ISSUE BRIEF
SECTION 965

Section 965, enacted as part of P.L. 115-97 on December 22, 2017,[1] levies a one-time transition tax on a US shareholder's pro rata share of the net positive deferred foreign earnings of its foreign subsidiaries (defined as a "specified foreign corporation" (SFC) for this purpose).[2] The deferred foreign earnings amount is subject to the transition tax at two rates: 15.5% on the amount equal to the US shareholder's aggregate foreign cash position (AFCP) and 8% on the remainder.[3] The AFCP of a US shareholder equals the greater of (i) the US shareholder's aggregate pro rata share of the cash position of its SFCs determined on the last day of a SFC's last tax year beginning before December 31, 2017 (Single Year Rule), or (ii) the average of the US shareholder's aggregate pro rata share of the cash position of its SFCs as of (A) the close of the last taxable year of each SFC ending before November 2, 2017 and (B) the first year prior to that year (Averaging Rule). As a result, the AFCP of a SFC with a calendar tax year is measured on December 31, 2017 (Single Year Rule); or December 31, 2016 and December 31, 2015 (Averaging Rule). In contrast, the AFCP of a SFC with a November 30 fiscal tax year end is measured on November 30, 2018 (Single Year Rule); or on November 30, 2016 and November 30, 2015 (Averaging Rule).[4]

Without the Averaging Rule a US shareholder could have diversified the holdings of it SFCs to subject a greater amount of its mandatory inclusion to the 8% non-cash rate.[5] The Averaging Rule minimizes this opportunity but, importantly, can result in the 15.5% cash rate applying to an amount of a US shareholder's mandatory inclusion far in excess of its AFCP determined as of the close of its inclusion year. The Conference Report, in explaining the Averaging Rule included in the House bill (which used a three-year average but was otherwise similar to the Averaging Rule) provides that "[b]y using a three-year average as the aggregate cash position for a U.S. shareholders [sic], the effect of unusual or anomalous transactions is muted."[6] Section 965(d)(3)(F) compliments the Averaging Rule by disregarding transactions, for purposes of section 965, that the Secretary of the Treasury determines have a "principal purpose" of reducing a US shareholder's AFCP.

The Averaging Rule, however, goes beyond minimizing the effect of "unusual or anomalous transactions" by also ignoring the effects of ordinary course transactions. For example, cash used to fund distributions to US shareholders described in section 301(c)(1), which should be

[1] An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, P.L. 115-97.

[2] Section 965. Except as otherwise expressly provided herein, all references to "section" are to sections of the Internal Revenue Code of 1986, as amended (the Code), and all references to "Reg. §" or "Regulations" are to Treasury regulations issued pursuant to the Code. Furthermore, all references to "Service" are to the Internal Revenue Service and to "Treasury" are to the Treasury Department.

[3] The transition tax rates are achieved by allowing the US shareholder a deduction (based on the highest rate of corporate tax under section 11 for the relevant inclusion year) against the mandatory inclusion.

[4] So the SFC's cash position on November 30, 2017, would not be taken into account for this purpose.

[5] *See* section 965(c)(3)(F) (if a principal purpose of a transaction is to reduce the AFCP, such transaction will be disregarded for purposes of determining the AFCP).

[6] Conference Report on H.R.1, Tax Cuts and Jobs Act (H. Rept. 115-466).

encouraged because cash is repatriated sooner for use in the US, are not "unusual or anomalous" and should therefore not be treated the same as transactions undertaken principally to achieve the 8% non-cash transition tax rate. Consistent with the anti-abuse rule of section 965(c)(3)(F) described above, the reference to "unusual or anomalous transactions" in the Conference Report likely referred to reductions of cash in a manner that reduced the AFCP without resulting in a US income inclusion, which is not the case for section 301(c)(1) distributions. Thus, the Averaging Rule does not appear to be aimed at reversing the cash position effects of prior year taxable distributions from an SFC to its US shareholder, and as illustrated below, applying the Averaging Rule to such a US shareholder leads to anomalous and unintended results.

Assume a US corporation (USP) wholly owns a foreign corporation (CFC1). USP and CFC1 are both calendar year taxpayers. Assume for simplicity that CFC1 generated $1000x of E&P in years prior to 2015 and does not generate further E&P during 2015-2017; thus, the adjustments to its accumulated E&P during 2015-2017 are solely by reason of its cash distribution to USP in 2016, as described below:

Table 1: CFC1

	12/31/2015	**12/31/2016**	**12/31/2017**
Accumulated E&P	$1000x	$800x	$800x
Cash	$800x	$600x	$600x

In December 2016, CFC1 makes a $200x cash distribution used by USP to fund its general business needs. The distributions reduce CFC1's E&P from $1000x to $800x. The cash distribution reduces the cash position of CFC1 from $800x to $600x. As noted above, CFC1 does not generate additional E&P in 2017 and makes no further distributions. Under Section 965(a), CFC1's subpart F income during its 2017 tax year is increased by $800x, the greater of its E&P determined as of November 2, 2017 and December 31, 2017.

USP's AFCP equals the greater of (i) CFC1's cash position on December 31, 2017 ($600x), or (ii) the average of CFC1's cash position on December 31, 2016 and December 31, 2015 ($700x). As a result, USP's AFCP equals $700x, which means that $700x of the $800x mandatory inclusion with respect to CFC1 will be taxed at the 15.5% cash rate. In contrast, if the Averaging Rule did not apply, and AFCP was instead determined as of December 31, 2017, only $600x of USP's mandatory inclusion would be taxed at the 15.5% cash rate and the remaining $200 would be taxed at the 8% non-cash rate. As a result, a lesser cash balance ($600x) has resulted in a greater E&P amount ($1000x) being taxed at higher rates – 35% on the $200x distribution made in December 2016, and 15.5% on $700x of the $800x mandatory inclusion under section 965 with only $100x being taxed at 8%. This results in greater income subject to US tax (and at higher rates) than what would have resulted if CFC1 had not paid the dividend distribution to USP in December 2016.

To be more precise, if CFC1 had not made the $200x dividend distribution in December 2016, USP's mandatory inclusion under section 965 with respect to CFC1 would have been $1000x (the greater of its E&P on both November 2, 2017 and December 31, 2017). Assuming the same cash balances on December 31, 2017; December 31, 2016 and December 31, 2015, $800x of the mandatory inclusion would have been subject to the 15.5% cash rate and $200x would have been subject to the 8% rate. This would have resulted in a lesser amount of CFC1's $1000x E&P being subject to US tax, because of the deduction allowed by section 965 to achieve the transition tax rates.

So, a US taxpayer that affirmatively repatriates funds to the US in a taxable manner without the benefit of the section 965 deduction is subject to greater US taxation than a taxpayer that defers the same earnings to take advantage of the lower repatriation tax under section 965. From a policy perspective this result is inappropriate and seems particularly harsh given that the goal of section 965 is to encourage cash repatriation. The legislative history confirms the Averaging Rule was designed to address "unusual or anomalous transactions", not ordinary course distributions. As a result, the Averaging Rule is over-inclusive insofar as it also penalizes ordinary course transactions engaged in with a view to carry out the very results incentivized by section 965.

This is an inappropriate result and we encourage Treasury to issue regulations that would reduce a US shareholder's AFCP, otherwise taken into account to determine the repatriated rates to which the mandatory section 965 inclusion applies, by any cash distributions made by its SFCs described in section 301(c). If such a rule was promulgated, in the prior example, USP's AFCP with respect to CFC1 would have been reduced to $600x, resulting in $600x of USP's mandatory inclusion being subject to the 15.5% cash rate and $200x to the 8% non-cash rate. We believe Treasury has authority authority under section 965(o) to issue such regulations.