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Client Alert Commentary

Latham & Watkins Transactional Tax Practice | April 11, 2018 | Number 2303

New Guidance Issued for Transition Tax on Deferred Foreign Earnings

Anti-avoidance rules and limitations on application of the stock attribution rules among the topics to be addressed in forthcoming regulations.

Key Points:

- Certain transactions intended to reduce transition tax liability will be disregarded.
- Limitations imposed on downward attribution of stock from partners to partnerships.
- Reporting, election, and payment requirements clarified.

On April 2, 2018, the US Department of the Treasury (Treasury) and the Internal Revenue Service (the IRS) issued Notice 2018-26 (the Notice) describing regulations that Treasury and the IRS intend to issue regarding certain aspects of the "transition tax" under Internal Revenue Code Section 965.[1] As discussed in a recent Latham & Watkins *White Paper*, Section 965, enacted by the Tax Cuts and Jobs Act (the Act) on December 22, 2017,[2] imposes a one-time tax on the deferred foreign earnings of certain US-owned foreign corporations as part of the transition to a partial participation dividends-received deduction tax regime. Calculation of the transition tax liability is complex, but fundamentally based on two numbers, post-1986 earnings and the amount of cash or cash equivalents held by a foreign corporation. This *Client Alert* summarizes the primary changes announced in the Notice, which taxpayers may rely upon prior to the issuance of the regulations.[3]

Latham & Watkins has published additional materials analyzing Section 965 and the Act more generally. The firm will continue to share insights and provide resources, including worthwhile third-party content, through the Latham & Watkins US Tax Reform Resource Center.

Certain avoidance transactions disregarded

The Notice announces that Treasury and the IRS intend to issue regulations under which certain transactions undertaken with a principal purpose of reducing a taxpayer's transition tax liability will be disregarded for purposes of determining such liability. The Notice is the first guidance issued under Section 965 that specifically addresses so-called "avoidance" transactions. Under these rules, for purposes of determining a US shareholder's transition tax liability, the IRS will disregard transactions that:

- Occur, in whole or in part, on or after November 2, 2017 (one of the dates on which the deferred foreign earnings subject to tax may be measured)

- Would, if not disregarded, reduce a US shareholder's transition tax liability (by, for instance, reducing the amount of foreign earnings subject to tax or reducing the share of such earnings that are considered to be held in cash, which are taxed at a higher rate than earnings held in non-cash assets)

- Are undertaken with a principal purpose of reducing a US shareholder's transition tax liability

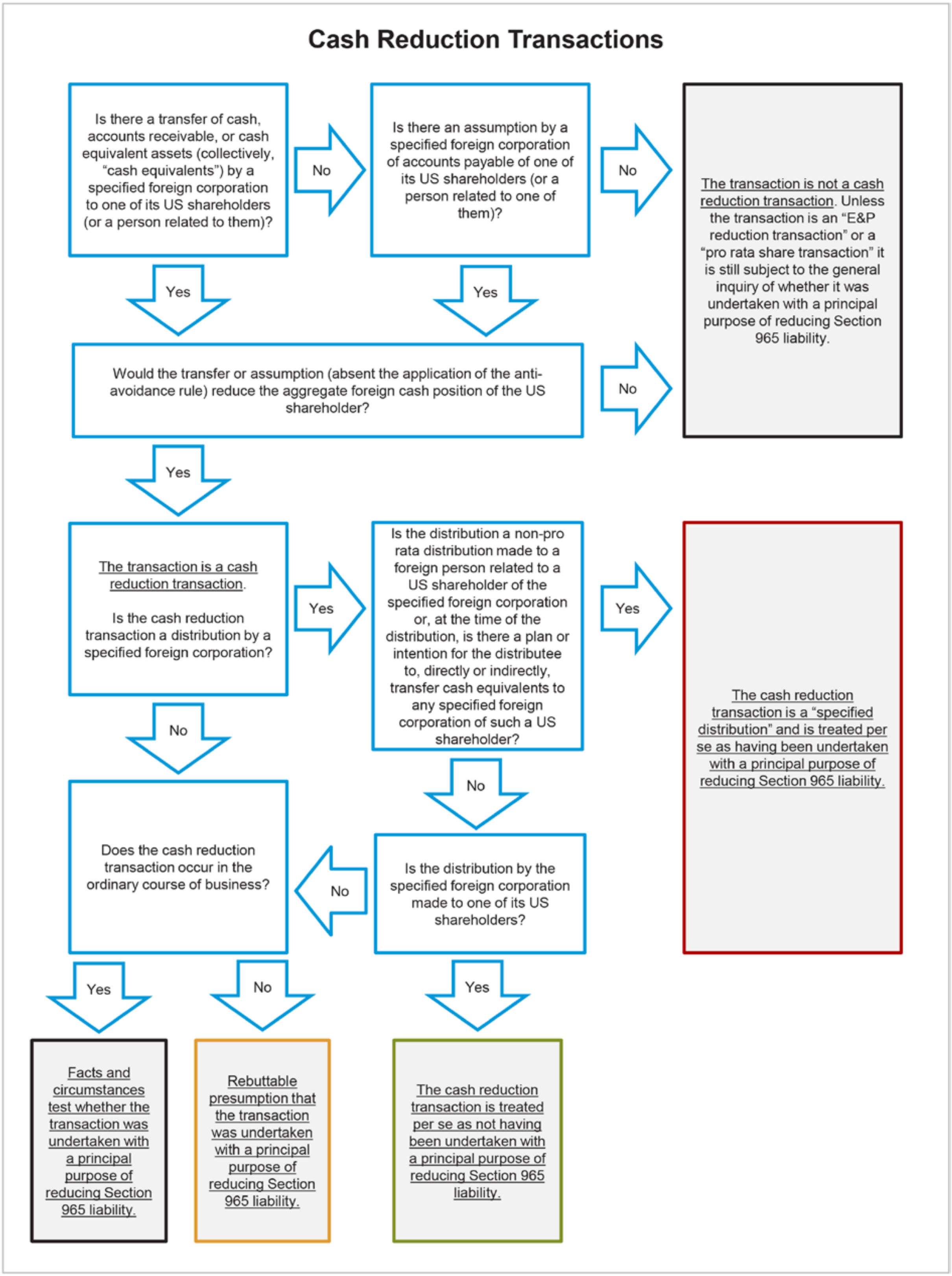
The Notice describes three sets of transactions that, if occurring, in whole or in part, on or after November 2, 2017, the IRS will presume were undertaken with a principal purpose of reducing a US shareholder's transition tax liability: cash reduction transactions, E&P reduction transactions, and pro rata share transactions.

- <u>Cash reduction transactions</u> are transfers by a "specified foreign corporation" (any controlled foreign corporation (CFC) and any other foreign corporation with respect to which one or more domestic corporations are US shareholders) to (i) a US shareholder or a person related to such US shareholder of cash, accounts receivable, or cash equivalents or (ii) an assumption by a specified foreign corporation of an accounts payable of a US shareholder or person related to such US shareholder, if such transfer or assumption would reduce the aggregate foreign cash position of the US shareholder. Such transactions occurring in the ordinary course of business, however, will not be presumed to have an avoidance purpose. Distributions by a specified foreign corporation to a US shareholder will be treated per se as not being undertaken with a principal purpose of reducing a taxpayer's transition tax liability. However, (i) certain non-pro rata distributions to a foreign person that is related to the US shareholder and (ii) distributions made when there was a plan or intention for the distributee to transfer cash, accounts receivable, or cash equivalents to any specified foreign corporation owned by the US shareholder will be treated as per se having been undertaken with a principal purpose of reducing a taxpayer's transition tax liability.

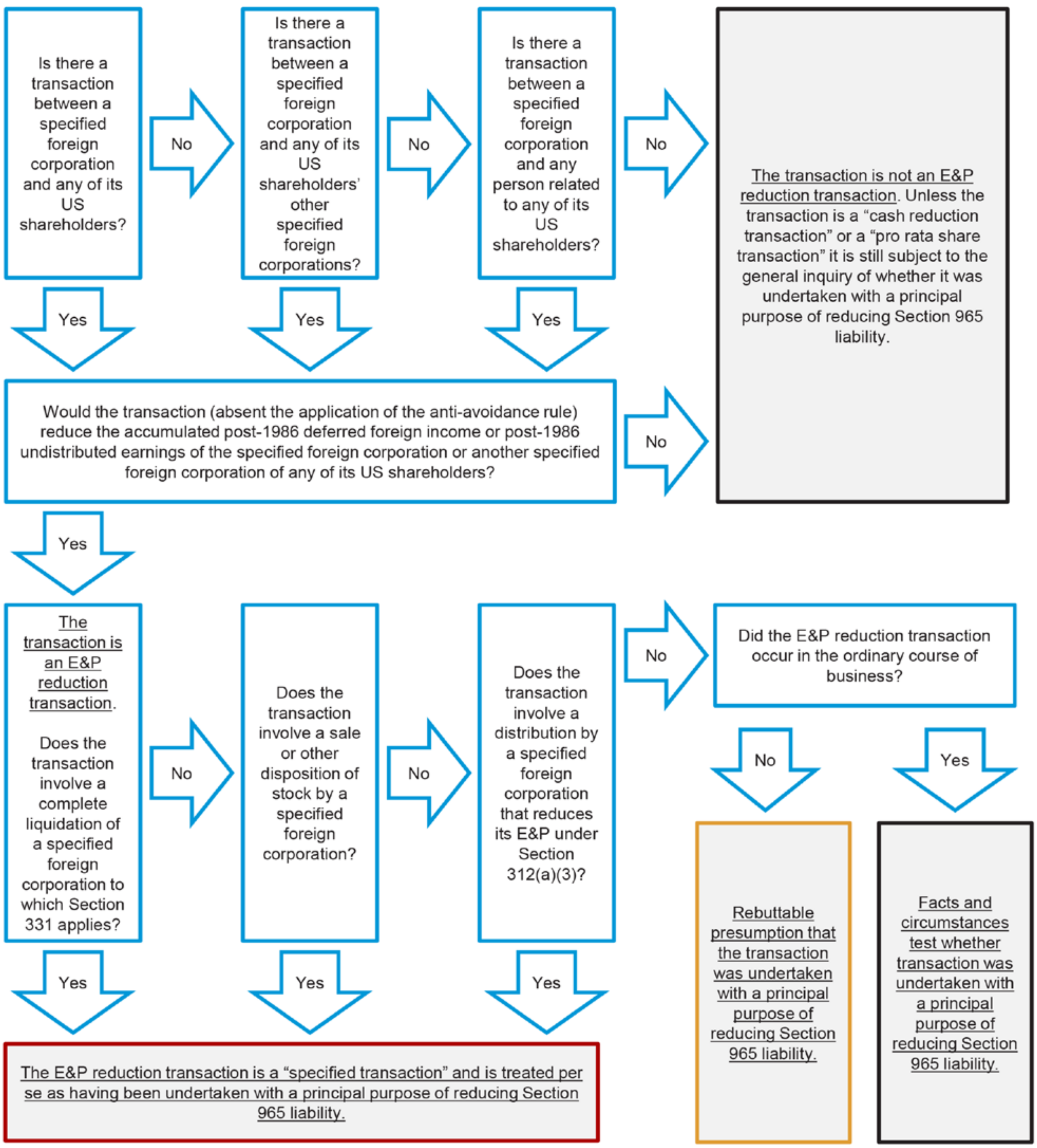
- <u>E&P reduction transactions</u> are defined broadly to include any transaction between a specified foreign corporation and a US shareholder of such corporation, another specified foreign corporation of such a US shareholder, or any person related to such a US shareholder, which would reduce the amount of deferred foreign earnings subject to the transition tax. Transactions occurring in the ordinary course of business will not be presumed to have an avoidance purpose; however, certain complete liquidations, stock sales or dispositions, and distributions will be treated per se having been undertaken with a principal purpose of avoidance.

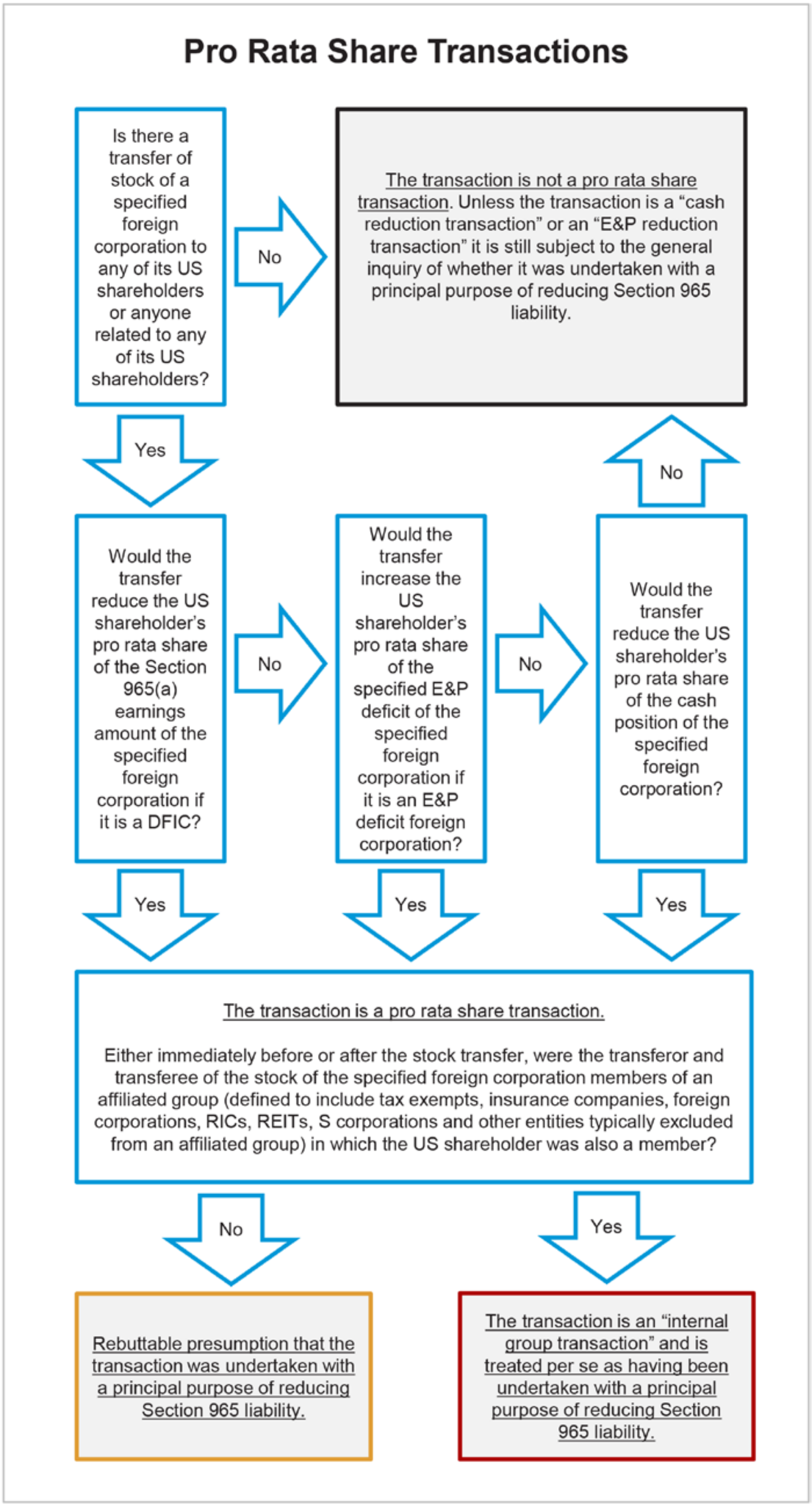
- <u>Pro rata share transactions</u> are transfers of stock of a specified foreign corporation to a US shareholder of such corporation or a person related to such a US shareholder that would (i) reduce such shareholder's pro rata share of the specified foreign corporation's cash position or amount of earnings subject to the transition tax; or (ii) increase such shareholder's pro rata share of the specified E&P deficit of the specified foreign corporation if it is an E&P deficit corporation. Transfers of stock between members of an affiliated group of which the US shareholder is also a member will be treated as per se having been undertaken with a principal purpose of avoidance.

The following charts illustrate application of these rules:

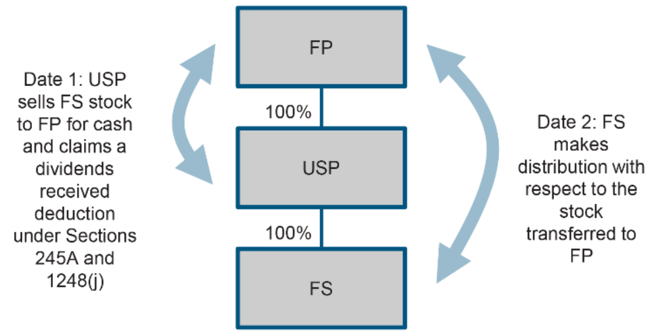

Cash Reduction Transactions
Is there a transfer of cash, accounts receivable, or cash equivalent assets (collectively, "cash equivalents") by a specified foreign corporation to one of its US shareholders (or a person related to them)?
No
Is there an assumption by a specified foreign corporation of accounts payable of one of its US shareholders (or a person related to one of them)?
No
The transaction is not a cash reduction transaction. Unless the transaction is an "E&P reduction transaction" or a "pro rata share transaction" it is still subject to the general inquiry of whether it was undertaken with a principal purpose of reducing Section 965 liability.
Yes
Yes
Would the transfer or assumption (absent the application of the anti-avoidance rule) reduce the aggregate foreign cash position of the US shareholder?
No
Yes
The transaction is a cash reduction transaction.
Is the cash reduction transaction a distribution by a specified foreign corporation?
Yes
Is the distribution a non-pro rata distribution made to a foreign person related to a US shareholder of the specified foreign corporation or, at the time of the distribution, is there a plan or intention for the distributee to, directly or indirectly, transfer cash equivalents to any specified foreign corporation of such a US shareholder?
Yes
The cash reduction transaction is a "specified distribution" and is treated per se as having been undertaken with a principal purpose of reducing Section 965 liability.
No
No
Does the cash reduction transaction occur in the ordinary course of business?
No
Is the distribution by the specified foreign corporation made to one of its US shareholders?
Yes
No
Yes
Facts and circumstances test whether the transaction was undertaken with a principal purpose of reducing Section 965 liability.
Rebuttable presumption that the transaction was undertaken with a principal purpose of reducing Section 965 liability.
The cash reduction transaction is treated per se as not having been undertaken with a principal purpose of reducing Section 965 liability.

E&P Reduction Transactions




Pro Rata Share Transactions
Is there a transfer of stock of a specified foreign corporation to any of its US shareholders or anyone related to any of its US shareholders?
No
The transaction is not a pro rata share transaction. Unless the transaction is a "cash reduction transaction" or an "E&P reduction transaction" it is still subject to the general inquiry of whether it was undertaken with a principal purpose of reducing Section 965 liability.
Yes
No
Would the transfer reduce the US shareholder's pro rata share of the Section 965(a) earnings amount of the specified foreign corporation if it is a DFIC?
No
Would the transfer increase the US shareholder's pro rata share of the specified E&P deficit of the specified foreign corporation if it is an E&P deficit foreign corporation?
No
Would the transfer reduce the US shareholder's pro rata share of the cash position of the specified foreign corporation?
Yes
Yes
Yes
The transaction is a pro rata share transaction.
Either immediately before or after the stock transfer, were the transferor and transferee of the stock of the specified foreign corporation members of an affiliated group (defined to include tax exempts, insurance companies, foreign corporations, RICs, REITs, S corporations and other entities typically excluded from an affiliated group) in which the US shareholder was also a member?
No
Yes
Rebuttable presumption that the transaction was undertaken with a principal purpose of reducing Section 965 liability.
The transaction is an "internal group transaction" and is treated per se as having been undertaken with a principal purpose of reducing Section 965 liability.

Example of Pro Rata Share Transaction



Transfer of FS stock treated as pro rata share transaction because FP is related to USP and the transfer would reduce USP's transition tax liability with respect to FS.

Transfer also per se treated as being undertaken with a principal purpose of avoidance since USP and FP are members of an affiliated group.

In order to rebut the presumption that a cash reduction transaction, E&P reduction transaction, or pro rata share transaction was undertaken with a principal purpose of reducing a taxpayer's transition tax liability, the Notice states that a US shareholder must "attach a statement to its income tax return for its taxable year in which or with which the relevant taxable year of the relevant specified foreign corporation ends disclosing that it has rebutted the presumption." A US shareholder may rebut the presumption only if the facts and circumstances clearly establish that the transaction was not undertaken with a principal purpose of reducing the US shareholder's transition tax liability.

In addition, the Notice announces that Treasury and the IRS intend to issue regulations whereby certain changes in accounting methods and/or entity classification elections that reduce a taxpayer's transition tax liability will be disregarded for purposes of computing such liability, regardless of whether such changes were made with a principal purpose of reducing a US shareholder's transition tax liability.

Observations

- The Notice creates four categories of transactions for purposes of the anti-avoidance rules: (i) those that the IRS will disregard per se; (ii) those that the IRS will presumptively disregard; (iii) those that require an analysis of facts and circumstances under a subjective approach; and (iv) those that the IRS will per se not disregard.

- Only transactions that occur, in whole or in part, on or after November 2, 2017 are subject to being disregarded under the anti-avoidance rules. Regulations may clarify the meaning of "transaction" and "in whole or in part" for purposes of these rules.

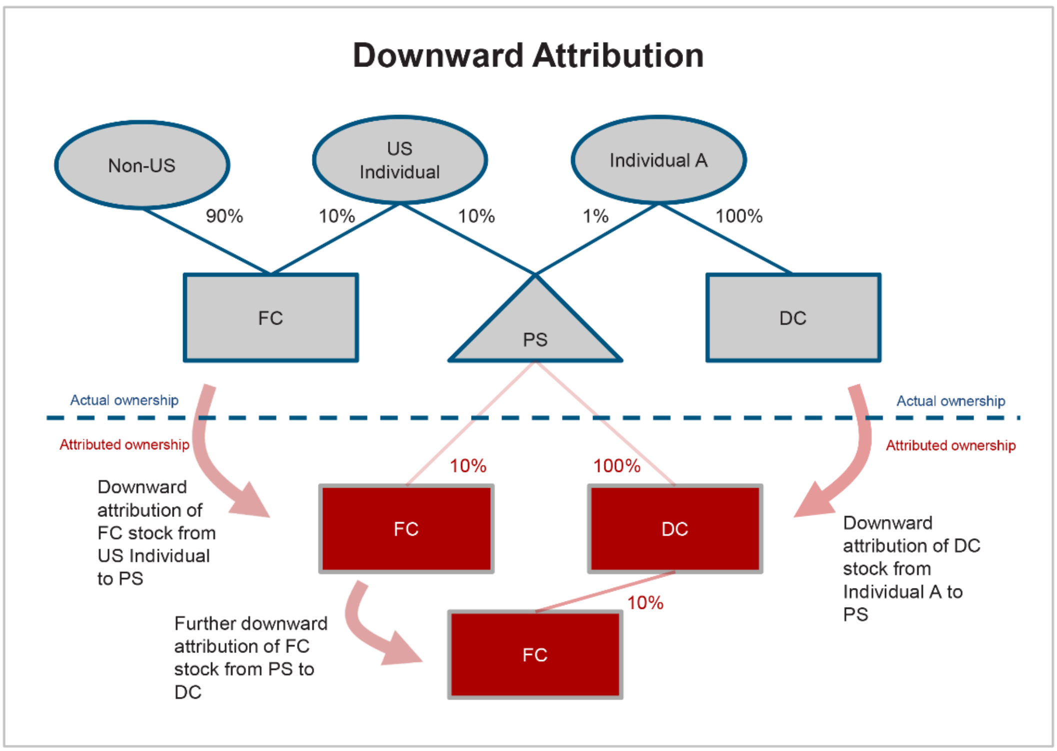
- Regulations may also specify how a principal purpose of avoidance will be determined for transactions that do not fall under one of the three specified transaction types.

- The Notice does not elaborate on how taxpayers may rebut a presumption that a transaction was taken with a principal purpose of avoidance. Additional guidance on this question may be forthcoming.

Downward attribution limited to 5% partners

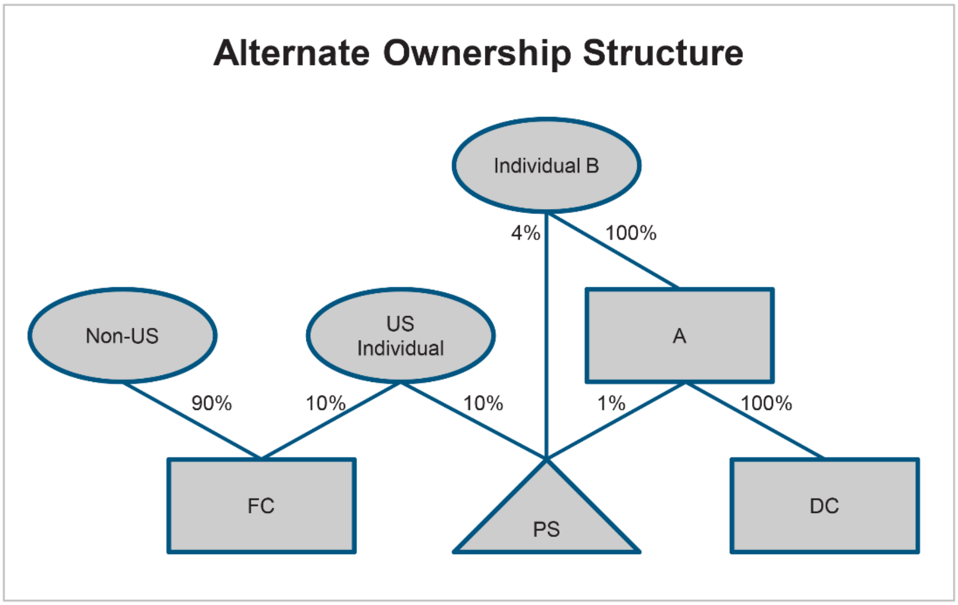
As discussed above and described in detail in a previous [Latham & Watkins *White Paper*], the transition tax is based on a US shareholder's pro rata share of its deferred foreign income corporation (DFIC) subsidiaries' post-1986 undistributed E&P. A DFIC is a specified foreign corporation that has accumulated post-1986 deferred foreign income. As noted above, a specified foreign corporation is any CFC and any other foreign corporation with respect to which one or more domestic corporations are US shareholders. A domestic corporation is a US shareholder of a foreign corporation if the domestic corporation owns, actually or constructively, by vote or value, 10% or more of the foreign corporation's stock.

By repealing the rule that formerly provided that stock owned by a foreign person is not attributed to a US person, the Act made certain "downward attribution" rules applicable to the determination of whether a US person, including a domestic corporation, constructively owns 10% or more of a foreign corporation's stock. This change, coupled with the rule that all stock owned, directly or indirectly, by or for a partner is attributed to the partnership regardless of the extent of the partner's interest in the partnership, can lead to unexpected constructive ownership of corporate stock, as illustrated below.



In the example above, because of downward attribution, DC becomes, via the constructive ownership rules, a US shareholder of FC and FC is therefore a specified foreign corporation, despite the fact that FC has no direct or indirect US corporate shareholders. The US Individual is therefore a US shareholder of a specified foreign corporation and, absent an exception, would be subject to the transition tax on his or her pro rata share of FC's post-1986 undistributed E&P.

The Notice addresses this situation by providing that, solely for purposes of determining whether a foreign corporation is a specified foreign corporation, stock actually or constructively owned by a partner in a partnership will not be considered as owned by the partnership unless the partner owns at least 5% of the partnership's capital or profits. Thus, in the example above, Individual A's DC stock would not be attributed to PS because Individual A owns only 1% of PS. Note, however, that if Individual A actually or constructively owned 5% of PS, unexpected results would still arise. For example, if Individual A were instead Corporation A, wholly owned by Individual B who also owned 4% of PS (as shown below), Individual B's interest in PS would be attributed to Corporation A under the downward attribution rules and Corporation A would therefore constructively own 5% of PS. Under this alternate ownership structure, the US Individual would again be a US shareholder of FC, a specified foreign corporation, and, absent an exception, the US Individual would be subject to the transition tax on his or her pro rata share of FC's post-1986 undistributed E&P.

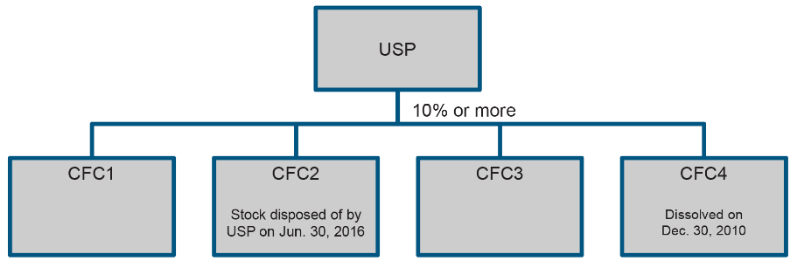


Clarification of cash measurement dates

The Act imposes the transition tax at two different rates: 15.5% on E&P to the extent of the US shareholder's aggregate foreign cash position (including cash and other liquid assets) and 8% on all residual E&P. The foreign cash position of a specified foreign corporation is the greater of (i) the average of its foreign cash position on the first and second cash measurement dates and (ii) its foreign cash position on the final cash measurement date. The Notice addresses how these three cash measurement dates are determined with respect to a US shareholder that does not own the specified foreign corporation on all of the cash measurement dates, including by reason of the specified foreign corporation ceasing to exist. The Notice also provides that a US shareholder must take into account its pro rata share of the specified foreign corporation's cash positon as of any cash measurement date on which it was a US shareholder of the specified foreign corporation regardless of its ownership of the foreign corporation on other cash measurement dates.

The first cash measurement date of a specified corporation is the close of the last taxable year of the specified foreign corporation that ends after November 1, 2015, and before November 2, 2016, if any. The second cash measurement date of a specified corporation is the close of the last taxable year of the specified foreign corporation that ends after November 1, 2016, and before November 2, 2017, if any. The final cash measurement date is the close of the last taxable year of the specified foreign corporation that begins before January 1, 2018, and ends on or after November 2, 2017, if any. The approach taken by the Notice is illustrated by the following example.

Cash Measurement Dates



	CFC1	CFC2	CFC3	CFC4
Taxable year of CFC	Calendar Year	Calendar Year	Dec. 1 – Nov. 30	Dec. 1 – Nov. 30
First cash measurement date	Dec. 31, 2015	Dec. 31, 2015	Nov. 30, 2015	N/A
Second cash measurement date	Dec. 31, 2016	N/A	Nov. 30, 2016	N/A
Final cash measurement date	Dec. 31, 2017	N/A	Nov. 30, 2018	N/A

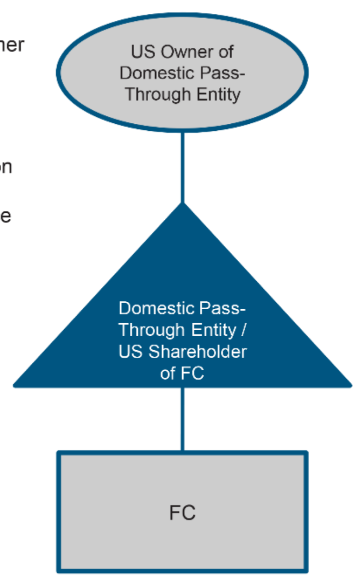
Special rules for pass-through entities

The Notice clarifies whether certain determinations with respect to US shareholders that are pass-through entities, such as S corporations or partnerships, will be made at the level of the pass-through entity itself or at the level of the owner of such pass-through entity. Most notably, the Notice states that the transition tax will be calculated at the entity level, but owners ultimately will be liable for their share of the tax regardless of whether such owner is a US shareholder with respect to the foreign corporation. Additional rules with respect to pass-through entities are illustrated below.

Domestic Pass-Through Entities

Determinations at owner Level:
- Liability for transition tax regardless of whether owner is a US shareholder of FC
- Elections to
  - Pay transition tax over 8 years
  - Be subject to tax at corporate rates
  - Include income subject to the transition tax over 8 years if owner is a REIT
  - Not to apply NOL deductions to reduce transition tax liability

Determinations at entity level
- Calculation of transition tax liability



Other announcements

The Notice also provides that:

- Certain foreign income taxes accrued by specified foreign corporations after November 2, 2017 but on or before December 31, 2017 will be allocated to periods ending on or before November 2, 2017, if they are attributable to such periods. This rule is intended to eliminate situations in which foreign taxes imposed after November 2, 2017 — but which are attributable to earnings as of that date — are not treated for US federal income tax purposes as accrued as of that date, and consequently do not reduce the amount of earnings subject to the transition tax.

- Estimated tax underpayment penalties associated with the payment of the transition tax will be waived, regardless of whether a taxpayer elects to pay the transition tax over eight years.

- Under Section 965(n), a taxpayer can elect to determine the amount of a net operating loss deduction without regard to Section 965. The Notice provides that if an election under Section 965(n) is made with respect to a tax year that includes an inclusion year of a DFIC, the amount of a net operating loss for that tax year will be determined without taking into account as gross income the Section 965(a) inclusion amount or the corresponding Section 965(c) deduction. Also, regulations will clarify that an election made under Section 965(n) will be treated as made with respect to both the amount of a net operating loss for that tax year and the net operating loss carryovers or carrybacks for such taxable year.

- Only accounts receivable and payable with a term of less than one year will be included for purposes of determining the foreign cash position of a specified foreign corporation.

- Treasury and the IRS intend to issue forms, publications, regulations, or other guidance specifying the documentation needed to demonstrate that certain items should not be taken into account in determining the foreign cash position of a specified foreign corporation.

Conclusion

While the Notice removes some uncertainty and provides relief as to certain aspects of Section 965, the announcement of robust anti-avoidance rules will require taxpayers to analyze whether recent transactions will affect the calculation of their transition tax liability. Treasury and the IRS have requested comments on both the rules described in the Notice and additional guidance that they expect to issue on Section 965.

Latham & Watkins will continue to report on forthcoming guidance relating to the transition tax and the Act generally, through additional *Client Alerts* and on the Latham & Watkins US Tax Reform Resource Center.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

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Endnotes

[1] All references to "Section" are to sections of the Internal Revenue Code of 1986, as amended (the Code), unless otherwise indicated.

[2] Formally, An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, Pub. L. No. 115-97, 131 Stat. 2054 (codified in scattered sections of 26 U.S.C.).

[3] The Notice expands upon previous Treasury/IRS guidance regarding the implementation of Section 965. See Notice 2018-07, Notice 2018-13 and Rev. Proc. 2018-17.