61.90) [(21% - 8%)/ 21% x $100]	($26.19) [(21% - 15.5%)/21% x $100]
Taxable income	**$38.10**	**$73.81**
U.S. tax at 37%	$14.10	$27.31
Effective U.S. tax rate	**14.1%**	**27.31%**

Examples 4 and 5 illustrate that an individual U.S. shareholder may have section 965(a) income subject to an effective tax rate greater than 8 percent or 15.5 percent, especially if the section 965(a) income is in 2018.

If a partnership is a U.S. shareholder of a DFIC, Notice 2018-26 provides that the section 965(c) deduction is determined at the partnership level, and presumably according to the corporate tax rate applicable to the partnership's tax year. A partnership that uses the calendar year as its tax year and has $100 of 2017 section 965(a) income would have either $77.14 or $55.71 of section 965(c) deductions, based on the 2017 corporate tax rate of 35 percent. A corporate partner with a fiscal tax year would include its share of the partnership's section 965(a) income and the section 965(c) deduction in its 2017-2018 tax year, subject to a corporate tax rate as low as 21 percent, which may result in an effective tax rate of 4.8 percent or 9.3 percent.

1. Type of individual tax deduction.

Section 965 does not specify how the section 965(c) deduction should be claimed for individuals. The section 965(c) deduction is not an exclusion from gross income like section 171(e) bond amortization premiums.

The section 965(c) deduction is not listed in section 62(a) as a deduction allowed in arriving at adjusted gross income, and it is by default an itemized deduction under section 63(d). Section 67 divides all itemized deductions into miscellaneous itemized deductions and non-miscellaneous itemized deductions. Non-miscellaneous itemized deductions are listed in section 67(b), which does not include the section 965(c) deduction.

Based on a process of elimination, and without regulatory relief, the section 965(c) deduction is a miscellaneous itemized deduction, subject to a 2 percent of AGI threshold under section 67(a). The allowed section 965(c) deduction is entirely disallowed by section 55(b)(1)(A)(i) for the section 55 alternative minimum tax in 2017. The individual taxpayer therefore has section 965(a) income subject to the full 26 percent or 28 percent federal AMT tax rate in 2017.

For tax years beginning in 2018 through 2025, all section 67(a) miscellaneous itemized deductions are disallowed for individuals under section 67(g), as enacted by TCJA section 11045. A section 965(c) deduction for an individual taxpayer in 2018 therefore may be entirely disallowed for both regular U.S. tax and AMT purposes.

There is no indication that Congress intended individual U.S. shareholders to be subject to a 28 percent marginal (AMT) tax rate in 2017 and a 37 percent marginal tax rate in 2018 on their section 965(a) income.

On March 13 the IRS website provided "Questions and Answers About Reporting Related to Section 965 on 2017 Tax Returns." The Q&A said that the section 965(a) income and the section 965(c) deduction should be reported as a net amount of "other income" for an individual. The Q&A effectively converted the section 965(c) deduction into an exclusion from gross income. Notice 2018-26, issued April 2, explained that an individual's section 965(c) deduction was not intended to be subject to the limitations on miscellaneous itemized deductions, and that regulations will provide that the section 965(c) deduction will not be treated as an itemized deduction, including for purposes of the AMT and section 67. The precise nature of the section 965(c) deduction remains unclear, which may have implications for the section 1411 tax and state and local income taxes.

2. Section 962(b) election.

The conference report dismissed the tax rate disparities between individual taxpayers and corporate taxpayers by noting that an individual taxpayer can make a section 962(b) election to be subject to tax on the section 965(a) income and section 965(c) deduction at the same federal corporate income rate as a domestic C corporation.[9]

The section 962(b) election is made by an individual U.S. shareholder on a year-by-year basis. Once made, it applies to all of the taxpayer's subpart F income from all foreign corporations for the year of the election.

Section 962 is not clear on how the section 965(c) deduction is treated by an electing individual. There is no explicit rule stating that the section 965(c) deduction should be applied only against section 965(a) income, especially because the section 965(c) deduction is available to all taxpayers and reg. section 1.962-1(b)(1)(i) provides that the income subject to corporate tax is not reduced by any deductions. However, the legislative intent is clear that the section 962(b) election should result in an effective income tax rate of 8 percent or 15.5 percent, which suggests that the section 965(c) deduction should reduce only the section 965(a) income. The IRS Q&A and Notice 2018-26 confirm this approach by providing that reg. section 1.962-1(b)(1)(i) will be

[9] *Id.* at 620.

amended to allow the section 965(c) deduction solely for the corporate tax.

A section 962(b) election results in the individual being eligible for an indirect foreign tax credit under section 960 for foreign taxes paid by the foreign corporation. The section 962(b) election also has some adverse tax consequences, including section 962(d) generally subjecting the electing individual to federal tax on distributions from the DFIC's E&P, which would have otherwise been tax-free PTI distributions to a non-electing individual. Section 962(d) provides that despite the PTI provisions of section 959(a)(1), the distributed E&P is included in gross income of the shareholder to the extent that the distribution exceeds the amount of U.S. (corporate) tax paid under the section 962(b) election. Section 962(d) makes no reference to section 959(a)(2), which addresses PTI under section 956, so there might not be shareholder gross income if the foreign corporation makes investments in U.S. property otherwise subject to section 956.

Section 962(d) does not specify how to tax the distributions, and three views are possible on whether the distributions are qualified dividends subject to 20 percent federal tax.

The conservative view is that the distributions are not dividends. This view considers section 962(d) an independent gross-income-generating provision that causes the distributions to be included in gross income, without specifying the nature of that income as a dividend.[10] However, the distributions are in fact distributions out of the E&P of the foreign corporation, which should result in dividends as defined generally in section 316(a) — that is, corporate distributions out of E&P to shareholders.

The moderate view acknowledges that the distributions are dividends, but based on the limited effects in section 962 for making the election, the distributions are analyzed under the regular rules for distributions from any foreign corporation. If the foreign corporation is a section 1(h)(11)(B) qualified foreign corporation, its dividends are qualified dividends. If the foreign corporation is not a qualified foreign corporation, the dividends are ordinary dividends.

The liberal view is that the individual shareholder is deemed to have a domestic C corporation between him and the foreign corporation, based on the policy purpose of section 962 as described in the legislative history of the Revenue Act of 1962:

> The purpose of [section 962] is to avoid what might otherwise be a hardship in taxing a U.S. individual at high tax brackets with respect to earnings in a foreign corporation which he does not receive. This provision gives such individuals assurance that their burdens, with respect to these undistributed foreign earnings, will be no heavier than they would have been had they invested in an American corporation doing business abroad.[11]

The individual, therefore, always receives qualified dividends from the deemed domestic C corporation. This policy-based outcome is short on statutory support, since section 962 was enacted 41 years before the Jobs and Growth Tax Relief Reconciliation Act of 2003 established the lower qualified dividend rates.[12]

Under the liberal view, a distribution from the foreign corporation, deemed to be a dividend from a domestic C corporation, should be U.S.-source income under section 861(a)(2)(A), for which the U.S. tax cannot be reduced by FTCs. Before 2003, taxpayers may have preferred the conservative or moderate view to ensure that the distributions were foreign-source income. Between 2003 and 2017, the practical difference between the moderate view and the liberal view might not have been significant, because the section 962(b) election was generally used to obtain indirect FTCs, and a foreign corporation subject to substantial foreign taxes was likely to have been created or organized in a treaty country and could pay qualified dividends under either view.

[10] *See* Lowell D. Yoder and Larry R. Kemm, "CFCs — Sections 959-965 and 1248," Tax Mgmt. Port. 930-2d, at section I.V.f. n.458.

[11] S. Rep. No. 87-1881, at 92 (1962).

[12] The issue for a Hong Kong CFC is now before the Tax Court in *Smith v. Commissioner*, Dkt. No. 14900-15.

For a partnership that is a U.S. shareholder of an SFC, its section 965(a) income is allocated to its partners. Some of the individual partners might not themselves be U.S. shareholders of the SFC, based on their indirect ownership of it. Notice 2018-26 indicates that only an individual partner who is a U.S. shareholder of an SFC may make a section 962(b) election for section 965(a) income or other subpart F income from the SFC. The section 962(b) election is thus unavailable for individual partners who own smaller indirect interests in an SFC. The same limitation applies to an individual shareholder of an S corporation.

The following example illustrates the effect of a section 962(b) election on an individual U.S. shareholder.

Example 6: An individual is a U.S. shareholder who owns 100 percent of a CFC. The individual has $200 of section 965(a) income from the CFC, half of which is subject to the 8 percent rate equivalent percentage and half of which is subject to the 15.5 percent rate equivalent percentage. The individual makes a section 962(b) election, and the CFC makes a $200 distribution to the U.S. shareholder in a later year. The individual U.S. shareholder determines the 2017 federal individual income tax on his section 965(a) income as follows:

Table 6

	8% Rate Equivalent Percentage	**15.5% Rate Equivalent Percentage**
Section 965(a) income	$100	$100
Section 965(c) deduction	($77.14) [(35% - 8%)/35% x $100]	($55.71) [(35% - 15.5%)/35% x $100]
Taxable income	**$22.86**	**$44.29**
U.S. tax at 35%	$8	$15.50
Effective U.S. tax rate	**8%**	**15.5%**

When the individual U.S. shareholder receives a $200 distribution from the CFC, the distribution less the amount of taxes previously paid on those amounts under section 962 (that is, the $8 and the $15.50) is subject to federal tax of either 20 percent or 37 percent (Table 7).

3. Cash position.

The 15.5 percent rate equivalent percentage applies to the extent of the taxpayer's aggregate foreign cash position. Aggregate foreign cash position is defined in section 965(c)(3)(A) as the greater of (1) the aggregate of the U.S. shareholder's pro rata share of the cash position (as defined below) of each SFC as of the close of the SFC's last tax year beginning before 2018, or (2) half the sum of (A) the aggregate share of the cash position of each SFC as of the close of the SFC's last tax year ending before November 2, 2017, and (B) the aggregate share of the cash position of each SFC as of the close of the SFC's preceding tax year.

Example 7: A taxpayer is a U.S. shareholder that owns 100 percent of a CFC that uses a calendar year as the tax year. The CFC has a cash position of $100 at the end of 2015, $50 at the end of 2016, and $20 at the end of 2017. The cash position of the CFC is $75, because $75, which is the sum of $50 (half of the $100 at the end of 2015) and $25 (half of the $50 at the end of 2016), is greater than the $20 at the end of 2017.

Example 8: A taxpayer is a U.S. shareholder that owns 100 percent of a CFC with a tax year ending October 31. The CFC has a cash position of $100 as of October 31, 2015; $50 as of October 31, 2016; $20 as of October 31, 2017; and $100 as of October 31, 2018. The CFC's cash position is $100, because $35, which is the sum of $25 (half of the $50 as of October 31, 2016) and $10 (half of the $20 as of October 31, 2017), is less than the $100 as of October 31, 2018.

The Senate bill had proposed that the cash position be determined based on the average cash position of each SFC on three dates — November 2, 2017, and the last day of the two most recent tax years ending before November 2, 2017 — to reduce the effect of "unusual or anomalous transactions."[13] The TCJA's formula has less muting of unusual or anomalous transactions that increase the cash position.

Cash position is defined in section 965(c)(3)(B) and Notice 2018-13[14] as the sum of the

[13] Conf. Rep. at 609.

[14] 2018-6 IRB 341. Notice 2018-26 provides that net accounts receivable do not include accounts receivable and accounts payable with an initial term of one year or more.

Table 7

	8% Rate Equivalent Percentage		15.5% Rate Equivalent Percentage	
Section 965(a) income	$100		$100	
Section 965(c) deduction	($77.14) [(35% - 8%)/35% x $100]		($55.71) [(35% - 15.5%)/35% x $100]	
Taxable income	**$22.86**		**$44.29**	
U.S. tax at 35%	$8		$15.50	
Individual tax on dividend	**20%**	**37%**	**20%**	**37%**
Distribution	$100	$100	$100	$100
Distribution of PTI (= above tax)	($8)	($8)	($15.50)	($15.50)
Taxable distribution	**$92**	**$92**	**$84.50**	**$84.50**
Federal individual income tax on distribution	**$18.40**	**$34.04**	**$16.90**	**$31.27**
Total U.S. taxes	$26.40	$42.04	$32.40	$46.77
Effective U.S. tax rate	**26.4%**	**42.04%**	**32.4%**	**46.77%**

corporation's cash, net accounts receivable, and the fair market value of its following assets: (1) personal property that is actively traded and for which there is an established financial market; (2) commercial paper, certificates of deposit, and government securities; (3) foreign currency; (4) any obligation with a term of less than one year; and (5) any asset that the Treasury secretary identifies as being economically equivalent to any described asset.

Although an SFC's section 965(a) income generally does not include earnings of its U.S. trade or business, its cash position includes the cash position assets of the U.S. trade or business.

Any cash position held by an E&P deficit foreign corporation (that is, an SFC with a deficit in post-1986 E&P) increases its U.S. shareholder's aggregate foreign cash position, even though the U.S. shareholder does not have section 965(a) income from such corporations.

Because cash position includes the FMV of personal property that is actively traded, an SFC with a publicly traded subsidiary corporation must include the FMV of its entire stock of the subsidiary in its cash position. The House bill provided some double counting rules for publicly traded subsidiaries, net accounts receivable, and obligations with a term of less than one year, none of which made it into the TCJA. Section 965(c)(3)(C) merely places the burden on the taxpayer to prove to the satisfaction of the Treasury secretary that any of the above three categories was already taken into account in the taxpayer's aggregate foreign cash position by that item being included in the cash position of another SFC of the U.S. shareholder. Some double counting and other exceptions were addressed in Notice 2018-7,[15] but not the stock of a publicly traded subsidiary corporation.

If a CFC had subpart F income in prior years, the subpart F income increased the CFC's PTI that could be distributed tax-free to shareholders. The distribution would have reduced the CFC's cash position. But if the CFC did not distribute its PTI, the undistributed cash is included in the CFC's cash position, thereby penalizing a CFC that did not distribute its PTI for nontax reasons. The result is hard to reconcile with the fact that the U.S. shareholder's section 965(a) income is reduced by the PTI under section 965(d)(2)(B). A better approach, which may require a statutory correction, would be for a U.S. shareholder's cash position to be reduced by PTI.

[15] 2018-4 IRB 1.

The Senate amendment had a provision that, regardless of the form in which an SFC holds earnings, the cash position does not include blocked income under section 964(b) that could not be distributed by the corporation because of local jurisdiction restrictions. The Senate's provision is not in the TCJA, so blocked income of an SFC can be included in its cash position. If the SFC is a CFC, the blocked income is not counted as part of its earnings under section 964(b), thereby further inflating the cash position relative to the CFC's earnings.

For a partnership that is a U.S. shareholder of an SFC, Notice 2018-26 provides that the section 965(c) deduction is determined at the partnership level and presumably based only on the partnership's aggregate foreign cash position. This may benefit a partner who has an excess cash position from interests in other SFCs held outside the partnership, since that cash position would not reduce the partnership's section 965(c) deduction allocated to the partner. A shareholder of an S corporation also apparently does not have to recompute their share of the S corporation's section 965(c) deduction for the 15.5 percent rate equivalent percentage.

4. Cash position of a noncorporate entity.

A noncorporate entity, such as a domestic or foreign partnership, is treated under section 965(c)(3)(E) as an SFC for cash position purposes generally if (1) an interest in the entity is held by an SFC of that U.S. shareholder and (2) the entity would be an SFC of the U.S. shareholder if the entity were a foreign corporation. It is unclear why, as a policy matter, section 965 does not provide for a simpler and more general look-through rule. The conference report is explicit that "the cash position of a U.S. shareholder does not generally include the cash attributable to a direct ownership interest in a partnership, but [the conference agreement] preserves the rule" in section 965(c)(3)(E).[16]

Section 965(c)(3)(E) focuses on whether the U.S. person ultimately owns indirectly 10 percent or more of the noncorporate entity. If a U.S. person owns 16 percent of a CFC that owns a 50 percent interest in a domestic (or foreign) partnership, the U.S. person owns only 8 percent of the domestic partnership indirectly and is therefore not a U.S. shareholder of the domestic partnership if it were a foreign corporation.

If a U.S. person owns 100 percent of a CFC that owns an 11 percent interest in a partnership, the section 965(c)(3)(E) analysis depends on whether the U.S. person is a C corporation or an individual. If the U.S. person is a domestic C corporation that indirectly owns 11 percent of the partnership, the partnership would be an SFC of its indirect corporate U.S. shareholder under section 965(c)(3)(E). In contrast, if the U.S. person is an individual who indirectly owns 11 percent of the partnership, the partnership's hypothetical status as an SFC would depend on whether another 10 percent partner of the partnership is a domestic C corporation or if more than 39 percent of the partnership is owned by other U.S. shareholders.

A U.S. shareholder under section 951(b) is a U.S. person who owns 10 percent or more of the total combined voting power of all classes of stock of a foreign corporation entitled to vote. If a U.S. person owns 100 percent of a CFC that is a 90 percent limited partner in a partnership, the U.S. person may not be a U.S. shareholder who owns 10 percent or more of the voting power of the partnership. The partnership might therefore not be an SFC if it were a foreign corporation, and the partnership's cash position is not taken into account.

C. Section 965(g) Limitation on FTC

Section 965(g) disallows either a fixed 77.1 percent or 55.7 percent of FTCs attributable to amounts included in income by section 965, based on whether the income was subject to the 8 percent or the 15.5 percent rate equivalent percentage.

Example 9: A domestic C corporation is a U.S. shareholder that owns 100 percent of a CFC. The domestic C corporation has $130 of income in 2017 as a result of the accumulated post-1986 deferred foreign income of the CFC, half of which is subject to the 8 percent rate equivalent percentage and half of which is subject to the 15.5 percent rate equivalent percentage. The CFC had paid $70 (35 percent) of foreign income taxes on $200 of foreign taxable income to arrive at each

[16] Conf. Rep. at 621.

$130 of accumulated post-1986 deferred foreign income. The domestic C corporation determines its federal corporate tax on the section 965(a) income as follows:

Table 8

	8% Rate Equivalent Percentage	15.5% Rate Equivalent Percentage
CFC taxable income	$100	$100
Foreign income tax	($35) [35%]	($35) [35%]
Section 965(a) income	**$65**	**$65**
Section 965(c) deduction	($50.14) [(35% - 8%)/35% x $65]	($36.21) [(35% - 15.5%)/35% x $65]
Section 78 gross-up	$8 [$35 x ($65 - $50.14)/$65]	$15.50 [$35 x ($65 - $36.21)/ $65]
Taxable income	**$22.86**	**$44.29**
U.S. Tax at 35%	$8	$15.50
Indirect FTC	$35	$35
Section 965(g) limitation	($26.99) [77.1% x $35]	($19.50) [55.7% x $35]
Allowed FTC	$8.02	$15.51
Net U.S. tax	**($0.02)**	**($0.01)**

A corporate U.S. shareholder with section 965(a) income in 2018, subject to 21 percent U.S. tax, would have a 61.9 percent or 26.19 percent section 965(c) deduction, but the taxpayer is still disallowed 77.1 percent and 55.7 percent of its FTCs. The effective result is that the foreign income tax must still be 35 percent or higher to entirely offset 2018 section 965(a) income with FTCs.

Example 10: Same facts as Example 9 except that the domestic C corporation has the section 965(a) income in 2018, subject to a 21 percent federal corporate tax rate. The domestic C corporation determines its federal corporate tax on the section 965(a) income as follows:

Table 9

	8% Rate Equivalent Percentage	15.5% Rate Equivalent Percentage
CFC taxable income	$100	$100
Foreign income tax	($35) [35%]	($35) [35%]
Section 965(a) income	**$65**	**$65**
Section 965(c) deduction	($40.24) [(21% - 8%)/21% x $65]	($17.02) [(21% - 15.5%)/21% x $65]
Section 78 gross-up	$8 [$35 x ($65 - $40.24)/$65]	$15.50 [$35 x ($65 - $17.02)/ $65]
Taxable income	**$38.10**	**$73.81**
U.S. tax at 21%	$8	$15.50
Indirect FTC	$35	$35
Section 965(g) limitation	($26.99) [77.1% x $35]	($19.50) [55.7% x $35]
Allowed FTC	$8.02	$15.51
Net U.S. tax	**($0.02)**	**($0.01)**

Section 965(g) disallows 77.1 percent or 55.7 percent of both direct and indirect FTCs. Since section 965 is taxing deemed income under U.S. tax principles, it is unlikely that a shareholder has direct FTCs from the deemed income event. The disallowance should apply to direct FTCs from foreign withholding taxes imposed on distributions made by the CFC in 2017 or a later year and attributable to the section 965(a) income.

The disallowance does not apply to the taxpayer's other FTCs, which may be 100 percent applied against the U.S. taxes imposed on the section 965(a) income as reduced by the section 965(c) deduction.[17]

Section 904 generally divides foreign-source income and FTCs into two baskets: passive category income and general category income. Subpart F income is passive category income generally to the extent that the CFC's underlying income is passive category income under section 904(d)(3)(B). For the CFC's active income, the subpart F income is general category income under reg. section 1.904-5(c)(1).

[17] *Id.* at 610 n.1500.

A foreign withholding tax may be imposed on a tax-free section 959 distribution of PTI, which is not definitely addressed by section 904. Section 904(d)(2)(H)(i) provides that a foreign tax imposed on an amount that does not constitute income under U.S. tax principles (base difference) is in the general category.

If the CFC's underlying income is all active income, its subpart F income, including the section 965(a) income, would all be general category income. ILM 200223022 suggests that PTI distributions are a base difference, and thus the FTC from foreign withholding taxes imposed on the distributions would be general category as well. However, if some of the CFC's underlying income is passive category income, the subpart F income — including the section 965(a) income — would consist of some passive category income.[18] Under the base difference rule, the FTC would be general category income and may cause a category mismatch.

For a non-CFC SFC, section 904(d)(4) generally provides that any dividend from a noncontrolled 10-percent-owned foreign corporation is allocated between the categories based on the foreign corporation's E&P. There is no categorization of the non-CFC SFC's section 965(a) income and PTI distributions. Section 965(e) and (f) provide that section 965(a) income from a non-CFC SFC is treated in the same manner as subpart F income for some purposes, but not specifically for section 904 purposes. Regulatory guidance may be helpful in avoiding category mismatch.

If direct FTCs are generated after the year of the section 965(a) income and after the following year (for which an FTC carryback is available), there could be a timing mismatch for a taxpayer that does not have enough other foreign-source income to use the FTCs. However, section 960(c) (section 960(b) before the TCJA) provides that if an individual or corporate shareholder has subpart F income in one year and has a direct FTC in a later year because of a distribution of PTI attributable to the subpart F income, the shareholder can generally increase its section 904 limitation and use those FTCs in the later year. Section 960(c) should apply to a U.S. shareholder who has section 965(a) income from a CFC and possibly from a non-CFC SFC.

D. Section 965(h) Election to Defer Tax

Section 965(h) allows a U.S. shareholder that is subject to additional U.S. tax under section 965 to elect to pay the net tax liability in eight annual installments. The first five installments are each 8 percent of the tax, the sixth installment is 15 percent, the seventh installment is 20 percent, and the eighth installment is 25 percent.

The net tax liability in section 965(h)(6)(A) that may be deferred is the excess of (1) the net income tax with section 965(a) income over (2) the net income tax determined without regard to section 965 and without regard to any income or deduction attributable to a dividend received by that U.S. shareholder from any DFIC. It is unclear why DFIC dividends may increase the deferred tax. If a U.S. shareholder has section 965(a) income in 2017 from a calendar-year DFIC and dividend income in 2017 from a fiscal-year DFIC, with section 965(a) income in 2018 from the second DFIC, the 2017 U.S. tax on the 2017 taxable dividend from the second DFIC apparently may be deferred. The intent may be to cover FTCs, which is less than effective when PTI distributions are not dividends under section 959(d).

Net income tax is defined in section 965(h)(6)(B) as the "regular tax liability reduced by the credits allowed under subparts A, B, and D of part IV of subchapter A," which is the regular federal income tax and not the AMT.

Example 11: A single individual taxpayer has $500,000 of ordinary income. She also has $1 million of section 965(a) income. The taxpayer is subject to a 10 percent state income tax on her $1.5 million of state taxable income, in a state that does not allow the section 965(c) deduction. For regular U.S. tax purposes, see Table 10.

The difference of $50,914 of regular income tax corresponds to a 39.6 percent regular U.S. tax rate on the additional $128,571 of net section 965(a) income (after the section 965(c) deduction and a $100,000 state income tax deduction). The first installment of $4,073 (8 percent) is due for the first year.

[18] Passive category section 965(a) income may include foreign personal holding company income that was previously not subpart F income because of the section 954(b)(4) high-tax exception.

Table 10

	Net Income Before State Tax Deduction	State Tax Deduction	Taxable Income	Federal Regular Income Tax
Section 965(a) income	$1,000,000	($100,000)	$900,000	$356,400 [39.6%]
Section 965(c) deduction	($771,429)	$0	($771,429)	($304,486) [39.6%]
Other ordinary income	$500,000	($50,000)	$450,000	$178,200 [39.6%]
Adjustment for lower brackets				($44,181)
Total	**$728,571**	**($150,000)**	**$578,571**	**$184,933**
Increase because of section 965			$128,571	$50,914

Table 11

	Net Income Before State Tax Deduction	State Tax Deduction	AMT Taxable Income	Tentative Minimum Tax
Section 965(a) income	$1,000,000	$0	$1,000,000	$280,000 [28%]
Section 965(c) deduction	($771,429)	$0	($771,429)	($216,000) [28%]
Other ordinary income	$500,000	$0	$500,000	$140,000 [28%]
Adjustment for lower brackets				($3,756)
Total	**$728,571**	**$0**	**$728,571**	**$200,244**
AMT (tentative minimum tax less regular income tax)				**$15,311**

For AMT purposes, see Table 11.

The taxpayer must pay $4,073 of regular U.S. tax and the full $15,311 of AMT for the section 965(a) income in the first year, in addition to the $134,019 of regular tax on other income.

If a taxpayer must pay an addition to tax for failure to make a timely installment payment, the entire remaining deferred tax is immediately due under section 965(h)(3). Acceleration also happens for a taxpayer liquidating, selling substantially all its assets, or ceasing to do business, but a sale of substantially all of a taxpayer's assets will not cause an acceleration of payments if the buyer agrees with Treasury to be liable to make the installment payments.

Section 965(h)(5) provides that the taxpayer must make the section 965(h) election on the filing due date, including any extension (for example, October 15, 2018), for the taxpayer's tax return for the year of the section 965(a) income. Section 965(h)(2) provides that the first installment payment must be made on the unextended due date (for example, April 17, 2018) of the tax return for the year of the section 965(a) income. All future installment payments must also be made by the unextended due date of the tax return for the relevant tax year. The taxpayer is required to make the first installment payment when the taxpayer might not know the correct liability, and an incorrect amount may result in an addition to tax that accelerates all remaining installment payments.[19]

Section 965(h)(4) provides that if a deficiency is assessed on the net tax liability deferred under section 965(h), the deficiency is prorated to the eight installment payments. Any portion prorated

[19]Section 6651(a)(2) imposes an addition to tax of 0.5 percent of the unpaid tax per month, up to 25 percent, for failure to timely pay a tax by the unextended due date, unless the failure is the result of reasonable cause and not willful neglect.

to an installment payment that is not yet due will be collected at the same time that the installment payment is due. But there is no proration if the deficiency is the result of negligence, intentional disregard of rules and regulations, or fraud with intent to evade tax, and the deficiency is instead entirely due upon notice and demand.

It is unclear how section 965(h)(4) interacts with section 965(h)(3). One interpretation of section 965(h)(4) is that it applies to the rare deficiencies assessed without an addition to tax and therefore without any acceleration of the remaining installment payments. Section 965(h)(4) could instead imply that the section 965(h)(3) acceleration of the remaining installment payments is not triggered for a typical addition to tax, but only for additions to tax for negligence, intentional disregard of rules and regulations, or fraud with intent to evade tax, which would cause section 965(h)(3) acceleration and therefore not need section 965(h)(4) proration; for all other deficiencies, the remaining installment payments are not accelerated, and the deficiencies are prorated to the remaining installment payments.

If a taxpayer has both section 965(a) income and other income, the installment payments are not accelerated by any failure to pay the regular U.S. tax liability on the other income. Similarly, for taxpayers who are subject to the AMT, their failure to pay the AMT liability does not cause any acceleration of the installment payments of the regular U.S. tax. The IRS Q&A advises taxpayers to pay their 2017 tax in two payments: one reflecting the 2017 tax on the section 965(a) income; and a second payment reflecting tax on other income, presumably including the AMT. It is unclear whether a shortfall in the first payment can be covered by any excess in the second payment, to avoid the acceleration of all installments.

The section 965(h) election is available for a DFIC's U.S. shareholder, which may be a domestic partnership. Because the election is to defer the taxpayer's regular U.S. tax liability attributable to the section 965(a) income, and a partnership does not have that tax liability, the partner should make the election. Although the section 965(h) election technically may be made only by partners who are also U.S. shareholders of the DFIC, Notice 2018-26 indicates that regulations will allow all partners to make the election.

For a U.S. shareholder that is an S corporation, section 965(i)(4) suggests that all the S corporation shareholders can make the section 965(h) election, which is confirmed by Notice 2018-26.

If an individual taxpayer made the section 962(b) election to subject the section 965(a) income to the U.S. corporate tax rate, that election should defer the corporate tax amount. Section 962(d) provides that the foreign corporation may make a tax-free distribution to the individual shareholder for the amount of U.S. tax "paid" on the section 965(a) income. A taxpayer who makes the section 965(h) election might not be considered to have paid the deferred tax installments until the installment is actually paid, for purposes of receiving tax-free distributions under section 962(d).

E. Section 965(i) Election for S Corporation

If an S corporation is a U.S. shareholder of a DFIC, the S corporation's section 965(a) income and section 965(c) deduction are passed through to the S corporation's shareholders. Section 965(i) permits each shareholder to defer payment of the U.S. tax on the section 965 amounts from the S corporation until a "triggering event." The section 965(i) election is unavailable for the AMT and the section 1411 tax, although it should apply to the deemed corporate tax from a section 962(b) election.

The S corporation may be a partner in a partnership. If the partnership is a U.S. shareholder of a DFIC, some of the partnership's section 965(a) income is allocated to the S corporation. If the S corporation itself is not a U.S. shareholder of the DFIC because the S corporation has insufficient indirect ownership of the DFIC, Notice 2018-26 provides that the section 965(i) election is not available for the section 965(a) income from the partnership.

Under section 965(i)(2)(A), a triggering event includes the corporation's ceasing to be an S corporation, a liquidation of the S corporation or similar circumstances, and transfer of S corporation stock (including by reason of death). However, a transfer is not a triggering event if the transferee enters into an agreement with Treasury under which the transferee is liable for the transferor's deferred net tax liability. Upon the occurrence of certain triggering events, the shareholder may elect under section 965(h), at the time of the triggering event, to further defer the tax and pay it in eight installments.

An individual U.S. shareholder may try to obtain the benefit of section 965(i) and defer tax indefinitely by contributing DFIC stock to an S corporation. If the DFIC is a fiscal-year taxpayer, the DFIC stock may be contributed to the S corporation in 2018 before the end of the DFIC's 2017-2018 tax year. That transaction may be challenged under section 269 and the section 965(o) regulatory authority given to Treasury to prevent avoidance of the purposes of section 965, including the purpose of the section 965(i) election.

F. Section 1411 Tax

The section 965(h) and (i) elections to defer the individual's regular U.S. tax on the section 965(a) income do not affect the section 1411 tax, which is generally a 3.8 percent tax on investment income. The two elections apply to a taxpayer's net tax liability imposed by chapter 1 of the code, whereas section 1411 is in chapter 2A.

Reg. section 1.1411-10(c) provides that subpart F income from a CFC is not investment income subject to the section 1411 tax until that income is actually distributed to the taxpayer (as PTI for regular tax purposes). A technical clarification should be made to include section 965(a) income from a non-CFC DFIC.

Alternatively, reg. section 1.1411-10(g) allows an individual taxpayer to elect to include subpart F income from a CFC as income for section 1411 purposes at the same time the income is included under the regular tax. Reg. section 1.1411-10(c)(1)(i)(B) provides that a distribution of PTI, which is not treated as a dividend under section 959(d) for regular tax purposes for the electing taxpayer, is also not treated as a taxable dividend for section 1411 purposes. The irrevocable election is made separately for each CFC, and the election applies for the year of the election and all later years. A technical clarification should permit the reg. section 1.1411-10(g) election for section 965(a) income from a non-CFC DFIC.

If an individual taxpayer makes a section 962(b) election and makes (or has made) the reg. section 1.1411-10(g) election, the section 1411 tax may be partially imposed twice. Because the section 962(b) election has no effect for section 1411 purposes, the section 965(a) income in the initial year should be subject to both regular federal corporate tax and section 1411 tax. A distribution subject to section 962(d) that is taxable income for regular federal individual income tax purposes is also a taxable dividend for section 1411 purposes, since it cannot be PTI excluded under reg. section 1.1411-10(c)(1)(i)(B). The effects of the double section 1411 taxation on E&P and section 1411 stock tax basis are unclear.

When subpart F income is included in the taxpayer's income for section 1411 purposes, reg. section 1.1411-4(f) provides an exclusive list of deductions allowed for section 1411 purposes, including section 163(d)(4)(C) investment expenses, but only if the deductions are allowed for regular tax purposes.

It is unclear how to treat the section 965(c) deduction for section 1411 purposes, which may vary depending on whether the taxpayer has made a reg. section 1.1411-10(g) election. The section 965(c) deduction may be an exclusion from income for section 1411 purposes, based on the approach in the IRS Q&A for the regular income tax. Alternatively, the section 965(c) deduction may be an investment expense deductible in 2017 but not in 2018, although that treatment may be precluded by Notice 2018-26's stated intention to treat the section 965(c) deduction as not an itemized deduction for regular U.S. tax purposes. The section 965(c) deduction may be a unique type of deduction that is not in reg. section 1.1411-4(f)'s exclusive list of allowed deductions and is therefore not deductible for section 1411 purposes.

If the section 1411 tax does not allow the section 965(c) deduction, the additional 3.8 percent tax on section 965(a) income will cause an individual to have an even greater tax rate on section 965(a) income when compared with corporate taxpayers. In contrast, a 77.1 percent or 55.4 percent section 965(c) deduction (or exclusion) would result in effective section 1411 tax rates of 0.87 percent or 1.69 percent, although it is not evident that there was any congressional intent to cut the section 1411 tax.

G. Stock Tax Basis Adjustment

Section 965(o) directs Treasury to prescribe regulations or other guidance for appropriate basis adjustments. Section 961 generally provides that a U.S. shareholder's basis in CFC stock is increased by subpart F income and decreased by tax-free distributions of PTI. To the extent that the taxpayer would reduce its stock tax basis below zero, the reduction is treated under section 961(b)(2) as gain instead.

A U.S. shareholder's tax basis in DFIC stock should be increased by the full section 965(a) income, similar to other subpart F income. If the U.S. shareholder also has an E&P deficit foreign corporation, it is unclear how the allocated deficit affects the basis adjustment.

For the taxpayer in Example 1, who has $1,038 of section 965(a) income from Corp. C after a reduction by $362 of E&P deficit, one method is to increase the stock tax basis in Corp. C by the net $1,038 of income under section 961(a). This increase falls short of the $1,400 increase in PTI under section 965(b)(4)(A), which may result in additional taxable income upon later PTI distributions or stock dispositions.

An alternative method, which may require explicit guidance from Treasury, is to increase the stock tax basis in Corp. C by $1,400. There should be a $362 corresponding decrease in the stock tax basis of the E&P deficit foreign corporations, as noted in the conference report.[20] A negative stock tax basis may result in gain under section 961(b)(2).

Prior to the existence of such guidance, section 1248(j) may apply to a corporate U.S. shareholder's disposition of its stock in Corp. C, to exclude up to $362 of gain as a dividend under section 1248(a) that is subject to the 100 percent section 245A DRD. Section 1248(d)(1) provides that Corp. C's E&P, for section 1248 purposes, excludes its $1,038 of E&P previously included in a shareholder's gross income under section 951, so Corp. C still has $362 of E&P that can be a dividend under section 1248(a).

It is possible for a taxpayer to recognize a DFIC's section 965(a) income taxed at 8 percent or 15.5 percent U.S. tax rates, obtain a stock tax basis increase, and sell the DFIC stock at a tax loss, which may offset the taxpayer's other income subject to higher U.S. tax rates. Tax rate arbitrages are addressed in other contexts by sections 1059 and 961(d), but not for section 965 purposes.

H. Section 965(n) NOL Election

Section 965(n)(1)(B) allows a U.S. shareholder of a DFIC to elect to not take into account its section 965(a) income and its section 965(c) deduction (and any related section 78 gross-up) in computing the section 172 net operating loss carryovers or carrybacks used during the year, thereby preserving the NOL carryovers and carrybacks for a later year. A U.S. shareholder may wish to make the section 965(n) election if the preserved NOL carryovers and carrybacks could reduce the U.S. tax on other taxable income before the end of the eight-year tax deferral under section 965(h) or the indefinite tax deferral under section 965(i). The section 965(n) election will also be beneficial if the foreign-source section 965(a) income gives rise to U.S. tax that can be offset by otherwise-expiring FTCs.

Section 965(n)(1)(A) further provides that an electing taxpayer may disregard its section 965 amounts in determining the allowed section 172 NOL deduction for the electing year. Since the section 172 NOL deduction is the sum of the taxpayer's allowed NOL carryovers and carrybacks, section 965(n)(1)(A) has the same effect as section 965(n)(1)(B) and is somewhat redundant. Section 965(n) does not explicitly apply to taxable losses incurred in the same tax year as the section 965 amounts, such as a shareholder with 2017 section 965(a) income and a net tax loss from other activities in 2017.

The legislative purpose for section 965(n) was more evident in the House bill, which did not have the section 965(n) election but provided that all FTCs paid or accrued (or treated as paid or accrued) for section 965(a) income are allowed a 20-year carryforward period instead of the usual 10 years. Congress explained that those FTCs should be available for longer since they might

[20] Conf. Rep. at 620-621.

not be allowed in the year of the income "by reason of section 904 limitations (e.g., because part or all of the section 965(a) income is offset by a net operating loss deduction)."[21] A 2017 loss was no different than an NOL carryover from 2016 under the House bill, in that the resulting unused FTCs may be carried forward longer. The Senate amendment may have chosen the alternative method of a section 965(n) election as a simpler approach, but there was no clear intention that a taxpayer with a loss in the same tax year as the section 965(a) income should be worse off under the Senate amendment than under the House bill.

In Notice 2018-26, Treasury viewed section 965(n)(1)(A) as ambiguous and announced that regulations will allow the section 965(n) election to apply to tax losses arising in the same tax year as the section 965(a) income. A taxpayer with 2017 section 965(a) income and a net tax loss from other activities in 2017 may generate an NOL carryover or carryback in 2017 by making the election.

For AMT purposes, section 56(a)(4) replaces the section 172 NOL deduction with the section 56(d) alternative tax NOL deduction. Any comprehensive regulations implementing the section 965(n) election would likely address the AMT-specific NOL modifications and any AMT tax loss arising in the same year as the AMT section 965(a) income, as well as the effects on section 1411 NOL deductions under reg. section 1.1411-4(h).

IV. Conclusion

Section 965 was enacted by the TCJA to transition the United States to a more territorial tax regime. The consequences of section 965 may not have been fully considered in all respects, given its complexity, its retroactive effect, and the many elections available to different taxpayers. Some of the unresolved questions have existed for some time but acquired greater importance under section 965, such as the effects of a section 962(b) election on distributions. Regulatory guidance and possibly statutory technical corrections are welcomed for many of the outstanding issues. ■

[21] *Id.* at 611.