ALERT

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Proposed Treasury Regulations Provide Details on U.S. Tax Reform's Transition Tax

Just in time for tax return filing, much-needed guidance has been issued on the application of the transition tax on foreign subsidiaries' earnings imposed under last year's tax reform.

On August 1, 2018, proposed regulations under recently enacted section 965 of the Internal Revenue Code were released. Part of last year's tax reform, section 965 imposes a "transition tax" on the earnings of foreign subsidiaries. The transition tax is assessed at a 15.5 percent or 8 percent rate, depending on the foreign subsidiaries' cash positions, and can be paid in installments.

The proposed regulations are generally consistent with prior guidance and contain many technical details. Key aspects include:

- Unfavorable rules that may inflate cash positions above actual cash and require double counting, including: (i) a hybrid approach for measuring the cash position of consolidated groups; and (ii) rules addressing groups with multiple year ends;
- Rules allowing certain intercompany receivables to be disregarded for purposes of determining cash positions (including certain cash pools run through third-party banks if treated as intercompany transactions under general tax principles);
- Treasury's decision not to expand the definition of "accounts payable" to include other short-term ordinary expenses;
- Foreign tax credits for both income and withholding taxes reduced in proportion to the reduced transition tax rate;
- Anti-avoidance rules disregarding: (i) certain transactions that change the amount of the income inclusion, cash position, or creditable foreign taxes (whether or not such change affects a taxpayer's total tax liability or is material in amount) that are undertaken on or after November 2, 2017 (in whole or in part) with a principal purpose of effecting such change (with materiality of the change relevant in determining whether there was a purpose); and (ii) certain accounting method changes and entity classification elections with similar effects (even if effective before November 2, 2017, and including changes from impermissible to permissible methods);
- Instructions for electing to pay the tax in installments and permitting an acquirer to assume a target's installment obligation;
- An election to transfer basis between foreign subsidiaries to better align with foreign subsidiary earnings to facilitate repatriation;
- Rules for reducing an inclusion by deficits from other foreign subsidiaries, including an unfavorable rule reducing deficits by the amount of certain previously taxed earnings;
- Clarification that individual owners of pass-through entities may elect to be subject to tax at corporate rates under section 962 if they are "U.S. shareholders" with respect to foreign corporations;
- Application of the normal FX rules only to certain distributions of subsidiary earnings; and
- Strict filing requirements without late filing relief available for many of the statements and elections.

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