

# Highlights of the final ‘toll tax’ regulations under Section 965

January 22, 2019

## In brief

Treasury and the IRS on January 15 released 305-page [final regulations](#) (the Final Regulations) under Section 965 as amended by the [2017 tax reform legislation](#) (the Act). The Final Regulations provide guidance relating to the ‘toll tax’ due upon the mandatory deemed repatriation of certain deferred foreign earnings.

The Final Regulations incorporate with modifications the rules described in the [proposed regulations](#) under Section 965 and set forth additional guidance on a range of issues relating to the implementation of that provision. Significant divergences from the rules in the Proposed Regulations include provisions for the basis adjustment elections, modifications to cash position determinations, and revisions to the five-step ordering rule for E&P adjustments (including the interaction of the ordering rule with foreign tax credits and disregarded payment rules). The Final Regulations also clarify the timing and manners of certain Section 965 elections and payments.

Taxpayers subject to Section 965 should immediately review the Final Regulations and determine the impact, if any, on their toll tax liability. Note that the Final Regulations update the transition rules relating to transfer agreements to provide that for acceleration events that occur on or before December 31, 2018, **a transfer agreement must be filed by January 31, 2019.**

Some of the key highlights we have identified thus far are set forth below. In addition, we will discuss the Final Regulations on a January 23 webcast, [‘Tax reform readiness: Finally final. The section 965 regulations.’](#)

## In detail

### Background

#### *Prior Section 965 guidance*

As discussed in prior PwC Insights, following the amendment of Section 965 by the Act, the IRS released [Notice 2018-07](#), [Notice 2018-13](#), [Rev. Proc. 2018-17](#), and [Notice 2018-26](#). (For prior coverage on ‘toll tax’

administrative guidance, refer to the ‘See also’ section at the end of this document).

Subsequently, on August 1, 2018, Treasury and the IRS released the Proposed Regulations relating to amended Section 965, which generally provided guidance relating to the mechanisms for determining foreign

untaxed earnings and profits (E&P) taken into account for Section 965 purposes and the deduction allowable to the US shareholder for such E&P. The Proposed Regulations also contained rules for basis adjustments as a result of a Section 965 inclusion, certain anti-abuse and disregarded payment

rules, elections available to taxpayers, and special provisions for affiliated and consolidated groups.

### Highlights of the Final Regulations

The Final Regulations, released January 15, 2019, retain the overall structure and basic approach of the Proposed Regulations. While the preamble acknowledges various comments submitted by taxpayers, the majority of such comments were not adopted in the Final Regulations. At the same time, the Final Regulations include significant revisions to certain provisions found in the Proposed Regulations. The following is a high-level summary of the key modifications and revisions in the Final Regulations.

#### *Determination of aggregate foreign cash position (AFCP)*

The Final Regulations generally did not adopt recommendations for exclusion from a specified foreign corporation's (SFC's) cash position of certain 'illiquid' assets, such as cash subject to local restrictions, cash earmarked to fund foreign acquisitions, and certain publicly traded stock. However, the Final Regulations include several provisions that may provide taxpayers some relief with respect to cash position determination:

- Commodities held as inventory or supplies, and hedging transactions related to such commodities, are generally excluded from the cash position definition.
- Bona fide hedging transactions that hedge an aggregate risk may be treated as a cash-equivalent asset transaction.

The Final Regulations provide additional guidance regarding application of the rule under Section 965(c)(3)(D) for prevention of the double-counting of cash position. For

example, double-counting relief with respect to an SFC is available when an amount is taken into account in determining the US shareholder's pro rata share of the cash position of another SFC on the other SFC's corresponding cash measurement date. The preamble to the Final Regulations notes that whether a notional cash pooling arrangement is treated as creating a loan between participants (rather than with an unrelated cash pool provider) depends on the particular facts and circumstances.

If a non-corporate entity is treated as an SFC for purposes of determining a US shareholder's AFCP (i.e., because interest in the entity is held by an SFC of such US shareholder), the Final Regulations provide that the US shareholder's pro rata share of the cash position of the non-corporate entity is reduced by the amount attributable to the deemed stock of the entity not owned (directly or indirectly) by an SFC of the US shareholder.

Departing from the Proposed Regulations, the Final Regulations also adopt single-shareholder treatment for consolidated groups -- the consolidated group AFCP is determined as if all group members that are Section 958(a) US shareholders of an SFC are a single US shareholder.

#### *Basis adjustment election*

Broadly, under the Proposed Regulations, a taxpayer may elect to increase basis in the stock of a directly held deferred foreign income corporation (DFIC) (or applicable property) 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 (or applicable property).

Consistent with [Notice 2018-78](#), the Final Regulations extend the time

period by which taxpayers falling under a transition rule may make the basis adjustment election. If such an election was made prior to the issuance of Final Regulations, it will be revocable for up to 90 days after the date the Final Regulations are published.

To alleviate the potential that a basis-shifting election may result in a downward basis adjustment in excess of available basis and thereby cause gain recognition, 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 US shareholder may generally designate each DFIC and E&P deficit foreign corporation stock (or applicable property) with respect to which the adjustments are made.

The Final Regulations permit taxpayers to not apply the to-the-extent rule and, instead, make the full adjustments that would have been required under the Proposed Regulations and recognize gain as necessary.

While the Final Regulations generally retain the consistency requirement, the rule is modified to require only for the basis election to be made by a Section 958(a) US shareholder and any related Section 958(a) US shareholder of an E&P deficit foreign corporation or DFIC with respect to which the shareholder's pro rata share of the Section 965(a) earnings amount is reduced under Section 965(b).

In addition, the Final Regulations align the timing for basis adjustments of Section 958(a) stock or applicable property with respect to an SFC with the basis timing rules of Section 961. Therefore, the Final Regulations provide that a specified basis adjustment is made as of the last day of the SFC's last taxable year that

begins before January 1, 2018, on which it is an SFC (not as of the close of the last day of the last tax year).

*Ordering rule for E&P adjustment, foreign tax credit determination*

The five-step ordering rule in the Proposed Regulations, relating to E&P adjustments for purposes of determining a US shareholder's inclusion under Sections 951 and 965 and applying Section 959, is modified in the Final Regulations broadly as follows:

- The ordering rule applies not only for an SFC's last tax year that begins before January 1, 2018, but also for an SFC's tax year in which an E&P measurement date (November 2, 2017, or December 31, 2017) occurs.
- Section 1248 amounts are determined at the same time as the determination of subpart F income under Section 951(a)(1)(A) in Step 1 (and as a result, Section 1248 amounts may reduce a buyer's Section 965(a) inclusion with respect to a target DFIC).
- The treatment of distributions between SFCs made before 2018 subject to the disregard rules of Treas. Reg. sec. 1.965-4 is redetermined and taken into account in Step 4 (at the same time as all distributions from the SFC other than those taken into account in Step 2).

Furthermore, the Final Regulations clarify the interaction of the E&P ordering rule and the determination of the foreign tax credit consequences of inclusions and distributions in the toll tax inclusion year. The Final Regulations provide that, after E&P adjustments are made in accordance with the Treas. Reg. sec. 1.965-2(b) ordering rule, the ordering rule set

forth in Treas. Reg. sec. 1.960-1(i)(2) applies for purposes of calculating Section 902 and Section 960 deemed paid taxes (i.e., Section 960 is applied first), except that Section 902 is applied with respect to any pre-2018 distributions from an SFC to another SFC that are not disregarded under Treas. Reg. sec. 1.965-4 before Section 960 is applied with respect to an inclusion or distribution in Steps 3 through 5 of the E&P ordering rule.

*Anti-avoidance and double counting relief*

The Proposed Regulations provide a general anti-avoidance rule that disregards transactions undertaken with a principal purpose of changing the amount of a 'Section 965 element' of a US shareholder. Certain enumerated transactions are presumed to be, or treated as per se, undertaken with a principal purpose of changing a Section 965 element.

The Final Regulations retain the approach in the Proposed Regulations, with certain modifications:

- In the case of an SFC liquidation, the liquidation date is generally treated as the last day of the SFC's tax year for purposes of determining the US shareholder's Section 965 element. Special rules apply with respect to liquidations resulting from entity classification elections.
- An exception from the anti-avoidance rules is available for certain incorporation transactions.
- With respect to a cash reduction transaction that is a distribution by an SFC to a US shareholder, there is not considered to be a plan or intention to transfer cash-equivalent assets to any SFC of the US shareholder if the transfer

is made pursuant to a legal obligation entered into before November 2, 2017.

- The anti-avoidance rule for disregarding a change of accounting method only applies if the change results in a reduction of the Section 965(a) inclusion amount or AFCP, or an increase in Section 960 deemed paid taxes (other than by reason of an increase in a Section 965(a) inclusion amount).

The Final Regulations also modify the prevention of E&P double-counting rule in the Proposed Regulations that disregards certain payments (including distributions) between SFCs occurring between E&P measurement dates. The Final Regulations eliminate the requirement that payor and payee SFCs must have different 'tentative measurement dates' in order for the payment to be subject to the disregard rule of Treas. Reg. sec. 1.965-4(f), but also provide the US shareholder with the option to determine the post-1986 E&P of an SFC without applying the double-counting relief rule to disregard the payments under Treas. Reg. sec. 1.965-4(f). If a US shareholder elects to not apply the Treas. Reg. sec. 1.965-4(f) disregard rule, such election must be consistently applied by all related US shareholders with respect to each of their SFCs.

The preamble to the Final Regulations also clarifies that if a dividend is not disregarded under the Treas. Reg. sec. 1.965-4(f) double-counting rule, the taxpayer must still consider whether the dividend is subject to Treas. Reg. sec. 1.965-4(b) anti-avoidance provisions.

*Other rules relating to E&P*

The Final Regulations clarify that even if the US shareholder does not have

an aggregate Section 965(a) inclusion amount (e.g., due to earnings being fully offset by deficits), the E&P of a DFIC can still be treated as Section 965(b) previously taxed income (PTI). Additionally, Section 965(b) PTI is treated as E&P attributable to an amount previously included in the income of a person under Section 951 for purposes of Section 1248(d)(1).

Further, the preamble to the Final Regulations confirms, based on the principles of Rev. Rul. 86-131, that the increase to Section 959(c)(2) PTI by reason of Section 965(b) can create a deficit in E&P described in Section 959(c)(3) if there is insufficient untaxed E&P to be reclassified.

The Final Regulations did not adopt a recommendation to allow taxes accrued in a US tax year after the one that includes November 2, 2017, to be taken into account for purposes of computing post-1986 E&P on the November 2 measurement date, on the ground that it is important to have certainty about Section 965-related amounts as of December 31, 2017.

#### *Determination of pro rata share of earnings and deficits*

The Final Regulations modify the pro rata share rule in the Proposed Regulations (which provides that the US shareholder's pro rata share of the toll tax E&P of a DFIC is determined on the last day of the DFIC's inclusion year) to account for cases in which a DFIC loses its SFC status during the inclusion year. The preamble notes that, to ensure consistency with the statutory language of Sections 951 and 965, the Final Regulations modify the definitions of 'pro rata share' and 'Section 958(a) US shareholder inclusion year' to cause a US shareholder's pro rata share of a DFIC's E&P to be determined as of the last day of the DFIC's inclusion year on which it is a SFC. However

unlike the Section 951(a)(2) rule, the DFIC's E&P is not prorated based on the portion of the inclusion year that the DFIC is not an SFC.

With respect to the E&P deficit of an E&P deficit foreign corporation, the Final Regulations clarify that the deficit is allocated among shareholders of the corporation's common stock based on the liquidation value. To the extent an E&P deficit foreign corporation's common stock has zero liquidation value, the deficit may be allocated to preferred stock (if any). This liquidation value approach is similar to the method adopted in the [proposed Section 951A regulations](#) for determining the pro rata share of tested losses for CFCs with multiple classes of stock outstanding.

#### *Foreign tax credits*

The Final Regulations clarify that if a taxpayer has no aggregate Section 965(a) inclusion amount, then the disallowance of the applicable percentage of foreign taxes under Section 965(g)(1) is 55.7%.

In conjunction with that rule, the Final Regulations further clarify that the applicable percentage applies with respect to domestic pass-through owners and with respect to distributions of previously taxed E&P even if the domestic pass-through owner does not have a Section 965(a) inclusion amount.

The Final Regulations add new Treas. Reg. sec. 1.965-6(d), which provides that, to the extent a hovering deficit would have been absorbed by current-year E&P but for its inclusion in income under Section 965, such current-year E&P is considered available for hovering deficit offset and such offset is treated as occurring as of the last day of the DFIC's inclusion year. Therefore, the taxes related to such hovering deficit offset

may be taken into account for purposes of determining post-1986 foreign income taxes.

#### *Downward attribution*

The Final Regulations increase the de minimis threshold for the application of the special attribution rule for purposes of determining SFC status by reason of downward attribution from a partner to a partnership from 5% to 10%, and add a similar attribution rule for trusts.

#### *Section 965 elections*

Under Section 965(h), Section 958(a) US shareholders may elect to pay their 'net tax liability' over an eight-year period. The net tax liability is equal to the taxpayer's net income tax for the inclusion year minus net income tax determined 1) without regard to Section 965, and 2) 'without' regard to income or deductions attributable to dividends from DFICs. The Final Regulations clarify that the 'without' computation also disregards any inclusions under Sections 951(a)(1)(B) and 956.

The Final Regulations provide additional guidance on Section 965(h)(3) acceleration events, including adding covered acceleration events (and allowing for the parties to enter into a transfer agreement) for situations where a consolidated group ceases to exist.

The Final Regulations update the transition rules relating to transfer agreements to provide that for acceleration events that occur on or before December 31, 2018, **a transfer agreement must be filed by January 31, 2019**. No exceptions or relief was provided.

#### *Effective dates*

Consistent with the Proposed Regulations, the Final Regulations generally apply beginning the last tax

year of a foreign corporation that begins before January 1, 2018, and to US persons beginning the last tax year in which or with which the tax year of such a foreign corporation ends.

### **The takeaway**

Although the Final Regulations generally follow the structure and approach set forth in the Proposed Regulations, there are significant modifications that are likely to impact a taxpayer's 'toll tax' calculation.

Taxpayers should immediately review the Final Regulations to determine whether their 'toll tax' liability may be affected.

The above-mentioned highlights are not an exhaustive list of the provisions in the Final Regulations.

#### **See also:**

- [IRS issues lengthy proposed rules on 'toll tax' under amended Section 965](#)

- [Third Section 965 Notice on the 'toll tax' calls for immediate action](#)
- [IRS provides 'toll tax' reporting guidance](#)
- [Treasury and IRS release Revenue Procedure on toll tax](#)
- [Second IRS Notice issued regarding the 'toll tax' under amended Section 965](#)
- [IRS Notice addresses the 'toll tax' under amended Section 965](#)

### **Let's talk**

For a deeper discussion of how this might affect your business, please contact:

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