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Global Tax Alert

US Final Section 965 regulations have implications for S corporations, partnerships and individuals

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This Tax Alert examines how recently finalized regulations under Section 965[1] (the Final Regulations) affect taxpayers investing through domestic and foreign pass-through entities, including partnerships, S corporations, trusts, and estates, as well as individuals. Specifically, this Tax Alert will cover foreign tax credits under Section 965(g), Section 965(h) installment elections (including the eligible transferee exception discussed in Treas. Reg. Section 1.965-7(b)), and Section 965(i) elections for S corporation shareholders to defer tax (including the eligible transferee exception in Treas. Reg. Section 1.965-7(c)). Finally, this Tax Alert will address the modifications to the Section 962 regulations as they apply to Section 965. A detailed discussion of provisions not covered in this Alert can be found in EY Global Tax Alert, *US Final Section 965 regulations largely follow proposed regulations, but include significant changes*, dated 28 January 2019.

Most importantly, taxpayers who made Section 965(h) or Section 965(i) elections for their 2017 Section 965 tax liability, and who may have had an acceleration or triggering event on or before 5 February 2019 have until 7 March 2019 to file any applicable transfer agreements. A detailed discussion of acceleration and triggering events, as well as transfer agreements, can be found later in this Alert.

An overview of Section 965

Under Section 965(a), the subpart F income of a specified foreign corporation (SFC), in its last tax year beginning before 1 January 2018 (Measurement Year), increases by the greater of its accumulated post-1986 deferred foreign income

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determined as of 2 November 2017, and 31 December 2017 (the Section 965(a) Earnings Amount and the Measurement Dates, respectively). The tax resulting from the increase to subpart F income is commonly known as the "Transition Tax." An SFC is any controlled foreign corporation (CFC) (within the meaning of Section 957) and any other foreign corporation that has at least one 10% corporate United States (US) shareholder. An SFC that has accumulated post-1986 deferred foreign income is known as a deferred foreign income corporation (DFIC).

Generally, a US shareholder (within the meaning of Section 951(b)) only has a Section 965(a) reporting obligation or inclusion with respect to the stock of an SFC, a DFIC, or an E&P deficit foreign corporation[2] that the US shareholder owns, directly or indirectly, under Section 958(a).[3] Under Section 965(b), if a US shareholder owns at least one DFIC and at least one earnings and profits (E&P) deficit foreign corporation, then the amount of the Section 965(a) earnings that would otherwise be included in the US shareholder's income is reduced by the amount of the US shareholder's share of the aggregate foreign E&P deficit. The net amount is the Section 965(a) inclusion amount.

An SFC's accumulated post-1986 deferred foreign income equals its post-1986 E&P on a Measurement Date, reduced by any E&P attributable to income that: (i) is effectively connected with the conduct of a trade or business in the United States (ECI) and subject to tax under the Code; or (ii) would, if distributed, be excluded from the gross income of a US shareholder under the Section 959 exclusion for previously taxed E&P (PTI). Generally, the post-1986 E&P of an SFC equals E&P accumulated in years ending after 31 December 1986, but only during periods in which the foreign corporation was an SFC, reduced for dividends paid during the inclusion year to other SFCs.

Under Section 965(c), a US shareholder is entitled to a deduction that reduces the effective tax rate on the Section 965(a) inclusion amount. The amount of the deduction depends on the aggregate foreign cash position of the SFC.

Treas. Reg. Sections 1.965-5 and 1.965-6: Foreign tax credits

Section 965(g)(1) and (3), respectively, disallow a foreign tax credit under Section 901 (including deemed paid credits under Section 960) and any deduction for the "applicable percentage" of any foreign income "taxes paid or accrued (or treated as paid or accrued)" with respect to any amount for which a Section 965(c) deduction is allowed. The applicable percentage of a taxpayer's foreign tax credit disallowance is proportionate to the deduction afforded under Section 965(c) for the associated income.

The Final Regulations clarify that, for domestic pass-through owners, the reduction in foreign tax credits or deductions applies to the applicable percentage of taxes deemed paid by a domestic pass-through owner when an SFC distributes Section 965(b) PTI, even if the domestic pass-through entity does not have a Section 965(a) inclusion amount.

Implications: The disallowance of the "applicable percentage" prevents taxpayers from taking a credit or deduction for foreign taxes paid attributable to the Section 965(c) deduction even if the taxpayer does not have a Section 965(a) inclusion. When a domestic pass-through entity does not have a Section 965(a) inclusion amount, its domestic pass-through owners must reduce their credits for the applicable percentage of foreign taxes deemed paid on a distribution of Section 965(b) PTI.

Treas. Reg. Sections 1.965-7(b) and 1.965-7(c): Eight-year installment election and S corporation shareholder deferral election

Section 965(h) allows a US shareholder of a DFIC to elect to pay the net Section 965 tax liability over eight years through installment payments with no interest charge (8-year Installment Election). If an acceleration event occurs, however, then the unpaid portion of all remaining installments is due on the date of the acceleration event. An eligible Section 965(h) transferee exception exists for certain covered acceleration events, which prevents the immediate acceleration of the Section 965 tax liability.

Section 965(i) allows a shareholder of an S corporation that is, by attribution, a US shareholder of a DFIC to elect to defer payment of the shareholder's net tax liability under Section 965 with respect to the S corporation until the shareholder's tax year in which a triggering event occurs with respect to the liability (S corporation Deferral Election). For a triggering event, any Section 965(i) net tax liability will be assessed as an addition to tax for the shareholder's tax year in which the triggering event occurs. An eligible Section 965(i) transferee exception exists, however, for the transfer of any share of stock of the S corporation by the shareholder (including by reason of death or otherwise), which prevents the immediate triggering of the Section 965(i) net tax liability.

Signature requirement

Similar to the Section 965 proposed regulations (the Proposed Regulations), the Final Regulations provide specific instructions for taxpayers (i.e., individual Section 958(a) US shareholders or domestic pass-through owners of domestic pass-through entities that are Section 958(a) US shareholders) to make the 8-year Installment Election or the S corporation Deferral Election. Under the Proposed Regulations, it was unclear whether taxpayers must attach originally signed Section 965(h) elections and Section 965(i) elections to their tax returns. The Final Regulations clarify that the signature requirement is satisfied if an unsigned copy is attached to a timely-filed return of the person making the election, provided that the taxpayer retains a copy of the signed original. Furthermore, the Preamble to the Final Regulations explains that the general rules concerning who is authorized to sign tax returns apply to the Section 965 election statements.

Implication: Generally, spouses who file a joint income tax return must each sign the income tax return. Thus, both spouses should sign any Section 965 election statements.

Acceleration events and triggering events

Consistent with the Proposed Regulations, the Final Regulations identify acceleration events beyond those listed in the statute, including (i) an "exchange or other disposition" of substantially all of the assets of the person, (ii) death, and (iii) ceasing to be a US person. Similarly, the Final Regulations, consistent with the Proposed Regulations, treat an "exchange or other disposition" of substantially all of the assets of an S corporation as a triggering event for purposes of the S corporation deferral election.

The Internal Revenue Service (IRS) and Treasury Department received comments requesting that certain tax-free exchanges, such as those described in Section 351 or Section 721, not be treated as acceleration events or triggering events. The Preamble to the Final Regulations, however, states that Treasury is concerned that excluding non-taxable transactions from the definition of acceleration events or triggering events would impede the efficient administration and collection of transition tax. Accordingly, the Final Regulations retain as an acceleration event an "exchange or other disposition" of substantially all of a person's assets, and retain as a triggering event an "exchange or other disposition" of substantially all of an S corporation's assets, including via transactions that are otherwise non-taxable under the Code.

The IRS and Treasury also received comments requesting that the death of a transferor not be treated as an acceleration event for purposes of Section 965(h). The IRS and Treasury did not change the Final Regulation on the basis that an individual's death is similar to a transfer or other disposition of substantially all of a taxpayer's assets.

Another commenter suggested that, if death is an acceleration event, it should be treated as a covered acceleration event, which would allow the transferor and transferee to enter into a transfer agreement to prevent the immediate acceleration of the payment of the tax. The IRS and Treasury did not adopt this change to the Final Regulations because they believe there are administrative difficulties with transferring liabilities and executing transfer agreements in the event of death. In addition, as described later, a transfer to multiple transferees is not permitted for purposes of a Section 965(h) transfer agreement, and there could be multiple beneficiaries in the event of death.

Implications: Treating death as an acceleration event presents administrative difficulties as taxpayers generally are not prepared to have a check mailed to the IRS on their date of death. Individuals and trusts, particularly those that are shareholders of S corporations, should be mindful of the consequences of tax-free exchanges while a Section 965 tax liability is outstanding as a result of elections under Section 965(h) or (i).

Transfer agreements

As previously stated, certain events may not cause the Section 965 tax to be accelerated or triggered, provided that the requirements specified in the Final Regulations are satisfied, including when an eligible transferor and eligible transferee enter into a transfer agreement. One requirement, applicable to both Section 965(h) and (i) transfer agreements, is that the eligible transferor must attach its most recent Form 965-A (for individuals and trusts) or 965-B (for corporations) to the transfer agreement. The Final Regulations clarify that the form must be filed with the transfer agreement only if the transferor was required to file Form 965-A or 965-B. According to Q6 of "Questions and Answers about Tax Year 2018 Reporting and Payments Arising under Section 965," either Form 965-A or 965-B must be attached to a taxpayer's 2018 income tax return. Thus, if a transfer agreement must be filed before the due date for the 2018 income tax return, it is unclear from the Final Regulations whether Form 965-A or 965-B must be attached to the transfer agreement.

Implication: Although Form 965-A or 965-B is not required to be filed until the due date of the 2018 income tax return, taxpayers filing transfer agreements before the due date of the 2018 income tax return may consider preparing and submitting Form 965-A with their transfer agreements, if practical.

Consistent with the Proposed Regulations, the transfer agreement process for taxpayers making Section 965(i) elections is only available for a "covered triggering event" arising from the transfer of any share of S corporation stock by the shareholder (including by reason of death or otherwise) that results in a change of ownership for federal tax purposes. When a triggering event occurs due to a sale, exchange or other disposition of substantially all of the assets of the S corporation, or because the S corporation revokes its subchapter S election, the electing S corporation shareholders may not enter into a transferee agreement. Rather, the full amount of the shareholder's deferred net Section 965 tax liability becomes due in the year of the triggering event. The S corporation may make an 8-year Installment Election under Section 965(h), which must be filed with the return for the year in which the triggering event occurs.

The Final Regulations provide that, when the Section 965(i) triggering event arises as a result of a transfer of substantially all of the S corporation's assets, a Section 965(h) election may only be made with the consent of the Commissioner. For S corporation shareholders to obtain the consent of the Commissioner to make a Section 965(h) election in the year in which a triggering event occurs under Section 965(i), the taxpayers must file a consent agreement within 30 days of the occurrence of the triggering event and include a copy of the agreement with their timely-filed return for the year in which the triggering event occurs (with extensions).

Implication: It is critical that S corporation shareholders be made aware of transactions undertaken by the S corporation in order to permit the shareholder to obtain consent to make a Section 965(h) election if the transaction could constitute a triggering event under Section 965(i).

Consistent with the Proposed Regulations, the Final Regulations require a transfer agreement to be filed within 30 days of the date that an acceleration event occurs (for the 8-year Installment Election) or within 30 days of the date that a triggering event occurs (for the S corporation Deferral Election). The Final Regulations include transition rules stating that, if an acceleration event or triggering event occurred on or before 5 February 2019, the transfer agreement must be filed by 7 March 2019, to be considered timely filed.

Implication: The provision of the due date for acceleration and triggering events on or before 5 February 2019 is welcome relief for many taxpayers who did not realize they had acceleration or triggering events occurring in 2018. Now is the time for taxpayers to review any 2018 and early 2019 transactions to determine whether an acceleration or triggering event has occurred and file any transfer agreements, if applicable, by 7 March 2019.

When an S corporation shareholder dies, the Final Regulations require the transfer agreement to be filed by the later of the due date (without extensions) for the eligible Section 965(i) transferor's final income tax return or 7 March 2019. In addition, the Final Regulations clarify that, if the identity of the beneficiaries is known as of the due date for the transfer agreement, then the S corporation stock is treated as transferred from the eligible Section 965(i) transferor decedent directly to each of the eligible Section 965(i) transferees. In contrast, if the identity of the beneficiaries is not known as of the due date for the transfer agreement, then the S corporation stock is treated as transferred from the eligible Section 965(i) transferor decedent to his or her estate, and then transferred from the estate to the beneficiaries when the shares are actually transferred.

Implication: If the identities of the beneficiaries of the estate are not known as of the due date for the transfer agreement, then a second transfer agreement will be needed when the estate actually distributes the S corporation stock to the beneficiaries.

The Final Regulations add an additional requirement that must be included in the Section 965(h) and (i) transfer agreements. Under this rule, a transfer agreement must include a statement as to whether the "leverage ratio" of the eligible Section 965(h) transferee or eligible Section 965(i) transferee immediately after the acceleration event or triggering event exceeds three to one. The term "leverage ratio" is defined as the ratio the eligible transferee's total indebtedness bears to the sum of its money and the adjusted bases of all other assets reduced (but not below zero) by the total indebtedness. For Section 965(h) acceleration events, the Preamble to the Final Regulations explains that a transferee with a leverage ratio exceeding three to one may be an eligible Section 965(h) transferee; the IRS will use that information, however, to evaluate the validity of

the representation that the transferee has the ability to pay the assumed Transition Tax liability. Presumably, the same standard applies to an eligible Section 965(i) transferee, although the Preamble is silent on this.

Implication: Determining the leverage ratio could be time-consuming for individuals who do not maintain personal balance sheets. Transferees with leverage ratios exceeding three to one should carefully consider whether their other facts and circumstances support the position that they are able to pay the Transition Tax liability assumed.

Section 965(i)(2)(B) treats a partial transfer of S corporation stock as a triggering event only for the portion of the net Section 965(i) tax liability allocable to that stock. The Final Regulations clarify that, if there are multiple partial transfers of S corporation stock (e.g. when the S corporation shareholder dies), the eligible Section 965(i) transferor can enter into multiple transfer agreements with multiple eligible Section 965(i) transferees. The IRS and Treasury did not adopt a comment requesting that multiple transferees be allowed to be eligible transferees in the case of a Section 965(h) acceleration event because Section 965(h), unlike Section 965(i), does not contemplate partial transfers.

Section 965(i) and trusts

The Proposed Regulations raised uncertainty as to whether certain trusts, grantors, or beneficiaries could make the Section 965(i) election or be treated as "eligible Section 965(i) transferees" for transfers of S corporation stock. The reason for this uncertainty stems from the fact that "domestic pass-through entities" may not make the Section 965(i) election and are not treated as "eligible Section 965(i) transferees" for transfers of an S corporation's shares.

The Final Regulations confirm that grantor trusts and qualified subchapter S trusts (QSSTs) are treated as domestic pass-through entities, and the grantor of a grantor trust and the beneficiary of a QSST make the Section 965(i) election and sign transfer agreements as eligible Section 965(i) transferees if shares of an S corporation are transferred to such a trust. In contrast, the trustee of an electing small business trust makes the Section 965(i) election and signs a transfer agreement as the eligible Section 965(i) transferee.

The Proposed Regulations also raised uncertainty as to whether a transfer of S corporation stock was treated as a triggering event when the income tax owner of the S corporation stock did not change, *e.g.*, a transfer from a grantor to a grantor trust. The Final Regulations clarify that the transfer of S corporation stock constitutes a triggering event only if the transfer results in a change in ownership of the stock for US federal income tax purposes.

Implications: The refined definition of a triggering event is welcome relief for many S corporation shareholders who were uncertain as to whether transfers between grantors and grantor trusts were treated as triggering events requiring transfer agreements. S corporation shareholders should be mindful of any transfer or other transaction that results in a change in owner for income tax purposes. For example, the conversion of a grantor trust to a non-grantor trust constitutes a change in ownership for US federal income tax purposes and may be treated as a triggering event.

Section 962 elections

Section 962 permits an individual who is a US shareholder of a CFC to elect to be taxed on subpart F income, including Section 965(a) inclusions, at corporate income tax rates under Section 11. If an election is made under Section 962, the amounts included in the individual's gross income under Section 951(a) are treated as if they were received by a domestic corporation, which also permits the individual to claim foreign tax credits for deemed-paid foreign taxes. Actual distributions received by the electing US shareholder from the foreign corporation, however, are taxable again to the extent the distribution exceeds the amount of tax paid by the electing US shareholder with respect to the subpart F inclusion.

Treasury and IRS received comments requesting clarification on the basis adjustments required to be made when a Section 962 election applies to a distributive share from a pass-through entity. The Preamble to the Final Regulations acknowledges the issue but notes that it is outside of the scope of regulations concerning Section 965.

Where the Proposed Regulations reserved, the Final Regulations promulgated Treas. Reg. Section 1.965-2(e)(2), which provides that, for Section 958(a) US shareholders who have made a Section 962 election for the transition tax inclusion year, the increase in the basis in their DFIC stock (otherwise provided under Section 961(a)) cannot exceed an amount equal to the amount of tax paid with respect to the DFIC. Such basis adjustments must be made "taking into account any [Section] 965(h) election made by the [Section] 958(a) US shareholder." The Preamble to the Final Regulations indicates that Section 958(a) US shareholders

who have made both a Section 965(h) election and a Section 962 election for the inclusion year may only increase their tax basis in the DFIC stock as they pay their Section 965(h) net tax liability over time. Further, the IRS declined to adopt a comment that suggested accelerating those basis adjustments when the Section 958(a) US shareholder sells the DFIC stock before completing the Section 965(h) installment payments.

Implications: Some individuals and trusts may have made Section 962 elections on their 2017 federal income tax returns, and many more may consider the election for 2018 and on due to the new Global Intangible Low Taxed Income regime. As suggested in the Preamble to the Final Regulations, complex issues exist for owners of domestic pass-through entities that make Section 962 elections for amounts flowing through those entities. Without additional guidance, taxpayers will need to carefully consider the consequences of making the election and reasonably interpret the existing guidance.

Section 1411 Net Investment Income Tax (NIIT)

Section 1411, commonly known as the net investment income tax or NIIT, generally imposes a 3.8% tax on the net investment income of high-income individuals and of certain trusts and estates. Specifically, the NIIT applies to the lesser of (i) net investment income (NII), or (ii) the excess (if any) of the individual's modified adjusted gross income (MAGI) over a threshold amount. In general, investment income includes: interest, dividends, capital gains, rental and royalty income, non-qualified annuities, income from businesses involved in trading of financial instruments or commodities and businesses that are passive activities to the taxpayer. Generally, deductions allowed for regular income tax purposes are allowed in computing "net investment income," but only to the extent they are properly allocable to investment income.

The Final Regulations confirm that a Section 965(c) deduction is an above-the-line deduction taken into account in arriving at adjusted gross income. Consistent with the Proposed Regulations, the Final Regulations do not treat the Section 965(c) deduction as a deduction properly allocable to a corresponding Section 965(a) inclusion.

Implications: Because NIIT applies to the lesser of NII or MAGI in excess of a threshold, taxpayers with AGI that is predominately comprised of NII will receive the benefit of the Section 965(c) deduction if NII is greater than MAGI over the threshold amount. In contrast, taxpayers with predominately non-NII income will not get the benefit of the 965(c) deduction because the NIIT will apply to NII, which is not reduced by the Section 965(c).

Endnotes

1. All "section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
2. An E&P deficit foreign corporation is, with respect to a US shareholder, an SFC with respect to which, as of 2 November 2017, (1) the SFC had a deficit in post-1986 E&P, (2) the corporation was an SFC, and (3) the shareholder was a US shareholder of the corporation.
3. Section 958(a) provides that stock owned means stock owned directly, and stock owned indirectly through foreign corporations, foreign partnerships, foreign trusts or foreign estates.

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