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Proposed Regulations on “Toll Tax” Under Amended Section 965¹

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One of the hallmarks of the Tax Cuts and Jobs Act of 2017² (“TCJA,” or “Act”) is the imposition of a one-time “toll tax” on the undistributed, non-previously taxed post-1986 foreign earnings and profits (E&P) of certain U.S.-owned foreign corporations as part of the transition to a new territorial tax regime. The Act amended Section 965, which uses the mechanics of the subpart F regime to impose this tax.

On Aug. 1, U.S. Department of the Treasury and the IRS released lengthy proposed regulations under Section 965 (the Proposed 965 Regulations). The Proposed 965 Regulations, divided into nine sections, incorporate the rules described in prior guidance and introduce additional guidance on a range of issues relating to the implementation of Section 965.

The following provides a few highlights of the rules set forth in the Proposed 965 Regulations and the impact such rules have on the determination of various aspects of the toll tax calculation.

GENERAL: E&P

Section 965(a) increases the subpart F income of a “deferred foreign income corporation” (DFIC) for the last taxable year of such DFIC that begins before 2018 by the greater of tested E&P (*i.e.*, accumulated post-1986 deferred foreign income) measured on Nov. 2, 2017, or Dec. 31, 2017 [the Section 965(a) earnings amount]. For these purposes, a DFIC generally is any “specified foreign corporation” (SFC) that has positive earnings as of either measurement date. If Section 965 applies, a U.S. shareholder’s toll tax liability is determined by undertaking the following step-by-step approach: (1) measure post-1986 E&P of SFCs, (2) allocate E&P deficits, (3) calculate aggregate foreign cash position (AFCP), (4) compute allowed deductions under Section 965(c), and (5) determine foreign tax credits allowed.

A U.S. shareholder of a DFIC is required to include in income under Section 951(a)(1) its *pro rata* share of the Section 965(a) earnings amount of each DFIC. If, however, the taxpayer is a U.S. shareholder with respect to at least one DFIC and at least one “E&P deficit foreign corporation” (*i.e.*, an SFC with an accumulated E&P deficit as of the applicable measurement date), then Section 965(b) provides that the portion of the Section 965(a) earnings amount which otherwise would be taken into account under Section 951(a)(1) by the U.S. shareholder with respect to each DFIC is reduced by the amount of such U.S. shareholder’s “aggregate foreign E&P deficit” that is allocated to such DFIC. Therefore, in accordance with Sections 965(a) and (b), a U.S. shareholder of a DFIC must include in income under Section 951(a)(1) (as an increase to each DFIC’s subpart F income) its *pro rata* share of the Section 965(a) earnings amount of each DFIC, adjusted for the reduction provided by Section 965(b) [the Section 965(a) inclusion amount].

The Proposed 965 Regulations provide rules relating to E&P adjustments to account for the application of Sections 965(a) and (b). The Proposed Regulations also provide that Section 961(b)(2) gain which otherwise would be recognized as a result of a distribution from a DFIC in the toll tax year generally is



reduced (but not below zero) by the amount of Section 965(a) previously taxed income [Section 965(a) PTI]. This gain relief provision is also available with respect to Section 965(b) PTI for U.S. shareholders who make the election under Prop. Reg. sec. 1.965-2(f).

Prop. Reg. sec. 1.965-2(c) provides that a DFIC will have previously taxed E&P with respect to Section 965(a) inclusion amounts [referred to as the “Section 965(a) previously taxed E&P”]. For these purposes, any Section 965(a) inclusion amount is required to be translated (if applicable) into the functional currency of the DFIC using the spot rate on Dec. 31, 2017. Such Section 965(a) previously taxed E&P also reduces Section 959(c)(3) E&P of the DFIC. A deficit in E&P described in Section 959(c)(3) will be created or increased when the Section 965(a) inclusion amount with respect to the DFIC exceeds the E&P described in Section 959(c)(3) of the DFIC (e.g., when a DFIC sustains a loss after the measurement date).

E&P DEFICITS

Prop. Reg. sec. 1.965-2(d)(1) provides that any reduction to a DFIC’s Section 965(a) earnings amount will be considered previously taxed income under Section 965(b) [Section 965(b) PTI]. A parallel rule is provided for E&P deficit foreign corporations in Prop. Reg. sec. 1.965-2(d)(2), whereby such entities’ E&P is increased by the *pro rata* share of the specified E&P deficit of the E&P deficit foreign corporation taken into account under the reduction rules. For purposes of determining the Section 902 or Section 960 deemed paid credit associated with such deficit foreign corporation, such increase is deemed to occur on the first day of the first taxable year following the toll charge year.

Prop. Reg. sec. 1.965-2(e) provides rules for basis adjustments by reason of Section 965(a). Under Section 961(a), a Section 958(a) U.S. shareholder’s basis in Section 958(a) stock of a DFIC, or property by reason of which the Section 958(a) U.S. shareholder is considered as owning the Section 958(a) stock of a DFIC (applicable property), is increased by the Section 958(a) U.S. shareholder’s Section 965(a) inclusion amount with respect to the DFIC.

Prop. Reg. sec. 1.965-2(f) permits taxpayers to elect to make the following basis adjustments: (1) an increase in the Section 958(a) U.S. shareholder’s basis in the Section 958(a) stock of a DFIC or applicable property with respect to a DFIC by an amount equal to the Section 965(b) PTI of the DFIC with respect to the Section 958(a) U.S. shareholder, and (2) a corollary reduction in the Section 958(a) U.S. shareholder’s basis in the Section 958(a) stock of an E&P deficit foreign corporation or applicable property with respect to an E&P deficit foreign corporation by an

equal amount. This election must be made consistently for all foreign deficit corporations of the U.S. shareholder (and related persons), and in certain circumstances can give rise to gain.

PARTICIPATION EXEMPTION AND AFCP

Section 965(c) allows a U.S. shareholder of a DFIC to deduct, in each taxable year for which it has a Section 965(a) inclusion amount, a portion of the increased Section 951(a)(1) inclusion. The deductible amount is computed in a manner whereby, with respect to a domestic corporation U.S. shareholder, the Section 965(a) inclusion amount is taxed at a 15.5 percent effective rate to the extent of the U.S. shareholder’s aggregate foreign cash position and an 8 percent effective rate to the extent the inclusion exceeds the U.S. shareholder’s AFCP.

The Proposed 965 Regulations provide important rules for the determination of the “toll tax.”

The definition of AFCP under the Proposed 965 Regulations is consistent with prior administrative guidance. The preamble discusses several exceptions to the definition of AFCP requested in comments due to their insufficient “liquidity,” including cash held or attributable to an entity that is engaged in a regulated industry, such as life insurance. However, the Treasury and IRS provided no specific exceptions, pointing to legislative history and the statute itself, and difficulty of administering a rule that would provide exceptions. Comments are invited with respect to this issue.

FOREIGN TAX CREDITS

The Section 965 inclusion amount is treated as a dividend carrying deemed paid foreign taxes, but Section 965(g) provides that no credit will be allowed for 55.7 percent of the foreign taxes deemed paid with respect to the portion attributable to the AFCP, plus 77.1 percent of the foreign taxes paid with respect to the remainder of the mandatory toll tax inclusion. In other words, the foreign income taxes treated as deemed paid or accrued by a domestic corporation as a result of Section 965 are limited to those taxes in proportion to the taxable portion of the Section 965 inclusion amount.

The foreign tax credit provisions set forth in the Proposed 965 Regulations restrict the foreign tax credits allowed in connection with the toll tax in three distinct ways: (1) Prop. Reg. secs. 1.965-5(b) and (c)(1)(i) clarify that the section 965(g) disallowance applies to foreign taxes deemed paid under Section 960 as well

as any taxes imposed on the distribution of Sections 965(a) and (b) PTI; (2) Prop. Reg. sec. 1.965-5(c)(1)(ii) prevents taxpayers from claiming a credit for the portion of a foreign corporation's foreign taxes not deemed paid under Section 960(a)(1) because of the allocation of E&P deficits; and (3) Prop. Reg. sec. 1.965-6(c)(3) defers the Section 965(b)(4)(B) increase to the E&P of E&P deficit foreign corporations for purposes of Section 902.

In addition to the foreign tax credit disallowance provisions discussed above, Prop. Reg. sec. 1.965-6(d) prohibits taxpayers from treating as tax-exempt assets attributes created under the Section 965(a) inclusion [e.g., the Section 965(c) deduction, Sections 965(a) and (b) PTI, and the assets that give rise to them] for purposes of apportioning interest and other expenses. This includes the treatment of some or all stock as a tax-exempt asset under Section 864(e)(3).

ANTI-AVOIDANCE

Prop. Reg. sec. 1.965-4, consistent with Notice 2018-26, provides an anti-avoidance rule whereby the following transactions are disregarded for purposes of Section 965: (1) transactions undertaken with a principal purpose of changing the amount of a "Section 965 element" of a U.S. shareholder (as described below), (2) certain changes in method of accounting and entity classification elections, and (3) certain transactions occurring between measurement dates.

SECTION 965 ELECTIONS

Prop. Reg. sec. 1.965-7 provides guidance regarding eligibility, procedural mechanics, and timing for the following elections and payments: (1) Section 965(h) (elections to pay in installments) elections; (2) Section 965(i) elections (regarding S corporations and partnerships); (3) Section 965(m) elections [deferred inclusion for real estate investments trusts (REITs)]; (4) Section 965(n) elections [elections not to apply net operating loss (NOL) deductions]; and (5) the election to use the alternative method for calculating post-1986 E&P (the alternative method election).

Generally, the Proposed 965 Regulations require taxpayers to make the elections described above no later than the due date (with extensions) for the return for the related taxable year. The related taxable year for each election is determined by reference to the individual proposed regulation section. In order to make

the elections, taxpayers generally must attach a statement, signed under penalties of perjury, to their return that includes, but is not limited to, the taxpayer's name and taxpayer identification number. Relief under Treas. Reg. secs. 301.9100-2 or -3 is not available to make late elections.

AFFILIATED GROUPS

Prop. Reg. sec. 1.965-8 provides rules clarifying the application of Section 965 and the proposed regulations to members of an affiliated group [as defined in Section 1504(a)], and members of a consolidated group [as defined in Treas. Reg. sec. 1.1502-1(h)]. For purposes of Prop. Reg. sec. 1.965-8 only, all members of a consolidated group that are Section 958(a) U.S. shareholders of an SFC are treated as a single Section 958(a) U.S. shareholder for purposes of allocating aggregate foreign E&P deficits. However, each member of the consolidated group must separately compute foreign income taxes deemed paid with respect to a Section 965(a) inclusion.

CONCLUSION

The Proposed 965 Regulations provide important rules for the determination of the "toll tax." The Proposed 965 Regulations are generally proposed to apply beginning in the last tax year of a foreign corporation that begins before Jan. 1, 2018, and to U.S. persons beginning in the last tax year in which or with which the tax year of such a foreign corporation ends. Corporate taxpayers that are U.S. shareholders in foreign corporations which are on a calendar year basis would have to generally report the impact of section 965 in their 2017 U.S. tax return, whose extended due date is Oct. 15, 2018. ■

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ENDNOTES

- 1 This article is based on an alert issued by PwC's Washington National Tax Office: "IRS Issues Lengthy Proposed Rules on 'Toll Tax' Under Amended Section 965," August 2018.
- 2 P.L. 155-97.