HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

This notice contains a proposed revenue procedure that provides for a safe harbor under which a rental real estate enterprise will be treated as a trade or business solely for purposes of section 199A of the Internal Revenue Code (Code) and §§ 1.199A–1 through 1.199A–6 of the Income Tax Regulations (Regulations) (26 CFR Part 1). To qualify for treatment as a trade or business under this safe harbor, the rental real estate enterprise must satisfy the requirements of the proposed revenue procedure. If an enterprise fails to satisfy these requirements, the rental real estate enterprise may still be treated as a trade or business for purposes of section 199A if the enterprise otherwise meets the definition of trade or business in § 1.199A–1(b)(14).

This document contains proposed regulations concerning the deduction for qualified business income under section 199A of the Internal Revenue Code (Code). The proposed regulations will affect certain individuals, partnerships, S corporations, trusts, and estates. The proposed regulations provide guidance on the treatment of previously suspended losses that constitute qualified business income. The proposed regulations also provide guidance on the determination of the section 199A deduction for taxpayers that hold interests in regulated investment companies, charitable remainder trusts, and split-interest trusts.

These proposed regulations address when tax-exempt bonds are treated as retired for purposes of § 103. To be tax-exempt under § 103, a bond issued by a State or local government must satisfy various eligibility requirements under §§ 141 through 150 at the time the bond is issued. Notice 88–130 and Notice 2008–41 describe circumstances in which a tax-exempt bond is treated as having been retired for purposes of §§ 103 and 141 through 150 and a new bond issued in its place. These notices also provide special rules for certain financial products, such as qualified tender bonds. The proposed regulations propose rules similar to those in Notice 2008–41 and include a related conforming amendment to § 1.1001–3.

This revenue procedure provides methods for calculating W–2 wages, as defined in section 199A(b)(4) and § 1.199A–2 of the Income Tax Regulations, (1) for purposes of section 199A(b)(2) of the Internal Revenue Code (Code) which, for certain taxpayers, provides a limitation based on W–2 wages to the amount of the deduction for qualified business income (QBI); and (2) for purposes of section 199A(b)(7), which, for certain specified agricultural and horticultural cooperative patrons, provides a reduction to the section 199A deduction based on W–2 wages.

This revenue procedure provides a safe harbor method of accounting for determining depreciation deductions for passenger automobiles that qualify for the 100-percent additional first year depreciation deduction under section 168(k), as amended by the Tax Cuts and Jobs Act, PL 115–97 (TCJA), and that are subject to the depreciation limitations under section 280F, as amended by the TCJA.

T.D. 9846, page 583.
These final regulations implement section 965 of the Internal Revenue Code as amended by the Tax Cuts and Jobs Act, which was enacted on December 22, 2017. The final regulations affect United States persons with direct or indirect ownership interests in certain foreign corporations.

Section 199A provides that, for taxable years beginning after December 31, 2017 and before January 1, 2026, taxpayers other than C corporations may deduct 20 percent of the qualified business income from the taxpayer's qualified trades
or businesses, which can be operated through a partnership, S corporation, trust, estate, or sole proprietorship. The deduction is subject to multiple limitations based on the type of trade or business, the taxpayer’s taxable income, the amount of W–2 wages paid with respect to the qualified trade or business, and the unadjusted basis of qualified property held by the trade or business. Taxpayers other than C corporations generally may also deduct 20 percent of aggregate qualified REIT dividends and qualified publicly traded partnership income. Special rules apply to specified agricultural or horticultural cooperatives. The final regulations provide computational, definitional, and anti-abuse guidance necessary to apply these rules.
The IRS Mission

Provide America’s taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury’s Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

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Part I. Rulings and Decisions Under the Internal Revenue Code of 1986


T.D. 9846

DEPARTMENT OF THE TREASURY
Internal Revenue Service 26 CFR Part 1

Regulations Regarding the Transition Tax Under Section 965 and Related Provisions.

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations implementing section 965 of the Internal Revenue Code (the “Code”). Section 965 was amended by the Tax Cuts and Jobs Act, which was enacted on December 22, 2017. This document finalizes the proposed regulations published on August 9, 2018. The final regulations affect United States persons with direct or indirect ownership interests in certain foreign corporations.

DATES: Effective date: These regulations are effective on February 5, 2019. Applicability dates: For dates of applicability, see §§1.962–(d), 1.965–9(a), 1.965–9(b), and 1.986(c)–1(d).

FOR FURTHER INFORMATION CONTACT: Concerning the regulations §§1.962–1 and 1.962–2, 1.965–1 through 1.965–4, 1.965–7 through 1.965–9, and 1.986(c)–1, Natalie Punchak at (202) 317-6934; concerning the regulations §§1.965–5 and 1.965–6, Karen J. Cate at (202) 317-6926 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

On August 9, 2018, the Department of the Treasury (“Treasury Department”) and the IRS published proposed regulations (REG–104226–18) under sections 962, 965, and 986 in the Federal Register (83 FR 39514) (the “proposed regulations”). The proposed regulations were issued following guidance announcing and describing regulations intended to be issued under section 965, which was amended by section 14103 of the Tax Cuts and Jobs Act, Pub. L. 115–97 (2017) (the “Act”). See Notice 2018–07, 2018–4 I.R.B. 317; Notice 2018–13, 2018–6 I.R.B. 341; and Notice 2018–26, 2018–16 I.R.B. 480. Additional guidance describing certain provisions included in these regulations (the “final regulations”) was published on October 15, 2018. See Notice 2018–78, 2018–42 I.R.B. 604. Terms used but not defined in this preamble have the meaning provided in the final regulations.

A public hearing was held on October 22, 2018. The Treasury Department and the IRS also received written comments with respect to the proposed regulations. Comments received before the final regulations were substantially developed, including all comments received on or before the deadline for comments on October 9, 2018, were carefully considered in developing the final regulations. Several comments were received that do not pertain to the rules in the proposed regulations or that are otherwise outside the scope of this rulemaking. For example, certain comments regarding the payment and reporting of net tax liability under section 965 as addressed in the document containing Questions and Answers about Reporting Related to Section 965 on 2017 Tax Returns (available at https://www.irs.gov/newsroom/questions-and-answers-about-reporting-related-to-section-965-on-2017-tax-returns) are beyond the scope of the final regulations. Comments that are outside the scope of this rulemaking are generally not addressed in this preamble. The Treasury Department and the IRS will consider these comments in connection with any future guidance projects addressing the issues discussed in the comments. All written comments received in response to the proposed regulations are available at www.regulations.gov or upon request.

Summary of Comments and Explanation of Revisions

I. Overview

The final regulations retain the basic approach and structure of the proposed regulations, with certain revisions. This Summary of Comments and Explanation of Revisions section discusses those revisions as well as comments received in response to the solicitation of comments in the notice of proposed rulemaking accompanying the proposed regulations.

II. Comments and Changes to Proposed §1.965–1 – Overview, General Rules, and Definitions

Proposed §1.965–1 provides general rules and definitions under section 965, including general rules concerning section 965(a) inclusion amounts, general rules concerning section 965(c) deduction amounts, and rules concerning the treatment of certain specified foreign corporations as controlled foreign corporations (as defined in section 957) (“CFCs”) and certain controlled domestic partnerships as foreign partnerships. The comments and modifications with respect to these rules are discussed in this Part II.

A. Application of exchange rate for determining section 965(a) inclusion amount

The proposed regulations provide that a section 965(a) inclusion amount is determined by translating a section 958(a) U.S. shareholder’s pro rata share of the section 965(a) earnings amount of a deferred foreign income corporation (“DFIC”) into U.S. dollars using the spot rate on December 31, 2017. Proposed §1.965–1(b)(1). A comment suggested that the average exchange rate for the section 958(a) U.S. shareholder’s 2017 fiscal year should be used under section 889(b)(3) and stated that the approach of the proposed regulations created unnecessary complexity but did not elaborate on how complexity was created. The Treasury Department and the IRS have determined that while section 889(b)(3) would generally ap-
Proposed §1.965–1(e) contains a rule treating certain controlled domestic partnerships as foreign partnerships for purposes of determining the section 958(a) U.S. shareholders of a specified foreign corporation owned by the controlled domestic partnership and the section 958(a) stock owned by such shareholders. A comment suggested that because controlled domestic partnership is defined by reference to a specific United States shareholder, the rule could be read to apply only with respect to such shareholder but not with respect to other partners of the controlled domestic partnership, for which it would therefore still be treated as domestic. The definition of controlled domestic partnership is accordingly revised to not be defined only with respect to a United States shareholder, so that a controlled domestic partnership is clearly treated as a foreign partnership for all partners if the rule applies. See §1.965–1(e)(2).

The comment also recommended that a controlled domestic partnership treated as a foreign partnership be treated as such for purposes of the specified basis adjustment rules discussed in Part III.D of this Summary of Comments and Explanation of Revisions. The final regulations adopt this recommendation and provide that a controlled domestic partnership treated as a foreign partnership is treated as a foreign partnership for purposes of the specified basis adjustment rules discussed in Part III.D of this Summary of Comments and Explanation of Revisions. The final regulations adopt this recommendation and provide that a controlled domestic partnership treated as a foreign partnership is treated as a foreign partnership for purposes of section 965. The final regulations adopt this recommendation and provide that a controlled domestic partnership treated as a foreign partnership is treated as a foreign partnership for purposes of section 965.

The final regulations adopt this recommendation and provide that a controlled domestic partnership treated as a foreign partnership is treated as a foreign partnership for purposes of section 965.

C. Determination of accumulated post–1986 deferred foreign income

1. Application of Previously Taxed E&P Exception to Non-CFCs

Proposed §1.965–1(f)(7)(i)(B) and (C) exclude from accumulated post–1986 deferred foreign income certain earnings and profits ("E&P") described in section 959(c)(1) or 959(c)(2) ("previously taxed E&P") and amounts that would be treated as previously taxed E&P in the case of shareholders that are not United States shareholders on an E&P measurement date. These exclusions (consistent with section 965(d)(2)(B)) apply only to E&P of a CFC. A comment requested that the exclusion be expanded to previously taxed E&P and amounts that would be treated as previously taxed E&P of specified foreign corporations that are no longer CFCs as of the relevant E&P measurement date, given that section 959 can apply to distributions by foreign corporations that are no longer CFCs. The Treasury Department and the IRS have determined that the recommendation is inconsistent with the clear statutory language of section 965(d)(2)(B), which applies solely to CFCs. Accordingly, the final regulations do not reflect this recommendation. See Part IIJ of this Summary of Comments and Explanation of Revisions for a discussion of the consequences of an actual distribution of previously taxed E&P for purposes of section 965.

2. Expansion of Previously Taxed E&P Exception to Address Distributions

Another comment suggested that the final regulations expand on the rationale of section 965(d)(2)(B) and proposed §1.965–1(f)(7)(i)(B) and (C) to provide that accumulated post–1986 deferred foreign income is reduced by post–1986 earnings and profits described in section 959(c)(3) that have been distributed to an unrelated foreign corporation pursuant to a dividend pro rata to such corporation and a specified foreign corporation, given that the "no diminution rule" discussed in Part II.G.1 of this Summary of Comments and Explanation of Revisions would decrease the post–1986 earnings and profits by the amount distributed to the specified foreign corporation but not the unrelated foreign corporation. As discussed in more detail in Part II.G.1 of this Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS have determined that the application of the statutory "no diminution rule" is clear, and the special rules in section 965(d)(2)(B) for previously taxed E&P have no bearing on the fact pattern highlighted by the comment. Accordingly, the final regulations do not adopt this comment, nor a similar comment suggesting that step 2 of the ordering rule in proposed §1.965–2(b), discussed in Part III.A of this Summary of Comments and Explanation of Revisions, permit such dividends to persons other than specified foreign corporations to be taken into account before the application of section 965 is determined.

3. Expansion of Previously Taxed E&P Exception to Address Section 951(a)(1)(B) Inclusions

A comment suggested that a pre-inclusion year inclusion under sections 951(a)(1)(B) and 956 with respect to a DFIC whose inclusion year ends November 30, 2018, may not be properly accounted for in determining accumulated post–1986 deferred foreign income as of the measurement date on November 2, 2017. The comment notes that a distribution of an amount of E&P that would be described in section 959(c)(1) as a result of an inclusion under sections 951(a)(1)(B) and 956 during a pre-inclusion year taxable year would prevent sections 951(a)(1)(B) and 956 from applying. Accordingly, such E&P would not qualify for the exception from accumulated post–1986 deferred foreign income for previously taxed E&P in §1.965–1(f)(7)(i)(B). The comment suggested that the final regulations provide an additional exception from the definition of accumulated post–1986 deferred foreign income for E&P that would be included in the income of a United States shareholder under sections 951(a)(1)(B) and 956.
The Treasury Department and the IRS have determined that the statutory definition of accumulated post–1986 deferred foreign income is clear in not excluding such E&P. Moreover, modifications to reduce a section 965(a) inclusion amount to the extent of an inclusion under sections 951(a)(1)(B) and 956 in such circumstances are not warranted for the same reasons that modifications to address dividends with comparable results are not warranted, as discussed in Part II.G.1 of this Summary of Comments and Explanation of Revisions. A new example illustrates the treatment of E&P of a specified foreign corporation as of the E&P measurement date on November 2, 2017, which is described in section 959(c)(1) as a result of an inclusion under section 951(a)(1)(B) with respect to the specified foreign corporation’s taxable year ending on November 30, 2017. See §1.965–2(j)(5).

4. Application of Previously Taxed E&P Exception in the Case of Section 962 Elections

Under section 962(d), E&P giving rise to inclusions under section 951(a)(1) with respect to which an election under section 962 applies are, notwithstanding section 959(a)(1), includible in the gross income of a United States shareholder when distributed except to the extent of tax paid on the inclusions. Therefore, those E&P (that is, the non-excludable amount) are included in accumulated post–1986 deferred foreign income in an inclusion year. See section 965(d)(2)(B) (excluding from accumulated post–1986 deferred foreign income earnings that, if distributed, would be excluded from gross income under section 959). A comment suggested that accumulated post–1986 deferred foreign income should exclude all previously taxed E&P attributable to a prior year inclusion under section 951(a)(1) by a United States shareholder when a section 962 election applied with respect to the prior year inclusion. In the alternative, the comment suggested that the final regulations allow foreign income taxes deemed paid with respect to the original inclusion under section 951(a)(1) to be treated as deemed paid again with respect to a section 965(a) inclusion with respect to such previously taxed E&P. The Treasury Department and the IRS have determined that the statute is clear that a reduction to accumulated post–1986 deferred income is allowed only for E&P that would be excluded from income under section 959 upon distribution. In addition, there is no authority under the Code to allow the same foreign income taxes to be credited twice. Therefore, because there is no statutory authority for such modifications, the suggested modifications to the statutory definition of accumulated post–1986 deferred foreign income and operation of the foreign tax credit rules are not warranted and are not adopted in the final regulations.

D. Determination of aggregate foreign cash position and cash position

The proposed regulations define “aggregate foreign cash position” to mean the greater of the aggregate of a section 958(a) U.S. shareholder’s pro rata share of the cash position of each specified foreign corporation determined on the final cash measurement date or the average of the aggregate of a section 958(a) U.S. shareholder’s pro rata share of the cash position of each specified foreign corporation determined as of each specified foreign corporation’s first and second cash measurement dates. Proposed §1.965–1(f)(8). For purposes of this calculation, a specified foreign corporation’s cash position consists of cash held by the corporation, the net accounts receivable of the corporation, and the fair market value of the cash-equivalent assets held by the corporation. Proposed §1.965–1(f)(16)(i). Cash-equivalent assets include (i) personal property which is of a type that is actively traded and for which there is an established financial market. For example, comments suggested that the stock of a publicly traded company be excluded from a specified foreign corporation’s cash position if the stock represents a controlling interest in a corporation, meets an annual trading volume threshold, is the stock of a specified foreign corporation, is held in the ordinary course of a section 958(a) U.S. shareholder’s trade or business, or was not reported as a current asset on the audited financial statements of a section 958(a) U.S. shareholder or its specified foreign corporation. Similarly, comments requested that certain products or raw materials held as inventory that are a type of property that may be actively traded on, for example, commodities markets, and forward contracts with respect to those items be excluded from a specified foreign corporation’s cash position if the items are part of the corporation’s ongoing operations or are disposed of in the normal course of business. One comment requested guidance that actively traded personal property be presumptively treated as cash, subject to the ability of the taxpayer to rebut the presumption by submitting a statement with its tax return that establishes, based on all of the relevant facts and circumstances, that the property is illiquid. Another comment stated that the proposed regulations struck an appropriate balance and requested that the exceptions from the definition of cash position be limited to those in the proposed regulations and that no additional exceptions be given.
The Treasury Department and the IRS have determined that a narrow exemption from the definition of “cash position” is appropriate for certain assets held by a specified foreign corporation in the ordinary course of its trade or business as well as for certain privately negotiated contracts to buy or sell such assets. Therefore, in response to comments, the final regulations provide that a commodity that is described in section 1221(a)(1) or 1221(a)(8) in the hands of the specified foreign corporation is excluded from the category of personal property which is of a type that is actively traded and for which there is an established market, except with respect to dealers or traders in commodities. Section 1.965–1(f)(13)(i)(A) and (ii). Additionally, the final regulations exclude forward contracts and short positions with respect to such commodities from the definition of derivative financial instrument to the extent that they could have been identified as a hedging transaction with respect to such commodities. See §1.965–1(f)(18)(iii) and (v). This exemption does not raise the administrability concerns that are inherent in a liquidity-based test of widespread applicability.

However, the Treasury Department and the IRS decline to adopt the recommendations for additional cash position exceptions. Congress developed a statutory definition of “cash position” that includes all cash and certain assets held by a specified foreign corporation regardless of whether the cash or assets are illiquid or were transferred from the United States. See section 965(c)(3)(B). The legislative history is consistent with the unambiguous language in the statute. See, e.g., H.R. Rep. No. 115–446, at 609-10 (2017) (“The cash position of an entity consists of all cash, net accounts receivable, and the fair market value of similarly liquid assets, specifically including personal property that is actively traded on an established financial market, government securities, certificates of deposit, commercial paper, foreign currency, and short-term obligations.”). Therefore, the final regulations continue to provide that, for example, the fair market value of publicly traded stock held by a specified foreign corporation is included in a specified foreign corporation’s cash position, regardless of the specified foreign corporation’s ownership percentage in the publicly traded corporation, because such stock is “of a type” that is actively traded on an established securities market.

Additionally, creating broad regulatory exceptions to the statutory definition would require administratively complex tracing and facts-and-circumstances rules. For example, an exclusion for cash that originated in the United States and was earmarked to fund a foreign acquisition pursuant to a legal contract entered into before November 2, 2017, would necessarily require difficult-to-administer rules to identify such cash, which may currently be or may have previously been commingled with foreign-derived cash in a single account. Similarly, it would be challenging to administer a presumption or a test that assesses the liquidity of every asset based on the facts and circumstances.

Accordingly, the final regulations generally retain the definitions of “aggregate foreign cash position” and “cash position” set forth in the proposed regulations. See §1.965–1(f)(8) and (16).

2. Accounts Receivable and Accounts Payable

The proposed regulations provide that for purposes of determining net accounts receivable taken into account in determining the cash position of a specified foreign corporation, the term “accounts receivable” means receivables described in section 1221(a)(4), and the term “accounts payable” means payables arising from the purchase of property described in section 1221(a)(1) or 1221(a)(8) or the receipt of services from vendors or suppliers, and only receivables or payables with a term upon issuance that is less than one year are taken into account. Proposed §1.965–1(f)(5) and (6).

Comments requested that the definition of accounts payable for purposes of determining a specified foreign corporation’s cash position be expanded. Specifically, comments recommended that accounts payable be defined to include payables to employees in the ordinary course of business, payables arising from the purchase of depreciable property, payables related to the licensing of intellectual property, payables for taxes other than income taxes, payables for debt with a term of less than one year, and payables established under Revenue Procedure 99–32, 1999–2 C.B. 296. Although the statute does not define the term “accounts payable,” generally accepted accounting principles define the term to mean amounts owed to vendors and suppliers for the purchase of goods and services on credit, to the exclusion of obligations such as accrued taxes, interest expense, commission or royalty expense, and compensation payable, which are treated as accrued liabilities. The definition of accounts payable set forth in the proposed regulations therefore reflects the ordinary meaning of the term, and the final regulations do not adopt these recommendations.

3. Short-Term Obligations

The proposed regulations provide that for purposes of determining a specified foreign corporation’s cash position, the term “short-term obligation” means any obligation with a term at issuance that is less than one year and any loan that must be repaid at the demand of the lender (or that must be repaid within one year of such demand) but does not include any accounts receivable. Proposed §1.965–1(f)(43). Comments requested that the definition of short-term obligation be modified to allow netting of short-term notes payable against short-term notes receivable for purposes of computing a specified foreign corporation’s cash position.

The Treasury Department and the IRS decline to adopt these comments. The statute explicitly allows accounts payable to be netted against accounts receivable for purposes of determining the cash position of a specified foreign corporation but does not provide the same treatment with respect to short-term obligations. See section 965(c)(3)(B)(i), (c)(3)(B)(ii)(IV), and (c)(3)(C). The legislative history is consistent with the statute’s plain meaning. See H.R. Rep. No. 115–446, at 615 (2017). Accordingly, the final regulations retain the definition of “short-term obligation” set forth in the proposed regulations. See §1.965–1(f)(43).

4. Cash-Equivalent Asset Hedging Transactions

For purposes of determining the cash position of a specified foreign corporation, the proposed regulations include special
rules regarding the treatment of cash-equivalent asset hedging transactions. The term “cash-equivalent asset hedging transaction” is defined as a bona fide hedging transaction identified on a specified foreign corporation’s books and records as hedging a cash-equivalent asset. Proposed §1.965–1(f)(14). A bona fide hedging transaction is defined to mean a hedging transaction that meets (or that would meet if the specified foreign corporation were a CFC) the requirements of a bona fide hedging transaction described in §1.954–2(a)(4)(ii) (without regard to the identification requirements, in the case of a specified foreign corporation that is not a CFC). Proposed §1.965–1(f)(12).

The proposed regulations do not address whether, and the extent to which, a bona fide hedging transaction that hedges an aggregate risk (an “aggregate hedging transaction”), including risks with respect to one or more cash-equivalent assets, may be treated as a cash-equivalent asset hedging transaction. For example, a bona fide hedging transaction may hedge the risk with respect to multiple assets, some of which are cash-equivalent assets and some of which are not cash-equivalent assets. See generally §1.954–2(a)(4)(ii)(A) (defining a bona fide hedging transaction, in part, by reference to the requirements of §1.1221–2(a) through (d)); §1.1221–2(c)(3) (providing that a hedging transaction may manage aggregate risk).

The Treasury Department and the IRS have determined that it is appropriate to permit bona fide hedging transactions that are aggregate hedging transactions to be treated as cash-equivalent asset hedging transactions to the extent that the risks managed by the aggregate hedging transaction relate to cash-equivalent hedging transactions. Accordingly, the final regulations provide that an aggregate hedging transaction may be treated as a cash-equivalent asset hedging transaction and allocate the value of an aggregate hedging transaction between cash-equivalent hedging transactions and other assets, if any, being hedged. See §1.965–1(f)(14)(ii).

One comment requested guidance clarifying that hedging transactions that use cash-equivalent assets that are not derivative financial instruments as hedging instruments, are eligible to be treated as bona fide hedging transactions. The Treasury Department and the IRS have determined that it is clear that a hedging transaction that uses a cash-equivalent asset as a hedging instrument will qualify as a bona fide hedging transaction if the requirements in proposed §1.965–1(f)(12) are met, and no clarification is necessary.

E. Cash measurement dates

The proposed regulations provide that a specified foreign corporation’s 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. Proposed §1.965–1(f)(24). The second cash measurement date of a specified foreign 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. Proposed §1.965–1(f)(31). The first cash measurement date of a foreign 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. Proposed §1.965–1(f)(25). Under the proposed regulations, a section 958(a) U.S. shareholder takes into account its pro rata share of the cash position of a specified foreign corporation as of the close of any cash measurement date of the specified foreign corporation on which the section 958(a) U.S. shareholder is a section 958(a) U.S. shareholder of the specified foreign corporation, without regard to whether the section 958(a) U.S. shareholder is a section 958(a) U.S. shareholder as of any other cash measurement date, including the final cash measurement date of the specified foreign corporation. See proposed §1.965–1(f)(30)(iii).

A comment recommended that the proposed regulations be modified such that a section 958(a) U.S. shareholder would not take into account the pro rata share of the cash position of any specified foreign corporation liquidated before November 2, 2017. The comment is premised on the view that the references to “each such specified foreign corporation” in section 965(c)(3)(A)(ii) expressly link the specified foreign corporations whose cash positions are measured on the first and second cash measurement dates to those whose cash positions are measured on the final cash measurement date. Accordingly, the comment reads the statute to provide that if a specified foreign corporation did not exist or was not held by a section 958(a) U.S. shareholder on the final cash measurement date, its cash position may not be taken into account under section 965(c)(3)(A)(ii).

The Treasury Department and the IRS have determined that the comment’s reading of section 965(c)(3)(A)(ii) is an inferior reading and have determined that the cash measurement date rules in the proposed regulations are consistent with the text and underlying purposes of the relevant statutory provision and that the legislative history supports this conclusion. The phrase “each such specified foreign corporation” in section 965(c)(3)(A)(ii)(I) and (II) refers only to the phrase “each specified foreign corporation of such United States shareholder” in section 965(c)(3)(A)(i), and not the additional language in section 965(c)(3)(A)(i) referring to the final cash measurement date. Additionally, given that the purpose of the multiple cash measurement dates was to mitigate any incentive for taxpayers to manipulate their cash position as of the final cash measurement date, it is appropriate to ensure that the cash position of a specified foreign corporation in existence on a cash measurement date is taken into account by a United States shareholder on such date. For example, a rule that ignored the cash position of specified foreign corporations that did not exist or were not held by a section 958(a) U.S. shareholder on the final cash measurement date could allow a section 958(a) U.S. shareholder with an aggregate foreign cash position that was determined as of the earlier cash measurement dates described in section 965(c)(3)(A) to retroactively reduce its aggregate foreign cash position by liquidating or otherwise disposing of specified foreign corporations with significant cash positions, even when cash and cash-equivalent assets of the specified foreign corporation continued to be held by one or more other specified foreign corporations of the section 958(a) U.S. shareholder.

Finally, the Joint Committee on Taxation explanation of the Act also indicates that, for purposes of section 965, the cash
position of a specified foreign corporation that no longer exists must still be taken into account by a section 958(a) U.S. shareholder in determining its aggregate foreign cash position. See Staff, Joint Committee on Taxation, General Explanation of Public Law 115–97, JCS–1–18, at 359-360 (2018) (“If a specified foreign corporation does not exist on any particular cash measurement date, its cash position would be zero with respect to that date.”). Accordingly, the Treasury Department and the IRS do not adopt this recommendation.

Another comment requested confirmation that United States shareholder status, the United States shareholder’s pro rata share, and specified foreign corporation status are determined based on the facts and applicable law at the time of each cash measurement date. The Treasury Department and the IRS have determined that that is clear under proposed §1.965–1(f)(8) and (f)(30)(iii), as illustrated by the example in §1.965–1(g)(7). Accordingly, no changes are made in the final regulations in this regard.

F. Domestic pass-through entities

A comment made a number of suggestions premised on the assumption that aggregate foreign E&P deficits, section 965(a) inclusion amounts, and section 965(c) deductions are not determined at the section 958(a) U.S. shareholder level when the section 958(a) U.S. shareholder is a domestic pass-through entity, and instead that shares of the components of those amounts (such as specified E&P deficits, section 965(a) earnings amounts, and aggregate foreign cash positions) are taken into account separately by the domestic pass-through owners. As discussed in more detail in this Part II.F with respect to the specific suggestions made by the comment, the Treasury Department and the IRS have determined that the statute clearly provides otherwise, and the proposed regulations and final regulations are consistent with the statute.

The comment requested that the final regulations clarify that if a domestic pass-through entity is a United States shareholder of an E&P deficit foreign corporation, a domestic pass-through owner of the domestic pass-through entity can take into account its shares of the domestic pass-through entity’s pro rata share of the specified E&P deficit of the E&P deficit foreign corporation to reduce the domestic pass-through owner’s pro rata share of a section 965(a) earnings amount of a DFIC. In support of its recommendation, the comment cited the rule provided in proposed §1.965–1(e) treating a controlled domestic partnership as a foreign partnership, such that its partners could be treated as having a pro rata share of specified E&P deficits of E&P deficit foreign corporations owned by the partnership. However, that rule is intended to ensure that the accumulated post–1986 deferred foreign income of DFICs of such a partnership is subject to U.S. tax. The Treasury Department and the IRS have determined that it should not be extended to structures that do not present the same tax-avoidance concerns, such as the one raised by the comment involving a United States person that is a partner in a domestic partnership. The Treasury Department and the IRS have determined that it is clear under the statute that a domestic pass-through entity’s pro rata share of a specified E&P deficit can only be used to reduce the domestic pass-through entity’s pro rata share of section 965(a) earnings amounts, and the proposed and final regulations are consistent with the statute.

Similarly, under the statute, a domestic pass-through owner’s distributive share of a domestic pass-through entity’s section 965(a) inclusion amount cannot be reduced by the domestic pass-through owner’s pro rata share of a specified E&P deficit foreign corporation’s post–1986 earnings and profits).

The comment also suggested clarifying that if a domestic pass-through entity’s aggregate foreign cash position exceeds its aggregate section 965(a) inclusion amounts, the domestic pass-through owners of the domestic pass-through entity need only take into account their share of the excess aggregate foreign cash position, and not their share of the aggregate foreign cash position taken into account in determining the section 965(c) deduction amount of the domestic pass-through entity. The Treasury Department and the IRS have determined that because only a section 958(a) U.S. shareholder can have an aggregate foreign cash position, and there is no mechanism for treating a domestic pass-through owner of a domestic pass-through entity that is a section 958(a) U.S. shareholder as having a share of an aggregate foreign cash position, it is clear under the statute, the proposed regulations, and the final regulations, that domestic pass-through owners do not take into account any amount of a domestic pass-through entity’s aggregate foreign cash position. Accordingly, no clarification is needed, and the comment is not adopted.

G. Post–1986 earnings and profits

1. Treatment of Distributions

Under the proposed regulations, a specified foreign corporation’s post–1986 earnings and profits are determined without diminution by reason of dividends distributed during the last taxable year of the foreign corporation that begins before January 1, 2018, other than dividends distributed to another specified foreign corporation (“no diminution rule”). Proposed §1.965–1(f)(29)(i)(B). Comments noted that the no diminution rule may result in overinclusion of a specified foreign corporation’s post–1986 earnings and profits and suggested that the final regulations limit the rule’s application (that is, to allow diminution of a specified foreign corporation’s post–1986 earnings and profits) in the case of dividends to a seller before a sale during the inclusion year. The statute explicitly provides that dividend distributions, other than distributions to another specified foreign corporation, must not be taken into account for purposes of computing a specified foreign corporation’s post–1986 earnings and profits. Section 965(d)(3)(B). The legislative history supports the plain language of the statute. See H.R. Rep. No. 115–446, at 619 (2017). See Part II.H of this Summary of Comments and Explanation of Revisions for additional discussion of rules affecting the treatment of pre-sale distributions by a DFIC. Therefore, the comments are not adopted.
Similarly, comments have suggested reducing post–1986 earnings and profits by dividends to a United States shareholder between November 2, 2017, and December 1, 2017, by a DFIC with an inclusion year ending November 30, 2018, in order to mitigate double counting of E&P in connection with such dividends. However, the legislative history to section 965(a) makes clear that the Treasury Department and the IRS were expected to provide regulations to address double counting resulting from transactions between specified foreign corporations but is silent with respect to transactions between specified foreign corporations and United States shareholders. Id. Accordingly, the Treasury Department and the IRS have determined that the grant of regulatory authority in section 965 was not intended to address such fact patterns. Further, and as the preamble to the proposed regulations notes, payments by a specified foreign corporation to a United States shareholder can have attendant U.S. tax effects that do not occur with respect to payments between specified foreign corporations. For example, a distribution to a United States shareholder may permit that shareholder to take into account foreign tax credits under section 962 and avoid the limitation under section 965(g)(1) that would apply if the underlying foreign taxes had been deemed paid with respect to the shareholder’s section 965(a) inclusion amount. Accordingly, the Treasury Department and the IRS decline to adopt this recommendation. The alternative recommendations in some of the comments, to treat the dividend as out of previously taxed E&P arising in the subsequent taxable year or to allow the same foreign income taxes to be deemed paid with respect to both the dividend and the section 965(a) inclusion, are inconsistent with the statute and the Code at large, and, accordingly, these recommendations are not adopted.

2. Foreign Income Tax Rule

The proposed regulations provide that for purposes of determining a specified foreign corporation’s post–1986 earnings and profits as of the E&P measurement date on November 2, 2017, in the case in which foreign income taxes (as defined in section 901(m)(5)) of the specified foreign corporation accrue after November 2, 2017, but on or before December 31, 2017, and during the specified foreign corporation’s U.S. taxable year that includes November 2, 2017, the specified foreign corporation’s post–1986 earnings and profits as of November 2, 2017, are reduced by the applicable portion of such foreign income taxes. Proposed §1.965–1(f)(29)(ii). Comments requested that the rule be expanded to permit reduction for foreign income taxes accrued after December 31, 2017, for purposes of determining post–1986 earnings and profits on the measurement dates on both November 2, 2017, and December 31, 2017, and regardless of whether the foreign corporation’s U.S. taxable year includes November 2, 2017. The Treasury Department and the IRS have determined that it would be inappropriate to allow taxes accrued for a U.S. tax year after the one that includes November 2, 2017, to be taken into account in determining post–1986 earnings and profits on November 2, 2017, because such taxes could not have accrued for the first year under the general foreign tax credit rules. Moreover, expanding the rule to take into account taxes accrued after December 31, 2017, would prevent section 965-related amounts from being determined with certainty as of December 31, 2017. As discussed in Part II.A of this Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS have determined that it continues to be important to have certainty about section 965-related amounts as of December 31, 2017, and accordingly decline to adopt the comments.

Another comment recommended modifying how the applicable portion of foreign income taxes taken into account on November 2, 2017, is determined. For ease of implementation, instead of basing the determination on the portion of the income for the foreign taxable period that includes November 2, 2017, as computed under foreign tax law, that had accrued as of such date, this comment recommended basing the determination on the ratio of the E&P for the U.S. taxable year, as computed under U.S. tax principles, as of November 2, 2017, to that as of December 31, 2017. The Treasury Department and the IRS have determined that taxpayers are generally required under §1.904–6 to associate foreign income taxes with taxable income computed under foreign law, such that the rule in §1.965–1(f)(29)(ii) does not create a significant additional burden. Moreover, the suggested approach could result in significant distortions if the foreign corporation’s U.S. and foreign taxable years differed. Accordingly, the recommendation is not adopted.

3. Other Exclusions from Post–1986 Earnings and Profits

A comment also requested that the definition of post–1986 earnings and profits exclude cashless earnings generated by foreign corporations while they were not controlled by United States shareholders. In the same vein, it requested that dividends paid out of earnings earned before a foreign corporation became a specified foreign corporation be excluded from the post–1986 earnings and profits of the recipient specified foreign corporation. Because the term “post–1986 earnings and profits” clearly includes E&P (which is not tied to cash and is often attributable to cashless income) earned while a corporation was a specified foreign corporation, without regard to whether it was controlled by United States shareholders, and because section 965(d)(3)(B) clearly evidences consideration for the impact of dividends between foreign corporations on post–1986 earnings and profits, the Treasury Department and the IRS decline to adopt this comment.

4. Alternative Measurement Methods

A comment requested guidance permitting taxpayers to determine their specified foreign corporations’ post–1986 earnings and profits and cash positions using an alternative measurement method. The comment noted that before the enactment of section 965, foreign corporations other than CFCs or section 902 corporations (as defined under former section 909(d)(5)) had no reason to track E&P under U.S. tax principles; therefore, requiring a United States shareholder to obtain information from a foreign corporation that the corporation would not have known to maintain is unduly burdensome.

Section 965(d)(3) provides, without exception, that for purposes of determining post–1986 earnings and profits, the E&P of a specified foreign corporation must be “computed in accordance with
sections 964(a) and 986.” Likewise, section 965(c)(3)(B), which contains rules for determining a specified foreign corporation’s cash position, applies to “any specified foreign corporation.” Moreover, there is no indication in the legislative history that Congress intended to ease the requirements for computing the post–1986 earnings and profits and the cash position for those specified foreign corporations that may not have previously calculated E&P under U.S. tax principles. Accordingly, the Treasury Department and the IRS do not adopt this comment.

H. Determination of pro rata share of section 965(a) earnings amount

The proposed regulations provide that a section 958(a) U.S. shareholder’s pro rata share of the section 965(a) earnings amount of a DFIC is the portion of the section 965(a) earnings amount that would be treated as distributed to the section 958(a) U.S. shareholder under section 951(a)(2)(A) and §1.951–1(e), determined as of the last day of the inclusion year of the DFIC. Proposed §1.965–1(f)(30)(i). The Treasury Department and the IRS have determined that this definition is inconsistent with the statutory language of sections 951 and 965 in the case in which a specified foreign corporation, whether it is or is not a CFC, ceases to be a specified foreign corporation during its inclusion year. Under section 951, a section 958(a) U.S. shareholder of such a specified foreign corporation would generally have an inclusion under section 951 with respect to the corporation if it were a DFIC because it would own stock of the specified foreign corporation on the last day of the inclusion year on which the corporation was a specified foreign corporation. Because a specified foreign corporation is treated as a CFC for purposes of section 951, the Treasury Department and the IRS have determined that the final regulations should be consistent with section 951 in requiring a section 965(a) inclusion by such a section 958(a) U.S. shareholder. Moreover, the Treasury Department and the IRS have concluded that it would not be appropriate to prorate a section 965(a) earnings amount based on the portion of the inclusion year that the DFIC is a specified foreign corporation, as the reference in proposed §1.965–1(f)(30)(i) to section 965(a)(2)(A) might suggest, given that the limitation of post–1986 earnings and profits to E&P accumulated in periods in which the DFIC was a specified foreign corporation would already prevent E&P accrued after the DFIC ceased to be a specified foreign corporation from being taken into account. The definitions of “pro rata share” and “section 958(a) U.S. shareholder inclusion year” are revised accordingly in the final regulations. See §1.965–1(f)(30) and (f)(34). The definition of pro rata share continues to preclude reduction by distributions to other owners under section 951(a)(2)(B) in order to be consistent with section 965(d)(3)(B) and prevent double non-taxation in the case of certain 2018 dispositions of specified foreign corporations. Id.; see §1.965–2(j)(6).

I. Determination of pro rata share of specified E&P deficit

The proposed regulations provide that, for purposes of determining a section 958(a) U.S. shareholder’s pro rata share of a specified E&P deficit of an E&P deficit foreign corporation, the specified E&P deficit is allocated among the shareholders of the corporation’s common stock in proportion to the value of the common stock held by such shareholders. Proposed §1.965–1(f)(30)(ii). The Treasury Department and the IRS have determined that a specified E&P deficit should be allocated to shareholders of an E&P deficit corporation’s preferred stock in cases involving common stock with no liquidation value. The final regulations therefore provide that any amount of a specified E&P deficit that would otherwise be allocated in a hypothetical distribution to a class of common stock that has no liquidation value is instead allocated to the most junior class of equity with a positive liquidation value to the extent of the liquidation value. Section 1.965–1(f)(30)(ii)(A). The final regulations also provide that, in cases in which a corporation’s common stock has a liquidation value of zero and there is no class of equity with a liquidation preference relative to the common stock, the specified E&P deficit is allocated among the common stock using any reasonable method consistently applied. Section 1.965–1(f)(30)(ii)(B).

J. Determination of specified E&P deficit

The proposed regulations provide that previously taxed E&P are not excluded in determining the existence and amount of an E&P deficit foreign corporation’s specified E&P deficit. See proposed §1.965–1(f)(22)(ii). Comments requested that the final regulations provide to the contrary. The Treasury Department and the IRS have determined that it is clear that previously taxed E&P are not excluded in determining a specified E&P deficit. Section 965(b)(3)(B) and (C) provide that a specified E&P deficit is, with respect to an E&P deficit foreign corporation, a deficit in post–1986 earnings and profits as of November 2, 2017. For purposes of section 965, the term post–1986 earnings and profits is defined in section 965(d)(3) and is computed in accordance with sections 964(a) and 986. Under section 964(a), E&P are determined according to rules substantially similar to those applicable to domestic corporations. Previously taxed E&P are a type of E&P. See section 959(c). No express exclusion of previously taxed E&P is provided in section 965(d)(3) for purposes of determining post–1986 earnings and profits. In contrast, the term accumulated post–1986 deferred foreign income, as defined in section 965(d)(2), starts with post–1986 earnings and profits and then explicitly excludes previously taxed E&P. See section 965(d)(2)(B). Accordingly, the comments are not adopted. While previously taxed E&P is not excluded in the statutory definition of post–1986 earnings and profits, there is no double taxation of previously taxed E&P related to the E&P deficit foreign corporations because section 959 continues to apply when the previously taxed E&P are distributed.

A comment also requested that the final regulations confirm that E&P or deficits in E&P attributable to income that is effectively connected with the conduct of a trade or business within the United States and subject to tax under chapter 1 (“effectively connected E&P”) are taken into account in determining the specified E&P deficit of an E&P deficit foreign corporation. The Treasury Department and the
IRS have determined that section 965 clearly allows deficits in effectively connected E&P to be included in an E&P deficit foreign corporation’s specified E&P deficit. No express exclusion for effectively connected E&P is provided in section 965(d)(3) for purposes of determining post-1986 earnings and profits. Moreover, the term accumulated post-1986 deferred foreign income, as defined in section 965(d)(2), expressly excludes effectively connected E&P. Accordingly, no clarification is made to the proposed regulations with respect to effectively connected E&P.

A comment also requested confirmation that a distribution of previously taxed E&P in the last taxable year of a CFC beginning before January 1, 2018, can affect an E&P deficit foreign corporation’s specified E&P deficit. Because previously taxed E&P can only be distributed pursuant to a dividend, which, pursuant to section 316, requires positive E&P, the Treasury Department and IRS have determined that a distribution of previously taxed E&P could not affect a specified E&P deficit. Accordingly, the comment is not adopted.

K. Application of attribution rules for purposes of determining status of foreign corporation as a specified foreign corporation

To limit the administrative and compliance difficulties associated with determining whether a foreign corporation is a specified foreign corporation solely by reason of downward attribution of its stock under section 318(a)(3)(A) from a partner to a partnership when the partner has only a de minimis interest in the partnership, proposed §1.965–1(f)(45)(ii) provides a special attribution rule for purposes of determining whether a foreign corporation is a specified foreign corporation within the meaning of section 965(e)(1)(B) and proposed §1.965–1(f)(45)(i)(B). Specifically, the definition of specified foreign corporation provides that, for purposes of determining whether a foreign corporation is a specified foreign corporation within the meaning of section 965(e)(1)(B), stock owned, directly or indirectly, by or for a partner ("tested partner") will not be considered as being owned by a partnership under sections 958(b) and 318(a)(3)(A) if the tested partner owns less than five percent of the interests in the partnership’s capital and profits. Proposed §1.965–1(f)(45)(ii). Similar rules apply with respect to S corporations. See sections 318(a)(5)(E) and 1373a.

1. Downward Attribution to Trusts

A comment requested that the final regulations adopt a similar rule for trusts, noting that downward attribution of stock to trusts is also possible when a beneficiary has a de minimis interest in the trust, unless that interest is a remote contingent interest. See section 318(a)(3)(B). The Treasury Department and the IRS agree that downward attribution of stock to a trust from de minimis beneficiaries of the trust presents similar administrative and compliance difficulties to those addressed in the proposed regulations. Accordingly, the final regulations extend the special rules concerning downward attribution (as modified per the discussion in Part II.K.2 of this Summary of Comments and Explanation of Revisions) to trusts. See §1.965–1(f)(45)(ii)(A)(2).

2. Other Relief from Attribution

A comment indicated that, in determining specified foreign corporation status under section 965(e)(1)(B), the final regulations should take into account domestic corporations that are United States shareholders only if they own (within the meaning of section 958(a)) stock of the specified foreign corporation. Another comment indicated that the Treasury Department and the IRS should generally consider additional de minimis constructive ownership exceptions in determining specified foreign corporation status without specifically identifying the nature of such relief. A comment also recommended that the five percent threshold in proposed §1.965–1(f)(45)(ii) be increased to a more significant percentage, such as ten percent. A similar comment suggested that the five percent threshold apply only to managing and controlling partners, and that a threshold of fifteen percent apply to partners who have no ability to manage or control the partnership. In response to these comments, the Treasury Department and the IRS have determined that a ten-percent threshold for application of the special attribution rules relating to partnerships and trusts would strike the appropriate balance between mitigating administrative and compliance burdens and accurately identifying which foreign corporations are, in fact, specified foreign corporations. Accordingly, the final regulations increase the threshold for application of this special attribution rule for partnerships from five percent to ten percent, and similarly use a ten-percent threshold for the newly-added special attribution rule for trusts.

Another comment suggested that a foreign corporation that is a CFC solely by reason of downward attribution not be treated as a CFC for purposes of determining whether it is a specified foreign corporation with respect to a United States shareholder that is not a related person (within the meaning of section 954(d)(3)) with respect to the domestic corporation to which ownership was attributed. Nothing in the plain statutory language of section 965 or 958(b), as amended by the Act, prevents the application of section 318(a)(3) so as to treat a foreign corporation as a CFC with respect to a United States shareholder as a result of downward attribution of stock from a foreign person to a United States person if the United States person and the United States shareholder are not related persons as defined by section 954(d)(3). Furthermore, it may benefit taxpayers for a specified foreign corporation with respect to which section 965 would otherwise apply to be respected as a CFC for purposes of section 965, as that could permit deemed paid credits to be claimed with respect to a section 965(a) inclusion with respect to the specified foreign corporation that would not otherwise be permitted. Consistent with the statutory text, the final regulations therefore do not adopt the exclusion from the definition of specified foreign corporation recommended by the comment.

3. Application of Section 318(a)(5)(A) and (C)

A comment stated that Example 1 and Example 2 in proposed §1.965–1(g), which illustrate the special attribution rule, apply section 318(a)(5)(A) and (a)(5)(C) inconsistently with informal advice issued by the IRS. Because the interpretation of those pro-
visions reflected in the examples is irrelevant to the application of the special attribution rule, the final regulations modify the examples to avoid the issue raised by the comment. See §1.965–1(g)(1) and (2). No inference, however, is intended regarding the proper interpretation of section 318(a)(5)(A) and (a)(5)(C).

III. Comments and Changes to Proposed §1.965–2 – Adjustments to E&P and Basis

Proposed §1.965–2 contains rules relating to adjustments to E&P and basis to determine and account for the application of section 965(a) and (b) and proposed §1.965–1(b), and a rule that limits the amount of gain recognized in connection with the application of section 961(b)(2). The comments and modifications with respect to these rules are discussed in this Part III.

A. Ordering rule

The proposed regulations set forth an ordering rule relating to adjustments to E&P for purposes of determining a section 958(a) U.S. shareholder’s inclusions under section 951(a)(1) and the treatment of distributions under section 959. See proposed §1.965–2(b).

1. Application in the Case of E&P Measurement Dates in Two Taxable Years

The Treasury Department and the IRS have determined that the ordering rule’s limited application to E&P for a specified foreign corporation’s last taxable year beginning before January 1, 2018, is too narrow, given that it is intended to apply for purposes of determining post–1986 earnings and profits and accumulated post–1986 deferred foreign income on the E&P measurement date on November 2, 2017; that measurement date may not fall within a specified foreign corporation’s last taxable year beginning before January 1, 2018. The final regulations address this issue by providing that the ordering rule applies for the taxable year of a specified foreign corporation in which an E&P measurement date occurs, as well as for the last taxable year of a specified foreign corporation that begins before January 1, 2018.

2. Section 1248

Comments have also raised questions about the proper point in the sequence at which to determine and take into account inclusions under section 1248. Although one comment suggested that section 965 should be taken into account before section 1248 amounts are determined, the Treasury Department and the IRS have determined that such an approach would not mitigate double taxation in the case of a sale in which the buyer (as opposed to the seller, as in the example provided by the comment) was subject to tax under section 965. However, such double taxation is mitigated by the approach suggested by another comment and taken by the final regulations, which provide that, for purposes of the ordering rules, section 1248 amounts are determined at the same time as the determination of amounts included under section 951(a)(1)(A) other than amounts included by reason of section 965. As a result, section 1248 amounts are determined before, and may reduce, a buyer’s section 965(a) inclusion amount with respect to a DFIC. The application of the ordering rule in connection with a sale to which section 1248 applies is illustrated in a new example in §1.965–2(j)(6).

The comment also suggested that the final regulations include an example addressing the interaction of the section 367 gain recognition agreement rules and the determination of section 965(a) inclusions. The Treasury Department and the IRS have determined that those rules are outside of the scope of these regulations and do not adopt the comment.

3. Interaction of Ordering Rule, Foreign Tax Credit Rules, and Disregard Rules

Comments have raised questions concerning the interaction of the ordering rule with the rule disregarding payments in proposed §1.965–4(f) and the determination of the foreign tax credit consequences of inclusions with respect to, and distributions by, a specified foreign corporation. The final regulations address these issues by providing rules concerning the ordering of the determination of foreign income taxes deemed paid with respect to an inclusion or distribution, after the E&P adjustments are determined in accordance with §1.965–2(b). The final regulations provide that for purposes of determining the consequences under sections 902 and 960 of a dividend or an inclusion under section 951(a)(1), respectively, the ordering rule in §1.960–1(i)(2) applies except that section 902 is applied with respect to any distributions from the specified foreign corporation described in §1.965–2(b)(2) that are not disregarded under §1.965–4 before section 960 is applied with respect to an inclusion or a distribution described in §1.965–2(b)(3), (b)(4), or (b)(5). Section 1.965–2(b). As discussed in more detail in Parts VI.C.3 and 4 of this Summary of Comments and Explanation of Revisions, the final regulations confirm that the other rules of sections 902 and 960 apply. See §1.965–6(b). The final regulations also provide that the E&P consequences of a distribution between specified foreign corporations that is disregarded for purposes of section 965 pursuant to §1.965–4 are redetermined after adjustments for section 965(a) inclusions, at the same time that the consequences of other distributions are determined. See §1.965–2(b)(1) and (4).

Modified and new examples illustrate the determination of the section 902 consequences of a distribution between specified foreign corporations before November 2, 2017, before the determination of the section 960 consequences of a section 965(a) inclusion and the foreign tax credit consequences of a distribution disregarded pursuant to §1.965–4. See §1.965–2(j)(1) and (4).

A comment recommended that the ordering rule be further modified to allow the foreign tax credit consequences of a distribution to a United States shareholder to be determined before applying section 965. The Treasury Department and the IRS decline to adopt the recommendation because ordering section 965(a) inclusions before distributions to United States shareholders is required to be consistent with section 965(d)(3)(B), which precludes diminution of post–1986 earnings and profits by distributions during the relevant year other than by dividends distributed to another specified foreign corpora-
tion, as well as to be consistent with the general treatment of inclusions under section 951 as being taken into account before distributions, as discussed in this Part III.A.3.

B. Adjustments to the E&P of DFICs

Under proposed §1.965–2(c), the E&P of a DFIC that are described in section 959(c)(3) (or that would be described in section 959(c)(3) but for the application of section 965(a) and the section 965 regulations) are reduced (or, in the case of a deficit, increased) by an amount equal to the DFIC’s section 965(a) previously taxed earnings and profits. A comment requested that the final regulations clarify that earnings described in section 959(c)(3) cannot be reduced below zero by reason of the rule in proposed §1.965–2(c), in order to ensure that the DFIC would be able to make a distribution of the section 965(a) previously taxed earnings and profits. The comment was also concerned that a deficit in E&P described in section 959(c)(3) could prevent foreign income taxes accrued on future subpart F income from being deemed paid with respect to inclusions under section 951(a)(1)(A) with respect to such income and requested that, in the alternative, guidance be provided allowing foreign income taxes to be deemed paid under those circumstances. The sum of a foreign corporation’s E&P described in each of the categories in section 959(c) must equal the foreign corporation’s total E&P. Rev. Rul. 86–131, 1986–2 C.B. 135 (“T]he section 959(c) components are intended to reflect the composition of the CFC’s total earnings and profits. . .”).

In order to ensure that a specified foreign corporation’s E&P and/or applicable property with respect to an E&P deficit foreign corporation. E&P described in section 959(c)(3) are not generally allocated to specific shareholders, and creating a rule that tracks section 959(c)(3) E&P resulting from a section 958(a) U.S. shareholder’s use of each E&P deficit foreign corporation’s specified E&P deficit in a shareholder-level account would entail considerable complexity. Accordingly, the final regulations do not adopt the proposed change. See §1.965–2(d)(2)(i)(A).

D. Basis election

1. Requirements for Making and Revoking Basis Election

The proposed regulations clarify that, in general, no adjustments to basis of stock or property are made under section 961 (or any other provision of the Code) to account for the reduction to a section 958(a) U.S. shareholder’s pro rata share of the section 965(a) earnings amount of a DFIC by a portion of its aggregate foreign E&P deficit. See proposed §1.965–2(f)(1). However, consistent with the legislative history, the proposed regulations allow a section 958(a) U.S. shareholder to elect to make certain basis adjustments (“specified basis adjustments”) with respect to each DFIC and each E&P deficit foreign corporation. Proposed §1.965–2(f)(2). Specifically, an election under the proposed regulations allows a section 958(a) U.S. shareholder’s basis in the section 958(a) stock of a DFIC or applicable property with respect to the DFIC to be increased by an amount equal to the section 965(b) previously taxed earnings and profits of the DFIC with respect to the section 958(a) U.S. shareholder. See proposed §1.965–2(f)(2)(ii)(A). The basis election also requires that the section 958(a) U.S. shareholder’s basis in the section 958(a) stock of an E&P deficit foreign corporation or applicable property with respect to an

Under the proposed regulations, the E&P described in section 959(c)(3) of an E&P deficit foreign corporation are increased by an amount equal to the portion of a section 958(a) U.S. shareholder’s pro rata share of the specified E&P deficit of the E&P deficit foreign corporation taken into account under section 965(b), translated (if necessary) into the functional currency of the E&P deficit foreign corporation using the spot rate on December 31, 2017. Proposed §1.965–2(d)(2)(i)(A). A comment recommended that the proposed regulations be modified such that any increase to the earnings and profits described in section 959(c)(3) of an E&P deficit foreign corporation is allocated only to a section 958(a) U.S. shareholder that takes into account its E&P deficit foreign corporation’s specified E&P deficit under section 965(b) and not to any other shareholders of the E&P deficit foreign corporation. E&P described in section 959(c)(3) are not generally allocated to specific shareholders, and creating a rule that tracks section 959(c)(3) E&P resulting from a section 958(a) U.S. shareholder’s use of each E&P deficit foreign corporation’s specified E&P deficit in a shareholder-level account would entail considerable complexity. Accordingly, the final regulations do not adopt the recommended change. See §1.965–2(d)(2)(i)(A).

C. Adjustments to the E&P described in section 959(c)(3) of E&P deficit foreign corporations

Under the proposed regulations, the E&P described in section 959(c)(3) of an E&P deficit foreign corporation are increased by an amount equal to the portion of a section 958(a) U.S. shareholder’s pro rata share of the specified E&P deficit of the E&P deficit foreign corporation taken into account under section 965(b), translated (if necessary) into the functional currency of the E&P deficit foreign corporation using the spot rate on December 31,
E&P deficit foreign corporation be reduced by an amount equal to the portion of the section 958(a) U.S. shareholder’s pro rata share of the specified E&P deficit of the E&P deficit foreign corporation taken into account under the reduction rules. See proposed §1.965–2(f)(2)(ii)(B).

The proposed regulations provide the general rule that the basis election must be made no later than the due date (taking into account extensions, if any) for the section 958(a) U.S. shareholder’s return for the first taxable year that includes the last day of the last taxable year of a DFIC or E&P deficit foreign corporation of the section 958(a) U.S. shareholder that begins before January 1, 2018. Proposed §1.965–2(f)(2)(iii)(B)(1)(i). If the relevant return was due before September 10, 2018, the proposed regulations provide that the basis election must be made by October 9, 2018 (the “transition rule”). Proposed §1.965–2(f)(2)(iii)(B)(1)(ii). The proposed regulations further require that, in order for the basis election to be effective, a section 958(a) U.S. shareholder and each section 958(a) U.S. shareholder that is related to the section 958(a) U.S. shareholder under section 267(b) or 707(b) (“related section 958(a) U.S. shareholder”) must make the election. Proposed §1.965–2(f)(2)(iii)(A).

Section 2 of Notice 2018–78 announced that the Treasury Department and the IRS had determined that requiring taxpayers to make a binding basis election before the finalization of the proposed regulations would be too onerous for taxpayers. Consistent with that announcement, the final regulations provide that the transition rule will apply with respect to returns due (determined with regard to any extension) before May 6, 2019, and that in such cases the basis election must be made no later than May 6, 2019. Section 1.965–2(f)(2)(iii)(B)(1)(ii). Additionally, as explained in section 2 of Notice 2018–78, the final regulations provide that if a basis election was made on or before February 5, 2019, the basis election may be revoked by attaching a statement to an amended return filed no later than May 6, 2019. Id.

Clarification was requested regarding whether a basis election must be made by a related section 958(a) U.S. shareholder if that shareholder owns a DFIC but does not own an E&P deficit foreign corporation and does not reduce its pro rata share of any section 965(a) earnings amount under section 965(b), proposed §1.965–1(b)(2), or proposed §1.965–8(b). The Treasury Department and the IRS have concluded that the requirement to make a basis election should not apply to such persons. Accordingly, the final regulations provide that the basis election must be made by a section 958(a) U.S. shareholder and any related section 958(a) U.S. shareholder of an E&P deficit foreign corporation or of a DFIC with respect to which the section 958(a) U.S. shareholder’s pro rata share of the section 965(a) earnings amount is reduced under section 965(b), §1.965–1(b)(2), or §1.965–8(b). Section 1.965–2(f)(2)(iii)(A). However, the final regulations do not adopt a comment’s suggestion that the consistency requirement be eliminated in its entirety because the Treasury Department and the IRS have determined that the requirement is necessary to prevent related taxpayers from applying the rules only where they are advantageous.

Another comment requested that the basis election be considered made by default unless a taxpayer affirmatively elects not to make specified basis adjustments. Given the potentially significant ramifications of the specified basis adjustments, the Treasury Department and the IRS have determined that providing for automatic basis adjustments and putting the onus on taxpayers to affirmatively elect out is not appropriate. Accordingly, the comment is not adopted.

2. Level and Consequences of Basis Adjustments

Comments requested that the final regulations provide that positive basis adjustments with respect to section 965(b) previously taxed earnings and profits apply down a chain of foreign corporations under section 961(c) and thus that they apply by default, such that the basis election and its concomitant downward basis adjustments with respect to E&P deficit foreign corporations need not be made. Comments also suggested that even if downward basis adjustments were required, the final regulations should not require them to be made for the entire amount of a specified E&P deficit taken into account, but instead allow taxpayers to elect an amount of basis that “shifted.” The comments were particularly concerned that downward adjustments not offset upward adjustments. Comments also recommended that the final regulations not require gain recognition to the extent that downward basis adjustments would exceed basis, and that, if such gain recognition is required, a special reduced rate of tax be provided for such gain.

The Treasury Department and the IRS have determined that it is clear under proposed §1.965–2(f)(1) that no adjustments are made under section 961 with respect to section 965(b) previously taxed earnings and profits, given that section 965(b) previously taxed earnings and profits do not represent amounts included in income by a section 958(a) U.S. shareholder, as required by section 961, and that adjustments apply only with respect to section 958(a) stock or applicable property owned directly by a section 958(a) U.S. shareholder (or in certain cases, through foreign pass-through entities). Id. Accordingly, the final regulations do not modify the proposed regulations in this regard.

The Treasury Department and the IRS have also determined that it would create economic distortions to provide for upward basis adjustments with respect to section 965(b) previously taxed earnings and profits without providing for corresponding downward basis adjustments with respect to portions of specified E&P deficits taken into account to reduce section 965(a) inclusion amounts and requiring gain recognition to the extent such adjustments exceed basis. Accordingly, it would not be appropriate to provide that section 965(b) previously taxed earnings and profits are treated as included in income under section 951 for purposes of section 961, even though the final regulations provide as much for purposes of section 1248(d), as discussed in Part III.B of this Summary of Comments and Explanation of Revisions. Moreover, the Treasury Department and the IRS have concluded that rules coordinating upward and downward tiered-basis adjustments are not warranted. Additionally, given the electivity of the specified basis adjustments and the ability of taxpayers to take into account factors like the tax rate at which gain is recognized as a result of the basis election, the Treasury Department
and the IRS decline to provide rules resulting in the application of a special tax rate to such gain.

However, the Treasury Department and the IRS have determined that it is appropriate to not require downward basis adjustments in excess of basis (in order to avoid gain recognition under §1.965–2(h)(3) to the extent of such excess) if the corresponding upward basis adjustments are correspondingly limited. Accordingly, §1.965–2(f)(2)(ii)(B)(2) provides that downward basis adjustments to the stock of, or applicable property with respect to, an E&P deficit foreign corporation may be limited to the available basis with the result that gain is not recognized (the “to-the-extent rule”). If the to-the-extent rule limits downward basis adjustments, the corresponding upward basis adjustments are correspondingly limited. See §1.965–2(f)(2)(ii)(A)(2)(ii). However, the section 958(a) U.S. shareholder can (subject to certain limitations) designate the stock of, or applicable property with respect to, a DFIC with respect to which the upward adjustments are made. Id. A taxpayer may also choose to make the full amounts of the adjustments that would have been required under the proposed regulations and recognize gain under §1.965–2(h)(3) as necessary. See §1.965–2(f)(2)(ii)(A)(I) and (f)(2)(ii)(B)(I).

3. Timing of Basis Adjustments

The proposed regulations provide that the specified basis adjustments are made as of the close of the last day of the last taxable year of the specified foreign corporation that begins before January 1, 2018. Proposed §1.965–2(h)(1). Questions have been raised about the application of the proposed rules in the case of a specified foreign corporation that ceases to be a CFC during its last taxable year of the specified foreign corporation that begins before January 1, 2018, due to a disposition of its stock. As discussed in Part II.H of this Summary of Comments and Explanation of Revisions, under section 951, a section 958(a) U.S. shareholder of such a specified foreign corporation would generally have an inclusion under section 951 with respect to the corporation if it were a DFIC because it would own stock of the specified foreign corporation on the last day on which the corporation was a controlled foreign corporation. Accordingly, under §1.961–1(a), a basis adjustment would generally be allowed as of the last day in the taxable year of such corporation on which it is a controlled foreign corporation.

As discussed in Part II.H of this Summary of Comments and Explanation of Revisions, because a specified foreign corporation is treated as a CFC for purposes of §1.965–1(b) and sections 951 and 961, the Treasury Department and the IRS have determined that income inclusion provisions in the final regulations should be consistent with these rules, and thus the basis adjustment provisions should as well, and the relevant rules in the final regulations are revised accordingly. See §§1.965–1(f)(30)(i) and (f)(34) and 1.965–2(h)(1) (providing that a specified basis adjustment is made as of the last day of the last taxable year of the specified foreign corporation that begins before January 1, 2018, on which it is a specified foreign corporation).

4. Share-by-Share Requirement for Basis Adjustments

Proposed §1.965–2(h)(3) requires that the specified basis adjustments be made on a share-by-share basis. A comment suggested that the specified basis adjustments be made in the aggregate to mitigate taxpayer burden in tracking and prevent what it described as inappropriate gain recognition. However, adjustments to basis under section 961 for inclusions under section 951 and distributions of previously taxed E&P are generally required to be made on a share-by-share basis, and it will be necessary to have information concerning basis share-by-share going forward. Furthermore, the to-the-extent rule included in the final regulations will provide relief to taxpayers that have low-basis and high-basis shares. Accordingly, the comment is not adopted.

5. Basis Adjustments with Respect to Foreign Pass-Through Entity

A comment suggested that the final regulations provide that for purposes of the specified basis adjustments with respect to foreign pass-through entities, the principles of section 743(b) apply for associating a specified basis adjustment with a section 958(a) U.S. shareholder with respect to whom it is made. The comment also recommended clarification of the basis consequences of a distribution in a structure with a foreign pass-through entity. The Treasury Department and the IRS will consider these recommendations in connection with future guidance concerning the application of sections 959 and 961 generally.

See Part II.B of this Summary of Comments and Explanation of Revisions for a discussion of the treatment of a controlled domestic partnership treated as a foreign partnership under §1.965–1(e) for purposes of the specified basis adjustment rules relating to foreign pass-through entities.

6. Section 962 Elections

The proposed regulations reserve on the issue of basis adjustments with respect to a section 958(a) U.S. shareholder that made a section 962 election. A comment noted that section 961(a)’s limitation on a basis increase to the amount of tax paid under chapter 1 of the Code with respect to amounts required to be included in income under section 951(a) (in the case of a United States shareholder who has made a section 962 election for the taxable year) means that a section 958(a) U.S. shareholder that makes a section 965(h) election may only increase its basis as it pays its section 965(h) net tax liability over time. As suggested by the comment, the final regulations include this rule. See §1.965–2(e)(2) and (h)(1). Consistent with this rule, no adjustments apply for section 965(b) previously taxed earnings and profits and the use of specified E&P deficits. See §1.965–2(f)(2)(ii)(C).

A comment requested that the final regulations provide guidance concerning the consequences if an individual section 958(a) U.S. shareholder that made both a section 962 election and a section 965(h) election that applied to a section 965(a) inclusion with respect to a DFIC disposed of the DFIC stock before all of its section 965(h) net tax liability had been paid, and thus before all corresponding basis adjustments had been made. The comment recommended that the basis adjustments be treated as made immediately before the
The Treasury Department and the IRS have determined that this treatment would not be appropriate, because it would allow the shareholder to obtain the benefits of the basis increase without having paid the corresponding tax, and do not adopt the comment.

The comment also requested that the final regulations clarify the basis adjustments to be made in the case of a domestic pass-through owner that has made a section 962 election applicable to its distributive share of a domestic pass-through entity’s section 965(a) inclusion amount. The issue raised by the comment is a longstanding issue of general applicability within subpart F that is outside of the scope of regulations concerning section 965. Accordingly, the Treasury Department and the IRS decline to adopt the comment, and the final regulations, like the proposed regulations, address only basis adjustments applicable to section 958(a) U.S. shareholders of DFICs.

E. Gain reduction rule and translation rates

The proposed regulations provide that, for purposes of section 986(c), foreign currency gain or loss with respect to distributions of section 965(a) previously taxed earnings and profits is determined based on movements in the exchange rate between December 31, 2017, and the date on which such E&P are actually distributed. See proposed §1.986(c)–1(a). The proposed regulations also provide that any gain or loss recognized under section 986(c) with respect to distributions of section 965(a) previously taxed earnings and profits is reduced in the same proportion as the reduction by a section 965(c) deduction amount of the section 965(a) inclusion amount that gave rise to such section 965(a) previously taxed earnings and profits. See proposed §1.986(c)–1(b). Moreover, proposed §1.986(c)–1(c) provides that section 986(c) does not apply with respect to distributions of section 965(b) previously taxed earnings and profits.

The proposed regulations also provide that if a section 958(a) U.S. shareholder receives a distribution from a DFIC (including through a chain of ownership described under section 958(a)) during the inclusion year of the DFIC that is attributable to section 965 previously taxed earnings and profits of the DFIC, then the amount of gain that otherwise would be recognized under section 961(b)(2) by the section 958(a) U.S. shareholder with respect to the section 958(a) U.S. shareholder’s section 958(a) stock of the DFIC or interest in applicable property with respect to the DFIC by reason of the distribution is reduced (but not below zero) by an amount equal to the section 965 previously taxed earnings and profits of the DFIC with respect to the section 958(a) U.S. shareholder. Proposed §1.965–2(g)(1)(i).

The proposed regulations do not specify the translation rate to be used for purposes of reducing the amount of gain that otherwise would be recognized under section 961(b)(2) when a DFIC that has a functional currency other than the U.S. dollar distributes section 965(b) previously taxed earnings and profits. In the absence of a rule providing that section 965(b) previously taxed earnings and profits should be translated into U.S. dollars at the spot rate on December 31, 2017, fluctuations in exchange rates would cause distortions in the application of the gain reduction rule to distributions of section 965(b) previously taxed earnings and profits. For example, distributions of section 965(b) previously taxed earnings and profits denominated in a currency other than the U.S. dollar during an inclusion year could result in gain recognition attributable to fluctuations in exchange rates, notwithstanding the fact that proposed §1.986(c)–1 specifically provides that a taxpayer is not required to recognize foreign currency gain or loss on such distributions. To prevent recognition of gain under these circumstances, the final regulations provide that the translation rate to be used with respect to section 965(b) previously taxed earnings and profits for purposes of the gain reduction rule is the spot rate on December 31, 2017.

The Treasury Department and the IRS are considering proposing regulations under section 961 to similarly ensure that a taxpayer is not required to recognize gain by reason of fluctuations in exchange rates on distributions of section 965(b) previously taxed earnings and profits in taxable years after the inclusion year. In addition, the Treasury Department and the IRS intend to study the proper amount of gain or loss, including foreign currency gain or loss, to be recognized on distributions of previously taxed E&P, including previously taxed E&P other than section 965(a) previously taxed earnings and profits and section 965(b) previously taxed earnings and profits.

IV. Comments and Changes to Proposed §1.965–3 – Section 965(c) Deductions

Proposed §1.965–3 provides rules regarding the determination of section 965(c) deductions and section 965(c) deduction amounts. The comments and modifications with respect to these rules are discussed in this Part IV.

A. Disregard of certain assets to prevent double counting

The proposed regulations contain rules for disregarding certain assets for purposes of determining the aggregate foreign cash position of a section 958(a) U.S. shareholder. See proposed §1.965–3(b).

1. Disregard of Certain Obligations Between Related Specified Foreign Corporations

One such rule in the proposed regulations provides that, for purposes of determining the aggregate foreign cash position of a section 958(a) U.S. shareholder, accounts receivable, accounts payable, short-term obligations, and derivative financial instruments between related specified foreign corporations are disregarded, if applicable, on a cash measurement date of the specified foreign corporations to the extent of the smallest of the section 958(a) U.S. shareholder’s ownership percentages of section 958(a) stock of the specified foreign corporations owned by the section 958(a) U.S. shareholder on the cash measurement date. Proposed §1.965–3(b)(1).

A comment suggested that the rule in proposed §1.965–3(b)(1) be extended to permit the same treatment for third-party accounts payable and third-party accounts receivable held by related specified foreign corporations of a section 958(a) U.S. shareholder. The comment also suggested that all members of a consolidated group that are section 958(a) U.S. shareholders be treated as a single section 958(a) U.S.
shareholder for purposes of such a rule. The Treasury Department and the IRS do not adopt this comment for several reasons. First, although the statute explicitly allows third-party accounts payable held by a specified foreign corporation to be netted against the same specified foreign corporation’s third-party accounts receivable for purposes of determining its cash position, it does not provide for netting of third-party payables and third-party receivables among a section 958(a) U.S. shareholder’s specified foreign corporations for purposes of determining that section 958(a) U.S. shareholder’s aggregate foreign cash position. See section 965(c)(3)(B)(ii) and (c)(3)(C). Second, the statutory language and the legislative history direct the Secretary to address the double counting of accounts receivable and accounts payable between related specified foreign corporations of a section 958(a) U.S. shareholder but do not grant authority to issue rules allowing one specified foreign corporation’s third-party accounts payable to offset another specified foreign corporation’s third-party accounts receivable. See section 965(c)(3)(D); H.R. Rep. No. 115–446, at 615 (2017). Furthermore, allowing third-party payables and third-party receivables of all related specified foreign corporations of a section 958(a) U.S. shareholder to be netted would require administratively onerous allocation rules. The final regulations therefore do not extend the rule in proposed §1.965–3(b)(1) to cover third-party accounts payable and third-party accounts receivable held by related specified foreign corporations with a common section 958(a) U.S. shareholder.

2. Disregard of Other Assets upon Demonstration of Double-Counting

Another rule in the proposed regulations intended to prevent double counting provides that, in determining the aggregate foreign cash position of a section 958(a) U.S. shareholder, amounts of net accounts receivable, actively traded property, and short-term obligations of a specified foreign corporation are disregarded to the extent such amounts are attributable to amounts taken into account in determining the section 958(a) U.S. shareholder’s pro rata share of the cash position of another specified foreign corporation on the same day. Section 1.965–3(b)(2). Corresponding cash measurement dates

a. Expansion

Comments recommended that the rule in proposed §1.965–3(b)(2) be expanded to cover all assets constituting a specified foreign corporation’s cash position, which are enumerated in section 965(c)(3)(B). Under this formulation, a section 958(a) U.S. shareholder would be able to disregard cash held by its specified foreign corporation (or any other asset described in section 965(c)(3)(B)) on a cash measurement date to the extent attributable to amounts already taken into account in determining the section 958(a) U.S. shareholder’s pro rata share of the cash position of another specified foreign corporation on such cash measurement date.

The Treasury Department and the IRS do not adopt this recommendation for a number of reasons. First, extending the rule in proposed §1.965–3(b)(2) to apply to assets other than net accounts receivable, actively traded property, and short-term obligations would be inconsistent with section 965(c)(3)(D), which expressly identifies net accounts receivable, actively traded property, and short-term obligations as assets not to be taken into account by a section 958(a) U.S. shareholder for purposes of determining its aggregate foreign cash position to the extent the shareholder demonstrates to the Secretary’s satisfaction that such amount is so taken into account by the shareholder with respect to another specified foreign corporation. The other assets described in section 965(c)(3)(C), including cash, are not mentioned in section 965(c)(3)(D). Second, the Treasury Department and the IRS have determined that expanding the rule in proposed §1.965–3(b)(2) to cover all assets taken into account in determining a specified foreign corporation’s cash position would require complex tracing rules to ensure that each asset was already taken into account by a section 958(a) U.S. shareholder with respect to another specified foreign corporation and have determined that such rules would entail significant administrative and compliance challenges. Accordingly, the final regulations do not expand the rule in proposed §1.965–3(b)(2) to allow a section 958(a) U.S. shareholder to disregard assets other than those specifically enumerated in section 965(c)(3)(D).

b. Clarification of cash measurement dates

Comments also recommended that the rule in proposed §1.965–3(b)(2) be clarified so that relief from double-counting is available with respect to a specified foreign corporation when an amount is taken into account in determining the section 958(a) U.S. shareholder’s pro rata share of the cash position of another specified foreign corporation on such specified foreign corporation’s corresponding cash measurement date even if the cash measurement date is not the same calendar date for both specified foreign corporations.

The Treasury Department and the IRS have concluded that section 965(c)(3)(D) allows relief from double counting whenever a section 958(a) U.S. shareholder can establish that net accounts receivable, actively traded property, or short-term obligations are “taken into account . . . with respect to another specified foreign corporation.” The statute does not require that an amount must have been taken into account with respect to another specified foreign corporation on the same day. Therefore, in response to the comments, the final regulations amend the rule in proposed §1.965–3(b)(2) to clarify that double-counting relief with respect to a specified foreign corporation is available when an amount is taken into account in determining the section 958(a) U.S. shareholder’s pro rata share of the cash position of another specified foreign corporation on the other specified foreign corporation’s corresponding cash measurement date. Section 1.965–3(b)(2). Corresponding clarifications are made for consistency in §1.965–3(b)(1).
3. Notional Cash Pooling Arrangements

Comments requested guidance providing that for purposes of computing a section 958(a) U.S. shareholder’s aggregate foreign cash position, notional cash pooling arrangements are treated as creating intercompany receivables. The facts and circumstances of each notional cash pool, including the underlying contractual rights and obligations of the parties to the arrangement and the role of the unrelated cash pool provider in the arrangement, are varied. Whether a notional cash pooling arrangement is treated as in substance creating a loan between and among participants, rather than between the participant and the unrelated cash pool provider, depends on the application of federal income tax principles to the particular facts and circumstances of the arrangement. Accordingly, the Treasury Department and the IRS do not adopt these comments.

B. Disregard of portion of cash position of noncorporate entities treated as specified foreign corporations

Section 965(c)(3)(E) provides that an entity (other than a corporation) is treated as a specified foreign corporation of a United States shareholder for purposes of determining the United States shareholder’s aggregate foreign cash position if any interest in the entity is held by a specified foreign corporation of the United States shareholder (determined after application of the rule in this sentence) and the entity, if it were a foreign corporation, would be a specified foreign corporation of the United States shareholder. A comment requested confirmation that application of section 965(c)(3)(E) to treat a noncorporate entity as a specified foreign corporation could depend on ownership by other owners of the noncorporate entity and on the definition of United States shareholder applicable for the year in which the status of a foreign corporation as a specified foreign corporation is being determined. The Treasury Department and the IRS have determined that this point is clear from the definition of specified foreign corporation. The comment also suggested that the Treasury Department and the IRS consider limitations on attribution for purposes of determining whether a noncorporate entity would be a specified foreign corporation if it were a foreign corporation. The Treasury Department and the IRS have determined that the special attribution rule described in Part II.K of this Summary of Comments and Explanation of Revisions, as modified to a ten-percent threshold in the final regulations, would apply for purposes of the noncorporate entity rule and that no additional limitations are warranted. The Treasury Department and the IRS have also determined that it is clear under the statute that section 951(b) as in effect for years of foreign corporations beginning before January 1, 2018, applies for purposes of determining whether a noncorporate entity would be a specified foreign corporation if it were a foreign corporation for purposes of section 965(c)(3)(E), given that the relevant year for application of the rule is the last taxable year of a foreign corporation beginning before January 1, 2018.

A comment also requested guidance clarifying the application of section 965(c)(3)(E) to noncorporate entities only partially owned by a specified foreign corporation. The legislative history to section 965(c)(3)(E) indicates that it was intended that “the cash position of a U.S. shareholder . . . not generally include the cash attributable to a direct ownership interest in a partnership,” and that the Treasury Department and the IRS “provide guidance for taking into account only the specified foreign corporation’s share of the partnership’s cash position, and not [an] interest directly owned by the U.S. shareholder.” H.R. Rep. No. 115–446, at 621 (2017). Accordingly, the final regulations include a rule in §1.965–3(b)(3) providing that if section 965(c)(3)(E) applies to an entity, the section 958(a) U.S. shareholder’s pro rata share of the cash position of the entity is reduced by the amount attributable to deemed stock of the entity not owned (within the meaning of section 958(a)) by a specified foreign corporation of the section 958(a) U.S. shareholder. This rule is illustrated in the example in §1.965–3(b)(4)(v).

C. Increase of income by section 965(c) deduction of expatriated entity

Under proposed §1.965–3(d)(1), if a person is allowed a section 965(c) deduction and becomes an expatriated entity, in certain circumstances, the person must pay tax equal to 35 percent of the person’s section 965(c) deductions. See also section 965(l)(1). A comment recommended clarifying and limiting the definition of expatriated entity to exclude United States individuals on the theory that the reference to “entity” in section 965(l)(2) was intended to so provide. Section 965(l)(2) defines expatriated entity by cross-reference to the definition provided in section 7874(a)(2), which includes not only entities but certain persons (which could be individuals) related to the entity at issue; therefore, the Treasury Department and the IRS have determined that section 965(l)(2) does not apply only to an entity but potentially to any person that is an expatriated entity, and the final regulations are clarified accordingly. See §1.965–3(d)(2).

D. Treatment of section 965(c) deductions

Under the proposed regulations, a United States person that must pay tax under section 4940 or 1411 on a section 965(a) inclusion cannot take into account a section 965(c) deduction for purposes of determining the amount of such tax. See proposed §1.965–3(f)(3) and (4). A comment recommended that the section 965(c) deduction be allowed for purposes of computing the amount of tax due under section 1411. It suggested that the rule in proposed §1.965–3(f)(3) was inconsistent with the rule in §1.1411–4(f)(3)(ii), which takes into account in determining net investment income itemized deductions that are investment expenses (as defined in section 163(d)(4)(C)). However, §1.1411–4(f)(3)(ii) is inapplicable because §1.965–3(f)(1) provides that a section 965(c) deduction is not an itemized deduction. The Treasury Department and the IRS have determined that the section 965(c) deduction was only intended to reduce the rate of tax attributable to income taxes contained in chapter 1 of the Code. See H.R. Rep. No. 115–446, at 620 (2017). Accordingly, the final regulations continue to provide that for purposes of section 1411 and §1.1411–4(f)(6), a section 965(c) deduction is not treated as a deduction properly allocable to a corresponding section 965(a) inclusion. Section 1.965–3(f)(3).
Another comment suggested that the final regulations clarify whether a section 965(c) deduction is taken into account for purposes of the tax imposed under section 4968. Because section 4968(c) provides that net investment income subject to the tax is determined under rules similar to the rules of section 4940(c), and §1.965–3(f)(4) provides that for purposes of section 4940(c)(3)(A), a section 965(c) deduction is not treated as an ordinary and necessary expense paid or incurred for the production or collection of gross investment income, the Treasury Department and the IRS have determined that it is clear that a section 965(c) deduction is not taken into account for purposes of section 4968, and no clarification is necessary. The comment also requested rules addressing the basis of the stock of a DFIC for purposes of section 4968; however, such rules would be outside of the scope of this rulemaking, and the request for such guidance is declined.

The comment also recommended that the final regulations clarify that a section 965(c) deduction is a deduction taken into account under section 62(a) in determining an individual’s adjusted gross income. The Treasury Department and the IRS have determined that such treatment is appropriate and the final regulations are modified to so provide. See §1.965–3(f)(1).

V. Comments and Changes to Proposed §1.965–4 – Disregard of Certain Transactions

Proposed §1.965–4 sets forth rules that disregard certain transactions for purposes of applying section 965. Specifically, proposed §1.965–4 provides rules that disregard (i) transactions undertaken with a principal purpose of changing a section 965 element of a United States shareholder and certain changes in method of accounting and entity classification elections, and (iii) certain transactions occurring between E&P measurement dates. The comments and modifications with respect to these rules are discussed in this Part V.

A. Scope and consequences of anti-abuse rules generally

The rules under proposed §1.965–4(b) through (e) (“anti-abuse rules”) relate to transactions undertaken with a principal purpose of changing a section 965 element of a United States shareholder and certain changes in method of accounting and entity classification elections. They provide that transactions subject to those rules are “disregarded for purposes of determining the amounts of all section 965 elements” of a United States shareholder. Comments questioned the consequences of disregarding a transaction under these rules, including with respect to certain E&P and foreign tax credit calculations. The final regulations retain the approach in the proposed regulations, which do not describe the consequences of disregarding a transaction other than the consequences with respect to the section 965 elements of a United States shareholder. A discussion of, or rules regarding, the consequences of these transactions for other purposes is outside the scope of the final regulations. However, the Treasury Department and the IRS have determined that it is appropriate to mitigate double taxation that could result from the application of the anti-abuse rules to a liquidation. Accordingly, §1.965–4(e)(4) provides that in the case of a liquidation of a specified foreign corporation that is disregarded for purposes of determining the section 965 elements of a United States shareholder pursuant to §1.965–4(b) or (c)(2), for purposes of determining the amounts of the section 965 elements of the United States shareholder, the date of the liquidation generally is treated as the last day of the taxable year of the specified foreign corporation. Special rules apply with respect to liquidations resulting from entity classification elections, including a rule that may defer the date of liquidation for this purpose to the date on which the entity classification election is filed. For example, if a domestic corporation (USP) wholly owns a foreign subsidiary (FS) that has a taxable year ending on November 30, and an entity classification election is filed on November 15, 2017, to treat FS as an entity that is disregarded as an entity separate from its owner for U.S. federal income tax purposes (“disregarded entity”) effective on October 1, 2017, then any transactions undertaken by FS through and including November 30, 2017, would be taken into account for purposes of determining the post-1986 earnings and profits and accumulated post-1986 deferred foreign income of FS, and any transactions involving FS after November 30, 2017, would not be taken into account for such purposes. Furthermore, any section 965(a) previously taxed earnings and profits and section 965(b) previously taxed earnings and profits of FS would be taken into account in determining the all earnings and profits amount under §1.367(b)–3(b) with respect to FS.

Comments also requested various exceptions from the anti-abuse rules for transactions that do not reduce the overall U.S. federal income tax liability of United States persons resulting from the application of section 965. In response to these comments, the final regulations provide an exception from the anti-abuse rules for certain incorporation transactions. Under the exception, the anti-abuse rules do not apply to disregard a transfer of stock of a specified foreign corporation by a United States shareholder to a domestic corporation (for this purpose, including an S corporation), provided that the section 965(a) inclusion amount with respect to the transferred stock of the specified foreign corporation is not reduced and that the aggregate foreign cash position of both the transferor and the transferee is determined as if each had held the transferred stock of the specified foreign corporation owned by the other on each of the cash measurement dates. See §1.965–4(e)(3).

B. Transactions with a principal purpose of changing a section 965 element

1. General Rules

Comments suggested that the anti-abuse rules be eliminated and that, if retained, the anti-abuse rules in proposed §1.965–4(b) not contain rebuttable presumptions or per se rules. The Treasury Department and the IRS have determined that the rebuttable presumptions and per se rules are appropriate for tax administration reasons. They identify situations in which tax avoidance is highly likely or unlikely in order to minimize the number
of circumstances in which more detailed facts and circumstances analyses are required.

A comment also suggested that ordinary course exceptions be provided for all of the anti-abuse rules, so that the rules can never apply to ordinary course transactions. The Treasury Department and the IRS have determined that excluding ordinary course transactions from the presumptions in the anti-abuse rules, rather than the overall application of the rules, while still applying those rules to transactions that were actually undertaken with a principal purpose of changing a section 965 element, strikes the appropriate balance between administrability and taxpayer certainty, and therefore do not adopt the comment.

A comment also suggested that the final regulations omit the requirement in proposed §1.965–4(b)(2) that a taxpayer file a statement indicating that it takes the position that a presumption in proposed §1.965–4(b) is rebutted. The Treasury Department and the IRS have determined that it is important for fair and effective tax administration that the IRS be aware of transactions for which there is a presumption of a principal purpose of changing a section 965 element and do not adopt the suggestion.

2. Cash Reduction Transactions and Specified Distributions

The proposed regulations provide that a cash reduction transaction is presumed to be undertaken with a principal purpose of changing a section 965 element of a United States shareholder unless the cash reduction transaction occurs in the ordinary course of business. Proposed §1.965–4(b)(2)(iii)(A). A cash reduction transaction includes a transfer of cash, accounts receivable, or cash-equivalent assets by a specified foreign corporation to a United States shareholder of the specified foreign corporation or a person related to a United States shareholder of the specified foreign corporation if the transfer or assumption reduces the aggregate foreign cash position of the United States shareholder. Id. The presumption may be rebutted only if the facts and circumstances clearly establish that the transaction was not undertaken with a principal purpose of changing the amount of a section 965 element of a United States shareholder, and a taxpayer taking the position that the presumption is rebutted must attach a statement to its tax return disclosing that it has rebutted the presumption. Section 1.965–4(b)(2)(i).

The proposed regulations also set forth a “per se” rule providing that a cash reduction transaction will be treated per se as being undertaken with a principal purpose of changing the amount of a section 965 element of a United States shareholder if it is a specified distribution. Proposed §1.965–4(b)(2)(iii)(B). The proposed regulations provide, in part, that a cash reduction transaction that is a distribution by a specified foreign corporation of a United States shareholder will be considered a specified distribution if and to the extent that, at the time of the distribution, there was a plan or intention for the distributee to transfer cash, accounts receivable, or cash-equivalent assets to any specified foreign corporation of the United States shareholder. Id. Under the proposed regulations, a cash reduction transaction that is a distribution by a specified foreign corporation to a United States shareholder of the specified foreign corporation, other than a specified distribution, is treated per se as not being undertaken with a principal purpose of changing the amount of a section 965 element of a United States shareholder. Id.

The Treasury Department and the IRS received requests that the final regulations exempt certain transactions from the definition of cash reduction transaction and specified distribution. A comment requested that a cash reduction transaction not be treated as a specified distribution if, and to the extent that, the distributee does not, within 24 months following the distribution, transfer cash, accounts receivable, or cash equivalents to a specified foreign corporation of the United States shareholder. Although the Treasury Department and the IRS have determined that the amount of time between a distribution and a transfer of cash may be relevant in determining whether there was a plan or intent for the distributee to transfer the cash, the Treasury Department and the IRS have determined that a per se rule disregarding transfers outside of a certain window is not warranted, as long-term plans for a transfer could exist, and providing such a rule would facilitate tax avoidance. A comment also suggested that it be clarified that any transferred amount disregarded be limited to the amount of the subsequent transfer. Because a specified distribution is defined as a cash reduction transaction “to the extent that” there is a plan or intent to re-transfer cash, the Treasury Department and the IRS have determined that it is already clear that the amount of a specified distribution is limited to the amount re-transferred, and accordingly no additional clarification is required.

Another comment requested that the per se rule not apply to cash reduction transactions planned before November 2, 2017. The final regulations do not adopt this requested change, as the Treasury Department and the IRS have determined that a rule exempting cash reduction transactions in planning stages before November 2, 2017, from the application of the per se rule would necessarily have to account for the possibility of subsequent plan modification or amendment and would require an inquiry regarding a taxpayer’s subjective intent, resulting in a standard that is difficult to administer.

Comments also suggested that a cash reduction transaction should not be considered a specified distribution to a United States shareholder by reason of a transfer of cash to a specified foreign corporation of the United States shareholder in the ordinary course of business. The Treasury Department and the IRS agree that payments pursuant to a legal obligation entered into before the Act’s introduction in Congress should not be considered to give rise to a plan or intention for the distributee in a cash reduction transaction to transfer cash, accounts receivable, or cash-equivalent assets to a specified foreign corporation of the distributee. Accordingly, the final regulations provide that in the case of a cash reduction transaction that is a distribution by a specified foreign corporation of a United States shareholder, there is not considered to be a plan or intention for the distributee to transfer cash, accounts receivable, or cash-equivalent assets to any specified foreign corporation of the United States shareholder if the transfer is made by the distributee pursuant to a legal obligation.
entered into before November 2, 2017. Section 1.965–4(b)(2)(iii)(B). If the taxpayer relies on this rule in determining that a cash reduction transaction is not a specified distribution, it must attach a statement to its return indicating that position. Id.

3. Pro Rata Share Transactions

The proposed regulations provide that a pro rata share transaction is presumed to be undertaken with a principal purpose of changing the amount of a section 965 element of a United States shareholder and treat certain internal group transactions as per se being undertaken with a principal purpose of changing the amount of a section 965 element of a United States shareholder. Proposed §1.965–4(b)(2)(v). A comment requested that internal group transactions not be treated as per se having a principal purpose of changing a section 965 element. The Treasury Department and the IRS have determined that the definition of internal group transactions is sufficiently narrowly tailored to apply the per se rule to tax-motivated transactions of the type that Congress intended the Treasury Department and the IRS to address and do not adopt the comment.

4. E&P Reduction Transactions

A comment noted that dividends paid by one specified foreign corporation to another between E&P measurement dates could potentially be subject to the rules in both proposed §1.965–4(f) (disregarding specified payments in order to mitigate double-counting) and proposed §1.965–4(b)(2)(iv) (which can result in disregard of rebutting the presumption. If, however, the dividend is not disregarded pursuant to §1.965–4(f), and the taxpayer takes the position that it is also not disregarded under §1.965–4(b), because it can rebut a presumption that applies under §1.965–4(b)(2)(iv), then it is appropriate that the taxpayer be required to document that rebuttal for the reasons discussed in Part V.B.1 of this Summary of Comments and Explanation of Revisions. Accordingly, the comment is not adopted.

C. Changes of accounting method and entity classification elections

A comment noted that a positive section 481 adjustment resulting from a change of accounting method could increase the section 965(a) inclusion amount and the amount of foreign income taxes deemed paid by a United States shareholder and thus be disregarded for purposes of determining the United States shareholder’s section 965(a) inclusion amount, allowing some or all of the adjustment to escape taxation under section 965, even though the increase in foreign income taxes deemed paid was minimal. The Treasury Department and the IRS have determined that this would be inappropriate and modify the rule in proposed §1.965–4(c)(1) to apply only if there is a reduction in a section 965(a) inclusion amount or an aggregate foreign cash position, or an increase in section 960 deemed paid taxes other than by reason of an increase in a section 965(a) inclusion amount. See §1.965–4(c)(1)(i).

Comments suggested that the rule in proposed §1.965–4(c)(1), which applies to changes in methods of accounting, not apply to changes from impermissible methods of accounting to permissible methods of accounting, and that the rule be conditioned on a principal purpose of changing a section 965 element. However, a principal purpose-based rule would be difficult to administer and unwarranted, given that changes after November 2, 2017, relating to specified foreign corporations likely would be tax-motivated. Moreover, the Treasury Department and the IRS have determined that allowing changes from impermissible methods of accounting to permissible methods of accounting to be taken into account will allow similarly situated taxpayers to take different positions in a way that is detrimental to the government, as taxpayers will choose to make currently those changes that result in reductions of tax due under section 965 while deferring such changes that would result in increases of tax due under section 965 until later years. Accordingly, the comments are not adopted.

Another comment requested that the final regulations permit the taxable year of a specified foreign corporation to be changed to a calendar year taxable year. Because neither the proposed regulations nor the final regulations affect the possibility of changing the accounting period of a specified foreign corporation, the final regulations do not adopt this comment. But see Rev. Proc. 2018–17, 2018–9 I.R.B. 384 (limiting certain changes in accounting periods of a specified foreign corporation).

In addition, comments raised questions regarding the scope of the rule in proposed §1.965–4(c)(2), which applies to any entity classification election under §301.7701–3 that is filed on or after November 2, 2017, and whether it is appropriate for that rule to be a per se rule that applies to all entity classification elections filed on or after that date. A comment suggested that the rule would inappropriately apply to a transaction that would have no impact on section 965 elements. Another comment suggested that certain transactions effectuated by entity classification elections, such as conversion of a United States shareholder from a domestic pass-through entity to a C corporation, or vice versa, should be excepted from the application of the rule. However, because an entity classification election is an election made specifically for tax purposes that could be made retroactively in order to be effective before November 2, 2017, and because the rule would only disregard such an election if it had the effect of changing a section 965 element, the final regulations do not change the rule from the proposed regulations. But see §1.965–4(e)(3) (discussed in Part V.A of this Summary of Comments and Explanation of Revisions).

D. Application of specified payment rule

The proposed regulations provide that certain amounts paid or incurred between related specified foreign corporations of a
VI. Comments and Changes to Proposed §1.965–5 and §1.965–6 – Foreign Tax Credits

Proposed §1.965–5 and §1.965–6 provide rules with respect to foreign tax credits. The proposed regulations include, in addition to the foreign tax credit-specific rules of section 965, rules coordinating the provisions of section 965 with the foreign tax credit provisions as in effect before their repeal or amendment by the Act. The comments and modifications with respect to these rules are discussed in this Part VI.

A. Application and determination of the disallowance of the applicable percentage of foreign income taxes

1. Disallowance of the Applicable Percentage of Foreign Income Taxes Attributable to Distributions of Previously Taxed Earnings and Profits

Under the proposed regulations, no deduction (including under section 164) or credit under section 901 is allowed for the applicable percentage (as defined in proposed §1.965–5(d)) of any foreign income taxes "paid or accrued" with respect to any amount for which a section 965(c) deduction is allowed for a section 958(a) U.S. shareholder inclusion year. Proposed §1.965–5(b). This includes foreign income taxes directly paid or accrued by a taxpayer attributable to a distribution of section 965(a) previously taxed earnings and profits or section 965(b) previously taxed earnings and profits. A similar rule applies to deny the applicable percentage of any foreign income taxes "treated as paid or accrued" with respect to any amount for which a section 965(c) deduction is allowed for a section 958(a) U.S. shareholder inclusion year. Proposed §1.965–5(c). For these purposes, foreign income taxes "treated as paid or accrued" include foreign income taxes deemed paid by the taxpayer under section 960 with respect to distributions of section 965(a) previously taxed earnings and profits or section 965(b) previously taxed earnings and profits.

Comments recommended that the proposed regulations be modified to allow a credit for the applicable percentage of foreign income taxes directly paid or accrued under section 901 or treated as paid or accrued under section 960 on a distribution of section 965(a) previously taxed earnings and profits or section 965(b) previously taxed earnings and profits. In general, these comments asserted that the disallowance of taxes attributable to a distribution of previously taxed E&P discourages the distribution of previously taxed E&P, which the comments assert is inconsistent with the purpose of section 965. Comments also argued that the rule created administrative complexity and asked for guidance on how to track previously taxed E&P for purposes of applying this rule. Other comments acknowledged that providing a reduction for the foreign tax credits attributable to a distribution of previously taxed E&P based on the applicable percentage was appropriate.

The final regulations do not adopt the recommended changes. As an initial matter, guidance on tracking previously taxed E&P is outside the scope of this rulemaking. In addition, the Treasury Department and the IRS have determined that the rules under §1.965–5(b) are consistent with the statutory purpose of sections 960 and 965 and do not discourage the repatriation of previously taxed E&P. In any event, the purpose of the foreign tax credit is not to encourage repatriation of E&P to the United States but to relieve double taxation. To the extent the income is subject to a lower effective rate of U.S. tax, it is consistent with the purpose of section 965(g) to reduce the credits allowed as part of relieving double taxation on such income.

Moreover, the statutory language of section 965(g) contemplates that the disallowance for the applicable percentage will apply to distributions of previously taxed E&P. Section 965(g)(1) provides, "[n]o credit shall be allowed under section 901 for the applicable percentage of any foreign income taxes paid or accrued (or treated as paid or accrued) . . . ." In addition, section 965(g)(3) provides that no deduction is allowed for any tax for which
allowance is inappropriate because these earnings and profits, asserting that the disallowance of section 965(b) previously taxed earnings and profits results in a dollar-for-dollar reduction to basis (to the extent thereof), followed by gain recognition, because there is no automatic basis increase in the amount of such earnings under section 961. Additionally, the comment pointed out that the proposed regulations could create inequities between taxpayers because the proposed regulations could be read to imply that a taxpayer that had no section 965(a) inclusion amount because of the operation of section 965(b) had no applicable percentage, and thus no reduction in creditable foreign income taxes paid or deemed paid on distributions of the section 965(b) previously taxed earnings and profits.

As discussed in Part VI.B.1 of this Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS have determined that section 965(b) previously taxed earnings and profits are treated as included in income under section 951(a) for purposes of section 960, and thus are treated similarly to section 965(a) previously taxed earnings and profits for purposes of applying section 965(g). Additionally, with respect to the reduction in basis associated with a distribution of section 965(b) previously taxed earnings and profits, the final regulations provide that a section 958(a) U.S. shareholder may elect to make certain basis adjustments to increase the basis of DFCIs with section 965(b) previously taxed earnings and profits. See §1.965-2(f)(2). Finally, comments concerning the applicable percentage for distributions of section 965(b) previously taxed earnings and profits are addressed in Part VI.A.4 of this Summary of Comments and Explanation of Revisions.

2. Compatibility of Applicable Percentage Credit Disallowance with U.S. Bilateral Income Tax Treaties

A comment stated that proposed §1.965–5 is incompatible with the provisions of U.S. bilateral income tax treaties that provide for relief from double taxation. However, the credit against U.S. income tax paid for in these treaties is generally allowed “[i]n accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof).” See, for example, paragraph 1 of Article 24 (Elimination of Double Taxation) of the income tax convention between the United States and Canada, as amended by the protocol signed June 14, 1983. This language provides that foreign tax credits allowed under the treaty are subject to the terms of the U.S. statutory credit, including “provisions such as Code sections 901(c), 904, 905, 907, 908, and 911,” but the applicable limitations of U.S. law are not limited to the illustrative listed provisions. See, for example, the U.S. Treasury Department Technical Explanation to the income tax convention between the United States and Canada, concerning Article 24, as amended by the protocol signed June 14, 1983.

The disallowance of the applicable percentage of foreign income taxes under section 965(g)(1) and §1.965–5 is similar to the application of section 904 and other provisions in the Code that limit the allowable foreign tax credit. The disallowance takes into account the section 965(c) deduction and reflects the fact that, because of the section 965(c) deduction, the income included under section 965 is subject to an effective rate of U.S. tax that is significantly lower than the U.S. tax rates ordinarily imposed on corporations or individuals. Absent this disallowance, foreign income tax incurred with respect to the income included under section 965 could inappropriately be used to offset U.S. tax on unrelated foreign source income, rather than to mitigate double taxation incurred with respect to the taxable amount of the section 965(a) inclusion. Accordingly, the application of section 965(g)(1) and §1.965–5 is consistent with the provisions of U.S. bilateral income tax treaties that provide for relief from double taxation.
3. Applicable Percentage with Respect to Foreign Income Taxes that are Not Net Basis Taxes

The proposed regulations provide that no deduction or credit is allowed for the applicable percentage of net basis taxes imposed on a United States citizen by the citizen’s jurisdiction of residence upon receipt of a distribution of section 965(a) previously taxed earnings and profits or section 965(b) previously taxed earnings and profits. Proposed § 1.965–5(b). A comment recommended that the final regulations define “net basis taxes” and clarify that proposed § 1.965–5(b) does not apply to creditable gross basis income taxes.

Section 965(g) and proposed § 1.965–5(b) apply to all creditable foreign income taxes. The reference to “net basis taxes” was included in the proposed regulations for illustrative purposes only, and the taxes listed in proposed § 1.965–5(b) are not an exhaustive list of the taxes subject to proposed § 1.965–5(b). The final regulations clarify this accordingly. See § 1.965–5(b).

4. Applicable Percentage with Respect to Distributions of Section 965(b) Previously Taxed Earnings and Profits

The definition of applicable percentage in section 965(g) and proposed § 1.965–5(d) is computed based on a taxpayer’s section 965(a) inclusion for a section 958(a) U.S. shareholder inclusion year. Comments noted that it was not clear under the proposed regulations how the applicable percentage with respect to section 965(b) previously taxed earnings and profits should be determined when a DFIC has section 965(b) previously taxed earnings and profits but the section 958(a) U.S. shareholder does not have an aggregate section 965(a) inclusion amount, because its pro rata shares of accumulated post-1986 deferred foreign income are entirely offset by its pro rata shares of specified E&P deficits. The final regulations provide that if there is no aggregate section 965(a) inclusion amount, the applicable percentage is 55.7 percent (that is, the applicable percentage that would apply if the section 965(b) previously taxed earnings and profits had been included in income and were an amount to which section 965(c)(1)(B) applied). See § 1.965–5(d)(2).

The final regulations also clarify how the applicable percentage applies with respect to domestic pass-through owners and with respect to distributions of previously taxed E&P. With respect to domestic pass-through owners, the final regulations provide that the applicable percentage determined under § 1.965–5(d)(1) or (2) with respect to a domestic pass-through entity applies with respect to taxes deemed paid by a domestic pass-through owner even if the domestic pass-through entity does not have a section 965(a) inclusion amount. Section 1.965–5(d)(3). With respect to foreign income taxes imposed on distributions of previously taxed E&P, the final regulations provide that the applicable percentage that is applied is the applicable percentage with respect to the section 958(a) U.S. shareholder and the section 958(a) U.S. inclusion year in which the section 958(a) U.S. shareholder had the section 965(a) inclusion as a result of which the section 965(a) previously taxed earnings and profits or the section 965(b) previously taxed earnings and profits first arose. Section 1.965–5(d)(4).

5. Applicable Percentage with Respect to Tax on Gain from Sale of Stock

The proposed regulations provide that the disallowance of foreign tax credits under section 965(g)(1) applies with respect to the applicable percentage of foreign income taxes attributable to distributions of section 965(a) previously taxed earnings and profits and section 965(b) previously taxed earnings and profits. Proposed § 1.965–5(b). A comment requested guidance on whether the applicable percentage also applies to foreign income taxes imposed on an amount of a shareholder’s gain from the sale of the specified foreign corporation’s stock taken into account for foreign, but not U.S., income tax purposes, equal to its tax basis increase under section 961(a) or § 1.965–2(f)(2) by reason of section 965. The Treasury Department and the IRS have determined that under § 1.904–6, foreign tax imposed on a disposition of stock is associated with the gain (or other income) that is (or would be) recognized for U.S. tax purposes upon a taxable disposition, without regard to whether the taxpayer’s basis in the stock (and, accordingly, the amount of gain recognized) is a different amount for U.S. and foreign tax purposes. Because no portion of a foreign tax imposed on the sale of a specified foreign corporation’s stock is considered imposed with respect to its previously taxed E&P, the final regulations do not expand the scope of the rule in the proposed regulations.

B. Operation of section 960(a)(3)

1. Disallowance of Credits for Foreign Taxes Treated as Deemed Paid Under Section 960(a)(1) with respect to Section 965(b) Previously Taxed Earnings and Profits

The proposed regulations provide that no credit is allowed under section 960(a)(3) or any other section for foreign income taxes that would have been deemed paid under section 960(a)(1) with respect to the section 965(b) earnings amount that is reduced under proposed § 1.965–1(b)(2) or proposed § 1.965–8(b). Proposed § 1.965–5(c)(1)(ii). The Treasury Department and the IRS have received comments asserting that this rule should not be included in the final regulations. The final regulations maintain the rule from the proposed regulations.

Comments stated that allowing a deemed paid credit under section 960(a)(3) is necessary to avoid double taxation; however, there is no double taxation associated with section 965(b) previously taxed earnings and profits. The section 965(b) earnings amount offset by an aggregate foreign E&P deficit is excluded from U.S. taxable income and thereby effectively exempted from U.S. tax under section 965(b)(4)(A) and proposed § 1.965–1(b)(2) or proposed § 1.965–8(b). As a policy matter, this exclusion eliminates the need for a foreign tax credit. The purpose of the foreign tax credit is to mitigate double taxation by allowing foreign income taxes to reduce the U.S. tax that would otherwise be imposed on foreign source income. Allowing foreign income taxes imposed on income that is not subject to U.S. tax by reason of section 965(b) to be credited against U.S. tax on unrelated income would confer a windfall double benefit for taxpayers with section 965(b) previously taxed earnings and profits.

As a technical matter, section 965(b)(4)(A) treats section 965(a) earnings amounts offset by an aggregate foreign E&P deficit as previously included in
income under section 951(a) “for purposes of applying section 959.” Accordingly, section 965(b) previously taxed earnings and profits are treated as previously taxed E&P resulting from a section 951(a) inclusion, despite never actually having been included in U.S. taxable income. Under section 960(a)(1), a domestic corporate shareholder that includes an amount in income under section 951(a) is deemed to have paid a ratable portion of the foreign corporation’s foreign income taxes at the time of the income inclusion. Amounts treated as previously taxed E&P resulting from an income inclusion under section 951(a) should similarly be treated as having resulted in foreign taxes deemed paid under section 960(a)(1).

Section 960(a)(3) allows a credit for foreign income taxes paid by CFCs upon a subsequent distribution of the section 965(b) previously taxed earnings and profits through a chain of CFCs to the domestic corporate shareholder, but does not allow a credit for foreign income taxes that were previously deemed paid (or treated as deemed paid) under section 960(a)(1) when the amounts were included (or treated as included) in income under section 951(a). Because foreign income taxes attributable to a section 965(a) earnings amount that were offset by an aggregate foreign E&P deficit were treated as deemed paid under section 960(a)(1) when those earnings were treated as included in income under section 951(a), those taxes are not available to be deemed paid again under section 960(a)(3) upon a subsequent distribution of the section 965(b) previously taxed earnings and profits. Consistent with that treatment and with section 960(a)(2), the regulations under section 902 remove from the foreign corporation’s pool of post–1986 foreign income taxes the foreign income taxes that are attributable to earnings included in income under section 951(a) or otherwise removed from its post–1986 undistributed earnings. See §1.902–1(a)(8)(i).

Comments argue that the plain language of section 965(b)(4)(A) means that section 965(a) earnings amounts offset by an aggregate foreign E&P deficit are treated as income previously included under section 951(a) solely for purposes of applying section 959, and not for purposes of applying section 960(a). However, the application of section 959 is a precondition to the application of section 960(a)(3). The Treasury Department and the IRS have determined that section 960(a)(3) cannot be applied independently of section 959 and that the Act did not change the relationship between these sections. Indeed, the comments recognize the interaction between sections 959 and 960(a)(3) by recommending that a credit be allowed under section 960(a)(3) upon a distribution of section 965(b) previously taxed earnings and profits, which requires treating such amounts as previously taxed E&P for purposes of section 960(a)(3) as well as for purposes of section 959. If the section 965(b) previously taxed earnings and profits are treated as previously taxed E&P excluded from gross income on distribution under section 959(a) in applying section 960(a)(3), it necessarily follows that in applying that same section those amounts are treated as having been included in income under section 951(a) and resulted in foreign taxes deemed paid under section 960(a)(1) as well.

Some comments raised the concern that U.S. companies would face a higher U.S. tax burden by not being able to claim foreign tax credits under section 960(a)(3) for foreign income tax imposed on E&P that is not subject to tax in the United States by reason of section 965(b). The comments argued that this would reduce the competitive advantage Congress sought to confer through the enactment of the foreign tax credit regime and discourage repatriation of previously taxed E&P. However, the purpose of the foreign tax credit regime is to relieve double taxation of foreign source income by reducing U.S. tax on that income, not to guarantee that U.S. taxpayers will be able to use all foreign income taxes paid to reduce their U.S. tax burden. See section 904. The foreign tax credit regime was never intended to subsidize foreign income taxes that are paid in excess of the U.S. tax burden on the foreign source income. Because these earnings are not subject to U.S. tax, any foreign tax credits related to these earnings would only be used to offset other unrelated foreign source income.

One comment explained that allowing a deemed paid credit under section 960(a)(3) with respect to section 965(b) previously taxed earnings and profits is equivalent to allowing a deemed paid credit for foreign income tax paid in a year in which losses recognized for U.S. (but not foreign) tax purposes reduced post–1986 undistributed earnings. Pre-Act law, however, associated foreign income taxes paid by a foreign corporation in post–1986 years with its post–1986 undistributed earnings, but did not treat earnings offset by losses as giving rise to previously taxed E&P. Therefore, the statutory scheme allowed a credit for those taxes in connection with dividends or inclusion of those earnings, and not in connection with distributions of previously taxed E&P.

Relatedly, comments also suggested that the premise of section 965(b) is to treat an E&P deficit foreign corporation and a DFIC as a single corporation to the extent that a DFIC’s accumulated post-1986 deferred foreign income is offset by an aggregate foreign E&P deficit. However, Congress did not adopt the single corporation approach, as evidenced by the allocation of the aggregate foreign E&P deficit to the DFICs under section 965(b). Section 965 as enacted requires a foreign corporation-by-foreign corporation determination, which method extends to the computation of the foreign tax credit. Congress did not change the computation of the deemed-paid credit to apply other than on a foreign corporation-by-foreign corporation basis.

After consideration of the comments, the Treasury Department and the IRS maintain the rule in the final regulations based upon both the technical analysis of the relevant sections of the Code and the underlying policy. As a result, no credit is allowed under section 960(a)(3) or any other provision of the Code for taxes attributable to section 965(a) earnings amounts offset by an aggregate foreign E&P deficit that would have been deemed paid under section 960(a)(1) had the amounts actually been included in income under section 951(a).

2. Definition of Upper-Tier Foreign Corporation

The proposed regulations provide that the credit allowed under section 960(a)(3) is only with respect to foreign income taxes imposed on an upper-tier foreign corpora-
tion on distributions of section 965(a) previously taxed earnings and profits or section 965(b) previously taxed earnings and profits from a lower-tier foreign corporation. Proposed §1.965–5(c)(1)(ii). A comment requested that the final regulations clarify that references to “upper-tier foreign corporation” includes a disregarded entity or partnership that is legally an owner of the specified foreign corporation in question, and that references to distributions similarly refer to legal distributions not to U.S. tax characterizations.

The final regulations do not broaden the definition of “upper-tier foreign corporation” as requested by the comment. To the extent that there is a distribution of previously taxed E&P from a foreign corporation to a disregarded entity or partnership that is owned by a foreign corporation, the foreign corporate owner would be considered an “upper-tier foreign corporation.” See, e.g., section 702(a). Therefore, a credit would be allowed under section 960(a)(3), upon ultimate distribution of the previously taxed E&P to an eligible United States shareholder, for creditable foreign income taxes imposed on the disregarded entity or partnership that are considered paid by the foreign corporate owner for U.S. tax purposes with respect to the distribution of previously taxed E&P from the lower-tier foreign corporation. To the extent that there is a distribution of previously taxed E&P from a foreign corporation to a disregarded entity or partnership that is owned by a domestic corporation, the domestic corporate owner should be entitled to a credit under section 901 for the creditable foreign income taxes imposed on the disregarded entity or partnership that are considered paid by the domestic corporation for U.S. tax purposes. Therefore, there is no need to broaden the definition of “upper-tier foreign corporation” to include disregarded entities and partnerships.

Similar comments requested that the final regulations clarify that a tax imposed on a disregarded payment from a disregarded entity to an upper-tier foreign corporation that owns the disregarded entity is related to a distribution of previously taxed E&P. Another comment stated that the limitation of the credit allowed under section 960(a)(3) to foreign income taxes imposed on an upper-tier foreign corpora-

tion impedes the avoidance of double taxation with respect to foreign income taxes imposed on a lower-tier CFC upon distribution of its previously taxed E&P to an upper-tier CFC or foreign income taxes imposed on a first-tier CFC upon distribution of its previously taxed E&P to its United States shareholder. The Treasury Department and the IRS do not address these comments in the final regulations because the characterization of taxes incurred with respect to disregarded payments for purposes of section 960(a)(3) is outside of the scope of this rulemaking.

Finally, clarification was requested on whether the requirement that the previously taxed E&P be distributed by a lower-tier foreign corporation in order for taxes to be deemed paid with respect to the previously taxed E&P under section 960(a)(3) applies to both section 965(a) previously taxed earnings and profits and section 965(b) previously taxed earnings and profits, or just to the latter. The Treasury Department and the IRS have determined that regulations are clear that the requirement applies to both section 965(a) previously taxed earnings and profits and section 965(b) previously taxed earnings and profits. See §1.965–5(c)(1)(ii).

C. Deemed paid credit computation

1. Treatment of Adjustment under Section 965(b)(4)(B)

The proposed regulations provide that, for purposes of section 902(c)(1), the post–1986 undistributed earnings of an E&P deficit foreign corporation are increased under section 965(b)(4)(B) and §1.965–2(d)(2)(i)(A) as of the first day of the foreign corporation’s first taxable year following the E&P deficit foreign corporation’s last taxable year that begins before January 1, 2018. Proposed §1.965–6(c)(3). Comments recommended that the final regulations conform to the language of section 965(b)(4)(B) to provide that these adjustments happen in the last taxable year that begins before January 1, 2018.

Section 965(b)(4)(B) provides that, for purposes of the Code, a United States shareholder’s pro rata share of the E&P of any E&P deficit foreign corporation is increased by the amount of the specified E&P deficit of such corporation taken into account by the shareholder by reason of allocation of the deficit to a DFIC. Under section 902(c)(1), post–1986 undistributed earnings are based on the E&P of the foreign corporation, computed in accordance with sections 964(a) and 986, without diminution for dividends distributed during the taxable year. Pursuant to section 902(c)(8), Treasury regulations modify the computation of E&P included in post–1986 undistributed earnings as necessary to carry out the provisions of section 902. For example, under §1.902–1(a)(9)(i), previously taxed earnings and profits arising in prior post–1986 taxable years are not included in post–1986 undistributed earnings. Section 965(o) also provides that the Treasury Department and IRS may issue regulations necessary to prevent the avoidance of the purposes of section 965.

Given this background, the Treasury Department and the IRS have determined that post–1986 undistributed earnings should not be increased during the last taxable year of an E&P deficit foreign corporation beginning before January 1, 2018, as a result of section 965(b)(4)(B). An immediate increase could allow shareholders to claim deemed paid credits with respect to amounts earned after November 2, 2017, by E&P deficit foreign corporations even though such earnings were not in excess of accumulated deficits. That would result in a windfall to section 958(a) U.S. shareholders of DFICs and E&P deficit foreign corporations because such shareholders are not taxable on accumulated post–1986 deferred foreign income of a DFIC to the extent of the DFIC’s allocable share of an aggregate foreign E&P deficit and, with respect to the E&P deficit corporation, they would be entitled to deemed paid taxes that they would not otherwise be eligible to claim because of the accumulated deficit, a result inconsistent with general operation of section 902. See, e.g., §1.902–1(b)(4). Additionally, the deemed paid taxes would not be subject to the disallowance for the applicable percentage provided for in section 965(g), even though the foreign income taxes were able to be deemed paid only as a result of the operation of section 965. Accordingly, the Treasury Department and the IRS do not amend this rule
in the final regulations. See §1.965–6(b)(3).

2. Deemed Paid Credits for E&P Deficit Foreign Corporations

The proposed regulations clarify that when the denominator of the section 902 fraction is zero or less than zero, the section 902 fraction is zero, and no foreign taxes are deemed paid. Proposed §1.965–6(c)(2). A comment requested that the foreign taxes of an E&P deficit foreign corporation could be deemed paid with respect to a section 965(a) inclusion, for example, by allocation of such taxes pro rata to DFICs.

The Treasury Department and the IRS do not adopt the suggestion to treat the post–1986 foreign income taxes of an E&P deficit foreign corporation as taxes paid or accrued by a DFIC because there is no basis in the statute for modifying the computation of deemed paid credits in this manner. In addition, neither section 902 nor 960 nor the regulations issued under those sections provide for the allocation of taxes from one foreign corporation to another as suggested by the comment.

3. Application of Section 902 as if Section 965(a) Inclusion Were a Dividend

The proposed regulations provide, in relevant part, that for purposes of determining foreign taxes deemed paid under section 960(a)(1) with respect to a section 965(a) inclusion with respect to a DFIC, section 902 applies as if the section 965(a) inclusion were a dividend paid by the DFIC. Proposed §1.965–6(b). Questions have arisen as to the effect of treating a section 965(a) inclusion as a dividend for this purpose. This language merely incorporates the language of section 960(a)(1) into the regulations, as section 960(a)(1) also provides in relevant part that “section 902 shall be applied as if the amount so included were a dividend paid by such foreign corporation.” The language in proposed §1.965–6(b) does not mean that any of the requirements of sections 902 and 960 should be considered inapplicable for purposes of determining deemed paid taxes with respect to section 965(a) inclusions.

Further, the language in proposed §1.965–6(b) does not mean that section 965(a) inclusions should be treated as dividends for purposes of the ordering rule under §1.960–1(i)(2). The final regulations clarify that the ordering rules of §1.960–1(i)(2) continue to apply, subject to the modification described in Part III.A of this Summary of Comments and Explanation of Revisions. See §1.965–2(b).

4. Section 902 Fraction

The proposed regulations provide that the term "section 902 fraction" means, with respect to either a DFIC or an E&P deficit foreign corporation, the fraction that is (i) the dividend paid by, or the inclusion under section 951(a)(1) (including a section 965(a) inclusion) with respect to, the foreign corporation, as applicable, divided by (ii) the foreign corporation’s post–1986 undistributed earnings. Proposed §1.965–6(c). A question was raised as to whether dividends and inclusions under section 951(a)(1) are combined for purposes of the section 902 fraction. Another comment concerned whether the definition of “section 902 fraction” implied that the ordering rule in §1.960–1(i)(2) was no longer effective.

The final regulations continue to include a defined term, “section 902 fraction,” that is consistent with section 902(a), while tying it to the computation of deemed paid taxes in section 902(a). See §1.965–6(b)(2) and (4). As noted in Part V.C.3 of this Summary of Comments and Explanation of Revisions, the final regulations also confirm that the ordering rule in §1.960–1(i)(2), as modified by §1.965–2(b), applies in years in which a taxpayer may have a section 965(a) inclusion; accordingly, the section 902 fraction must be computed separately with respect to dividends and inclusions under section 951(a)(1). As noted in Part III.A.3 of this Summary of Comments and Explanation of Revisions, the examples in §1.965–2(j)(1) and (4) illustrate the determination of deemed paid taxes (including the computation of section 902 fractions) under sections 902 and 960 in fact patterns involving section 965(a) inclusions.

5. Ownership Requirements for Deemed Paid Taxes

The proposed regulations provide that the rule treating members of a consolidated group as a single corporation does not apply for purposes of computing the foreign taxes deemed paid with respect to a section 965(a) inclusion, and that the foreign taxes deemed paid must be computed on a separate member basis. See proposed §1.965–8(e)(2). A comment requested that the final regulations treat all the members of a consolidated group as a single taxpayer for all purposes of section 965, such that members owning less than ten percent of a DFIC would be able to claim deemed paid credits with respect to the DFIC.

Another comment requested relief in the case in which a domestic corporation satisfied the ownership requirements under section 902 with respect to a DFIC when it received a distribution from the DFIC, but did not satisfy the ownership requirements under section 960 on the date of the section 965(a) inclusion.

The final regulations continue to follow the statute under section 960 regarding the ownership requirements for eligibility for a foreign tax credit and, therefore, do not adopt either of these comments. See §1.965–8(e)(2).

6. Hovering Deficits

In response to comments, the preamble to the proposed regulations stated that the regulations would not provide a rule that, to the extent that a hovering deficit is treated as reducing the post–1986 earnings and profits of a DFIC, related taxes would be added to the DFIC’s post–1986 foreign income taxes in the inclusion year with respect to the DFIC. After the issuance of the proposed regulations, the Treasury Department and the IRS received additional comments requesting reconsideration of this issue. Comments highlighted the following language in the legislative history to section 965:

[T]he conferees expect the Secretary may issue guidance to provide that, solely for purposes of calculating the amount of foreign income taxes deemed paid by the U.S. shareholder with respect to an inclusion under
section 965, a hovering deficit may be absorbed by current year earnings and profits and the foreign income taxes related to the hovering deficit may be added to the specified foreign corporation’s post-1986 foreign income taxes in that separate category on a pro rata basis in the year of inclusion.


To effectuate the legislative history, the final regulations provide that to the extent the hovering deficit would have been absorbed by E&P accrued during the taxable year but for a section 965(a) inclusion, taxes that relate to the hovering deficit are taken into account for purposes of determining post–1986 foreign income taxes. Therefore, §1.965–6(d) provides that in the last taxable year that begins before January 1, 2018, of a DFIC that is also a foreign surviving corporation, for purposes of determining the related taxes that are included in post–1986 foreign income taxes, the post-transaction earnings that can be offset by a hovering deficit include any current year earnings which were included under section 965 by a section 958(a) U.S. shareholder; and the hovering deficit offset is treated as occurring as of the last day of the DFIC’s inclusion year.

VII. Comments and Changes to Proposed §1.965–7 – Elections and Payment Rules

Proposed §1.965–7 provides rules regarding the timing and manner of certain elections that may be available to taxpayers under section 965, and payments to be made pursuant to those elections. The comments and modifications with respect to these rules are discussed in this Part VII.

A. Election statements

The proposed regulations provide that, in order to make elections with respect to section 965, the person making the election must attach an election statement, signed under penalties of perjury, to its return for the relevant taxable year. Proposed §§1.965–2(f)(2)(iii)(B), 1.965–7(b)(2)(iii), 1.965–7(c)(2)(iii), 1.965–7(d)(3)(iii), 1.965–7(e)(2)(iii), and 1.965–7(f)(5)(iii). The proposed regulations do not address whether the election statement attached to or included with the return must be signed or whether the person making the election can attach an unsigned statement and retain the signed copy in its records. The final regulations provide that the signature requirement is satisfied if the unsigned copy is attached to a timely-filed return of the person making the election, provided that the person retains the signed original in the manner specified in §1.6001–1(e).

In addition, comments requested clarification regarding whether the election statement could be signed by a return preparer and who must sign the statement in the case of a married filing jointly income tax return. The final regulations do not specifically address who must sign a statement but indicate that general rules concerning who is authorized to sign tax returns apply. Id.

B. Acceleration events and triggering events

Section 965(h)(3) provides that an acceleration event occurs when there is an addition to tax for failure to timely pay an installment required under section 965(h), a liquidation or sale of substantially all of the assets of the person who made the section 965(h) election (including in a title 11 or similar case), a cessation of business by the person who made the section 965(h) election, or any similar circumstance. Proposed §1.965–7(b)(3)(ii) clarifies what events are acceleration events and what is considered a similar circumstance. Proposed §1.965–7(b)(3)(ii)(B) provides that a liquidation, sale, exchange, or other disposition of substantially all of the assets of the person making the election (including in a title 11 or similar case or, in the case of an individual, death) is an acceleration event.

Similarly, section 965(i)(2) lists triggering events that end the payment deferral for purposes of the section 965(i) election, including a liquidation or sale of substantially all of the assets of the S corporation (including in a title 11 or similar case), a cessation of business by the S corporation, the S corporation ceasing to exist, or any similar circumstance. Proposed §1.965–7(c)(3)(ii) clarifies the similar circumstances treated as triggering events. Specifically, proposed §1.965–7(c)(3)(ii)(B) provides that a liquidation, sale, exchange, or other disposition of substantially all of the assets of the S corporation (including in a title 11 or similar case) is a triggering event.

In addition, section 965(m)(2)(B)(ii) provides that, with respect to a real estate investment trust (“REIT”) that made a section 965(m) election, a liquidation or sale of substantially all of the assets of the REIT (including in a title 11 or similar case), a cessation of business by the REIT, or any similar circumstance will cause any amount not yet included in gross income (due to the section 965(m) election) to be included in gross income as of the day before the date of the event. Proposed §1.965–7(d)(5) clarifies what a similar circumstance is by providing that a liquidation, sale, exchange, or other disposition of substantially all of the assets of the REIT will cause the acceleration of the remaining inclusion.

1. Disposition or Exchange of Substantially All of the Assets

Comments questioned whether a disposition of substantially all of the assets resulting from a downstream tax-free reorganization or an exchange described in section 351 or 721 should constitute an acceleration event or triggering event, particularly when the assets remain under the control of the taxpayer, and whether a reorganization described in section 368(a)(1)(F) should be treated as an acceleration event or triggering event. One comment, relating only to triggering events under section 965(i), proposed multiple alternatives, including removing the “exchange or other disposition” language from proposed §1.965–7(c)(3)(ii)(B) and providing that any nonrecognition transaction is not an exchange.

The Treasury Department and the IRS have determined that any disposition of substantially all of the assets of the person making the section 965(h) election, the S corporation, or the REIT, including in a tax-free reorganization or an exchange described in section 351 or 721, poses a risk to the IRS’s ability to collect the full amount of the section 965(h) net tax liability, section 965(i) net tax liability, or
total net tax liability under section 965, as the case may be. The Treasury Department and the IRS have determined that it is essential for tax administration purposes for the IRS to be apprised of these dispositions. Providing an exclusion to the general rule that an exchange or other disposition of substantially all of the assets of the person making the section 965(h) election, the S corporation with respect to which a section 965(i) election is in effect, or the REIT with a section 965(m) election in effect for nonrecognition transactions could hamper the IRS’s ability to collect the outstanding tax liabilities and could enable certain taxpayers to inappropriately dilute their interests in their assets or change their businesses in a way that is inconsistent with the purposes behind the elections and related triggering and acceleration events. The final regulations also do not include a special exception for reorganizations under section 368(a)(1)(F) because requiring a transfer agreement, if applicable, in those situations is necessary for tax administration purposes.

A comment also requested clarification of the meaning of “substantially all” for purposes of the acceleration event and triggering event rules. The phrase “substantially all” is used in various Code provisions and in regulations, and often is determined based on all of the facts and circumstances. Consistent with this general approach, the Treasury Department and the IRS decline to provide a brightline definition of “substantially all” in the final regulations.

2. Death of Transferor

Proposed §1.965–7(b)(3)(ii)(B) provides that for a person who made a section 965(h) election, the liquidation, sale, exchange, or other disposition of substantially all of the assets of the person, including, for an individual, by reason of death, is an acceleration event. Proposed §1.965–7(b)(3)(iii)(A)(I)(ii) specifically excludes death of an individual from the covered acceleration events that allow for a transfer agreement. A comment requested that, because death is specifically mentioned as a triggering event in section 965(i)(2)(A)(iii) but not section 965(h)(3), death not be treated as an acceleration event for purposes of the section 965(h) election. In addition, the comment requested that, if death is treated as an acceleration event for purposes of the section 965(h) election, it be treated as a covered acceleration event (as described in proposed §1.965–7(b)(3)(iii)(A)(I)) and thus be eligible for a transfer agreement. Under section 965(h)(3), an acceleration event includes a liquidation or sale of substantially all of the assets of the taxpayer or any similar circumstance, and proposed §1.965–7(b)(3)(ii)(B) provides that an exchange or other disposition of substantially all of the assets of the taxpayer (outside of the context of the death of an individual) is an acceleration event. The death of an individual taxpayer is similar to any transfer or other disposition of substantially all of the assets of a taxpayer, and, accordingly, is a similar circumstance that should be an acceleration event. The Treasury Department and the IRS have determined that there are administrative difficulties with transferring liabilities and executing transfer agreements in the event of death. Moreover, in many cases, there would be multiple beneficiaries in the case of death, and multiple transferees are not permitted for purposes of section 965(h). For those reasons, and because the section 965(i) rules more clearly contemplate allowing transfers on death (and allowing transfers to multiple transferees or beneficiaries), the Treasury Department and the IRS have determined that it is appropriate not to treat the death of an individual shareholder as a covered acceleration event for purposes of section 965(h), and the comment is not adopted.

C. Transfer agreements

1. Inclusion of Form 965-A or 965-B

The proposed regulations provide that transfer agreements for purposes of section 965(h) and section 965(i) are required to include the eligible section 965(h) transferor’s or eligible section 965(i) transferor’s most recent Form 965-A or 965-B, as applicable, among other information. Proposed §1.965–7(b)(3)(iii)(B)(4)(v) and (c)(3)(iv)(B)(4)(v). In some cases, no Form 965-A or 965-B will have been required to be filed before the transfer agreement. Accordingly, the final regulations clarify that the Form 965-A or 965-B is only required to be filed with a transfer agreement if the eligible section 965(h) transferor or eligible section 965(i) transferor was required to file the form. Section 1.965–7(b)(3)(iii)(B)(4)(v) and (c)(3)(iv)(B)(4)(v).

2. Due Date for Transfer Agreements

Proposed §1.965–7(b)(3)(iii)(B)(2)(ii) and §1.965–7(c)(3)(iv)(B)(2)(ii) provide that, if an acceleration event or a triggering event occurs before September 10, 2018, a transfer agreement must be filed by October 9, 2018, in order to be considered timely filed. In addition, proposed §1.965–7(b)(3)(iii)(B)(2)(i) and §1.965–7(c)(3)(iv)(B)(2)(i) provide that, if an acceleration event or a triggering event occurs on or after September 10, 2018, a transfer agreement must be filed within thirty days of the acceleration or triggering event in order to be considered timely filed. Proposed §1.965–7(b)(3)(iii)(B)(2)(i) and §1.965–7(c)(3)(iv)(B)(2)(i) provide that transfer agreements must be filed in accordance with the rules provided in publications, forms, instructions, or other guidance. Because additional guidance, including where to file the agreements, was not issued before certain transfer agreements would have been due, the transition rules in §1.965–7(b)(3)(iii)(B)(2)(ii) and §1.965–7(c)(3)(iv)(B)(2)(ii) have been updated to provide that if a triggering event or acceleration event occurs on or before February 5, 2019, the transfer agreement must be filed by March 7, 2019, in order to be considered timely filed. See also §1.965–7(c)(3)(v)(D)(2)(ii) (similarly extending the deadline for filing agreements to make a section 965(h) election after a triggering event).

3. Multiple Transferees

With respect to a section 965(h) acceleration event, proposed §1.965–7(b)(3)(iii)(B)(I) defines an eligible section 965(h) transferee as a “single United States person that is not a domestic pass-through entity” that meets additional requirements. With respect to a section 965(i) triggering event, proposed §1.965–7(c)(3)(iv)(B)(I) defines an eligible section 965(i) transferee as a “single United States person that is not a domestic pass-through entity.” A comment requested that multiple transferees be allowed to be eligible transferees for purposes of both section 965(h) and section 965(i).
4. Consolidated Groups

Proposed §1.965–7(b)(3)(ii)(F) provides that an acceleration event includes, in the case of a consolidated group, the consolidated group ceasing to exist. Proposed §1.965–7(b)(3)(iii)(A)(iv) provides that, for purposes of the eligible section 965(h) transferee exception (as defined in proposed §1.965–7(b)(3)(iii)), a covered acceleration event includes, with respect to an acceleration event under proposed §1.965–7(b)(3)(ii)(F), an event resulting from the acquisition of a consolidated group within the meaning of §1.1502–13(j)(6) if the acquired consolidated group members join a different consolidated group as of the day following the acquisition. The proposed regulations do not provide for covered acceleration events related to other fact patterns in which a consolidated group ceases to exist. Comments requested that there be an additional covered acceleration event to account for a situation in which the consolidated group ceases to exist by reason of one or more members of the consolidated group transferring all of their assets to other members, with only one member remaining (for example, a consolidated group consisting only of a parent and a subsidiary ceasing to exist by reason of the subsidiary liquidating into the parent). The Treasury Department and the IRS have determined that it is appropriate to permit the remaining member to enter into a transfer agreement in these circumstances. Accordingly, §1.965–7(b)(3)(iii)(A)(iv) includes this scenario as a covered acceleration event. In addition, §1.965–7(b)(3)(iii)(B)(I)(v) provides that, with respect to the acceleration event in §1.965–7(b)(3)(iii)(A)(iv), the remaining member of the consolidated group to which all of the other members’ assets are transferred is an eligible section 965(h) transferee (provided that it meets the remaining requirements of §1.965–7(b)(3)(iii)(B)(I)).

Another comment requested that there be an additional covered acceleration event to account for a situation in which a consolidated group is wholly owned by a corporation that is not an includible corporation (within the meaning of section 1504(b)) when a section 965(h) election was made but subsequently becomes an includible corporation even though the situation does not involve the acquisition of stock of the common parent. For example, this situation could arise when the corporation that owns the consolidated group is an S corporation and subsequently revokes its S corporation election. The Treasury Department and the IRS have determined that it is appropriate to permit transfer agreements in these circumstances. Accordingly, §1.965–7(b)(3)(iii)(A)(v) provides that a covered acceleration event occurs when the group ceases to exist as a result of the termination of the subchapter S election pursuant to section 1362(d) of a shareholder of the common parent of the consolidated group and, for the shareholder’s taxable year immediately following the termination, the shareholder joins in the filing a consolidated return as of a consolidated group that includes all of the former members of the former consolidated group. In addition, §1.965–7(b)(3)(iii)(B)(I)(v) provides that, with respect to the acceleration event in §1.965–7(b)(3)(iii)(A)(v), the agent (within the meaning of §1.1502–77) of the new consolidated group that includes the shareholder whose subchapter S election was terminated and all of the former members of the former consolidated group is an eligible section 965(h) transferee (provided that it meets the remaining requirements of §1.965–7(b)(3)(iii)(B)(I)).

5. Joint and Several Liability

Proposed §1.965–7(b)(3)(iii)(D)(2) provides that an eligible section 965(h) transferee remains jointly and severally liable for any unpaid installments assumed by the eligible section 965(h) transferee, as well as any penalties, additions to tax, or other additional amounts attributable to the section 965(h) net tax liability that was transferred. A representation to this effect is required in the transfer agreement if the section 965(h) transferee remains in existence after the transfer. Proposed §1.965–7(b)(3)(iii)(B)(4)(viii). A comment questioned whether the joint and several liability requirement was necessary, given that the eligible section 965(h) transferee has agreed to assume the liability and has the assets from which the liability would be satisfied, and whether there should be differing treatment between eligible section 965(h) transferees that liquidate immediately after the transfer and those that do not. The comment also noted that in many cases, the section 965(h) net tax liability would be taken into account in the purchase price of a sale of substantially all of the assets of the eligible section 965(h) transferee. The final regulations do not adopt this comment. Requiring the eligible section 965(h) transferee to be jointly and severally liable for the unpaid section 965(h) net tax liability, as well as any penalties, additions to tax, or other additional amounts attributable to the section 965(h) net tax liability, protects the IRS’s ability to collect the full amount of the section 965(h) net tax liability and helps guard against abusive transactions. In addition, as the comment noted, taxpayers are able to account for the joint and several liability in their transactions.

6. Death of an S Corporation Shareholder

Under section 965(i)(2)(A)(iii) and (ii)(2)(C) and proposed §1.965–7(c)(3) (i)(C) and (c)(3)(iv)(A)(I), the death of an S corporation shareholder who made a section 965(i) election is a triggering event, and the deferred liability can be transferred if a transfer agreement is entered into with an eligible section 965(i) transferee (as defined in proposed §1.965–7(c)(3)(iv)(B)(I)). Proposed §1.965–7(c)(3)(iv)(B)(2)(i) requires that any transfer
agreement with respect to a section 965(i) election be filed within 30 days of the date that the transfer occurred. The Treasury Department and the IRS have determined that when the triggering event is the death of the eligible section 965(i) transferor, filing a transfer agreement within 30 days may be impractical. Accordingly, the final regulations provide, in §1.965–7(c)(3)(iv)(B)(2)(iii), that in the case of the death of an eligible section 965(i) transferor, the transfer agreement is required to be filed by the later of the extended due date for the eligible section 965(i) transferor’s final income tax return and March 7, 2019.

In addition, the final regulations clarify in §1.965–7(c)(3)(iv)(B)(5) what transfer agreements are required following the death of an eligible section 965(i) transferor. In order to make the transfer agreements more administrable for both taxpayers and the IRS, the final regulations provide that, except in the case of transfers to trusts, in the event of the death of an eligible section 965(i) transferor, if the beneficiary or beneficiaries are known and determined as of the due date for the transfer agreement (that is, generally, the extended due date for the eligible section 965(i) transferor’s final income tax return), then the transfer will be treated as a transfer directly between the eligible section 965(i) transferor and the eligible section 965(i) transferee beneficiary or beneficiaries, and only one transfer agreement for each eligible section 965(i) transferee is required. If, however, the beneficiary or beneficiaries are not known and determined by the due date for the transfer agreement, then the transfer will be treated as two transfers: first, the transfer on death between the eligible section 965(i) transferor and his or her estate, and, second, a transfer (not on death) between the estate and the eligible section 965(i) transferee beneficiary or beneficiaries, and separate transfer agreements are required for each transfer. The general rule concerning transfers to trusts will continue to apply as discussed in Part VII.E.1 of this Summary of Comments and Explanation of Revisions.

7. Terms of Transfer Agreements
   a. Transfer agreements after acceleration events

   The proposed regulations provide specific information and representations that a transfer agreement must contain, including a statement that the transferee agrees to assume the transferor’s liability for any unpaid installment payments. The final regulations include modifications to certain requirements for the terms of a transfer agreement. First, the final regulations clarify that an eligible section 965(h) transferee must consent to an assessment with respect to the liability that it assumes. Specifically, when an eligible section 965(h) transferor and an eligible section 965(h) transferee enter into a transfer agreement, the amount of the section 965(h) net tax liability will already be assessed against the transferee. For the transfer agreements to be administrable, the final regulations add the requirement that an eligible section 965(h) transferee waive the right to a notice of liability and consent to the immediate assessment of the portion of the eligible section 965(h) transferor’s section 965(h) net tax liability remaining unpaid as a term of the transfer agreement. See §1.965–7(b)(3)(iii)(B)(4)(ix).

   Second, the final regulations retain the proposed regulations’ requirement that an eligible section 965(h) transferee represent that it is able to make the remaining payments with respect to the section 965(h) net tax liability being assumed. Because the transfer of substantially all of the assets of the eligible section 965(h) transferor presents a risk to the IRS’s ability to collect the outstanding section 965(h) net tax liability, the final regulations require a transfer agreement to include a statement as to whether the leverage ratio of the eligible section 965(h) transferee exceeds three to one, subject to modification by future guidance. See §1.965–7(b)(3)(iii)(B)(4)(ix) and (b)(3)(iii)(B)(6).

   A taxpayer with a leverage ratio in excess of three to one may be an eligible section 965(h) transferee and may file a valid transfer agreement, provided the requirements of §1.965–7(b)(3)(iii)(B) are met. The IRS may, however, use the information provided regarding an eligible section 965(h) transferee’s leverage ratio in connection with a subsequent evaluation of the accuracy of an eligible section 965(h) transferee’s representation that it has the ability to pay the outstanding section 965(h) net tax liability. The ability of an eligible section 965(h) transferee to pay the outstanding section 965(h) net tax liability depends on all of the relevant facts and circumstances, including its leverage ratio and also including the eligible section 965(h) transferee’s revenue, the value of its assets, its access to capital, the volatility of its business, the size of the section 965(h) net tax liability assumed, and other factors. The IRS may request further information when evaluating a transfer agreement in order to assess these aspects of the transferee. See §1.965–7(b)(3)(iii)(C)(2).

   Third, §1.965–7(b)(3)(iii)(B)(4)(xii) clarifies, consistent with the requirement in proposed §1.965–7(b)(3)(iii)(B)(2)(i) that a transfer agreement be filed consistent with other guidance, that additional terms for transfer agreements may be prescribed pursuant to publications, forms, instructions, or other guidance.

   b. Transfer agreements and consent agreements after triggering events

   The final regulations also include changes to the terms of the transfer agreements to be entered into by eligible section 965(i) transferees and the consent agreements to be entered into by certain shareholders after certain triggering events consistent with the changes to the terms of the transfer agreements to be entered into in connection with acceleration events discussed in Part VI.C.7.a of this Summary of Comments and Explanation of Revisions. The final regulations require a transfer agreement or consent agreement to include a statement as to whether the leverage ratio of the eligible section 965(i) transferee or the taxpayer making the section 965(h)
election after a triggering event exceeds three to one. See §1.965–7(c)(3)(iv)(B)(4)(ix), (c)(3)(iv)(B)(6), (c)(3)(v)(D)(4)(v), and (c)(3)(v)(D)(4)(vi). The final regulations also clarify that additional terms for transfer agreements and consent agreements in connection with triggering events may be prescribed pursuant to publications, forms, instructions, or other guidance. Section 1.965–7(c)(3)(iv)(B)(4)(x) and (c)(3)(v)(D)(4)(vii).

D. Section 965(h) elections

1. Deficiencies or Additional Liabilities

Section 965(h)(4) provides that if a deficiency is assessed with respect to a person’s section 965(h) net tax liability, other than in cases of negligence, intentional disregard of rules and regulations, or fraud with intent to evade tax, the amount of the deficiency will be prorated among the installments, and for any installment the due date of which has already passed, the part of the deficiency prorated to that installment will be due on notice and demand. Proposed §1.965–7(b)(1)(ii) extends this rule to apply in the case of a person that increases the amount of its section 965(h) net tax liability when it files a return after payment of the first installment or files an amended return. Requiring notice and demand before payment of the additional amount when it is not due to a deficiency that has been assessed is administratively difficult and inconsistent with the rule provided in proposed §1.965–7(b)(1) (ii)(C), applicable in the case of negligence, intentional disregard of rules and regulations, or fraud with intent to evade tax. Therefore, the final regulations have been modified to provide that in the case of an additional liability reported on a return or amended return, any amount that is prorated to an installment, the due date of which has already passed, will be due with the return reporting the additional amount. Section 1.965–7(b)(1)(ii)(B). The rule with respect to deficiencies remains the same, and payment for a deficiency prorated to an installment, the due date of which has already passed, is due on notice and demand. Id.

2. Elections in Multiple Years

A comment requested clarification regarding whether a person who has section 965(h) net tax liabilities in multiple taxable years due to ownership of DFICs with different inclusion years can make the section 965(h) election for each year individually. Because the section 965(h) election is made with respect to the section 965(h) net tax liability for a taxable year and is made with the person’s tax return, it must be made separately for each year that the person has a section 965(h) net tax liability. The Treasury Department and the IRS have determined that no additional clarification is necessary. Section 1.965–7(b)(2) and (g)(4).

E. Section 965(i) elections

1. Trusts and Estates

Comments requested clarification of the application of the rules regarding elections in the case of trusts and estates. These comments can largely be divided into two categories: (a) requests for guidance concerning which persons are treated as S corporation shareholders for purposes of the section 965(i) election and entering into transfer agreements after a triggering event, and (b) requests for guidance concerning what events constitute triggering events.

a. Persons eligible to make section 965(i) elections and eligible section 965(i) transferees

The comments requested that the final regulations clarify the definition of “pass-through entity” in proposed §1.965–11(f)(28) to provide more certainty on the status of grantor trusts and qualified subchapter S trusts (“QSSTs”). Comments further noted that it may be unclear whether grantor trust owners and beneficiaries of QSSTs are eligible to make a section 965(i) election and enter into transfer agreements as eligible section 965(i) transferees because it is not clear whether such persons are treated as shareholders of an S corporation for purposes of section 965. They also requested that the final regulations provide that a person with a section 965(i) net tax liability be permitted to make a section 965(i) election and that a person that would be subject to tax on a section 965(i) net tax liability be permitted to enter into a transfer agreement after a triggering event. Similarly, they requested that when an S corporation is owned by a domestic pass-through entity, the domestic pass-through owners be able to make the section 965(i) election. The comments also requested guidance on who is an eligible section 965(i) transferee when there is a death and a grantor trust becomes a non-grantor trust, given that an eligible section 965(i) transferee does not include a pass-through entity, as defined in proposed §1.965–11(f)(28).

The Treasury Department and the IRS have determined that the proposed regulations are clear that both grantor trusts and QSSTs constitute pass-through entities for purposes of proposed §1.965–11(f)(28). The entire portion of the income attributable to the S corporation stock is taxed to the beneficiary of a QSST. See §1.1361–1(j)(1)(i). The same is true for grantor trusts. See section 671 and §1.1361–1(h)(1)(i). The Treasury Department and the IRS have determined that, because the beneficiary of a QSST or the grantor (or beneficiary) of a grantor trust is treated as an S corporation shareholder for subchapter S purposes, it is appropriate that the beneficiary or grantor makes the section 965(i) election and signs a transfer agreement as the eligible section 965(i) transferee. While the beneficiaries of an electing small business trust (“ESBT”) are treated as S corporation shareholders for section 1361 purposes, they are not treated as such for purposes of consenting to an S corporation election or taking into account shares of an S corporation’s items of income, loss, or deduction. See §§1.1361–1(h)(3) and 1.1362–6(b)(2). Thus, the trustee of the S corporation portion of an ESBT should make a section 965(i) election and be the eligible section 965(i) transferee.

In the case of death, in which a grantor trust becomes a non-grantor trust, who can enter the transfer agreement should depend on whether, for example, an election is made to treat the trust as a QSST or an ESBT, whether the trust is treated as a testamentary trust, or whether a section 645 election is made to treat the trust as part of the estate. Generally, the QSST beneficiary, the trustee of an ESBT, or the executor of an estate should be permitted to enter into the transfer agreement. Accordingly, in response to these comments, the rules in §1.965–7(c)(1) and (c)(3)(iv)(B)(f) are revised to clarify that persons required to
The comments also requested clarification concerning whether an ESST or QSST that is treated as bifurcated under trust rules is also treated as bifurcated for purposes of section 965, including elections, acceleration events, and triggering events. The comments noted that certain trusts, in particular ESSTs, are divided into different portions when they hold stock of an S corporation. See §1.641(c)–1(a). Accordingly, separate section 965(h) elections and section 965(i) elections must be made. The final regulations do not, however, address the application of the trust bifurcation rules, which are outside of the scope of these rulemaking.

b. Triggering events

Comments requested that certain transactions that occur frequently with respect to S corporation trusts not be treated as triggering events and that guidance be provided concerning how to enter into a transfer agreement if such a transaction is a triggering event. For example, family settlement agreements, disclaimers, and certain decanting transactions result in a legal transfer but are not considered a transfer for either U.S. federal transfer tax or income tax purposes. The comments also noted that certain trust transactions may result in a change in taxpayer for U.S. federal income tax purposes although no legal transfer occurred. These transactions may include a conversion of a grantor trust to a non-grantor trust, a trust making a QSST or ESST election, a merger of two or more trusts, or a severance of trusts into separate shares. A comment also recommended that a material modification of a trust, such as through an amendment, decanting, or judicial reformation, or a material modification in a trust’s beneficiaries, not constitute a triggering event where there is no change in ownership for U.S. federal income tax purposes.

In response to the comments, the final regulations clarify that a transfer of S corporation stock can only be a triggering event if it is a transfer that results in a change in ownership for U.S. federal income tax purposes. Thus, for example, a transfer of S corporation stock between a person and a grantor trust of which the person is an owner, which is disregarded for U.S. federal income tax purposes, is not a transfer that can constitute a triggering event because it does not result in an ownership change for U.S. federal income tax purposes. Cf. Rev. Rul. 85–13, 1985–1 C.B. 184 (providing that no sale occurred upon the transfer of trust assets from a grantor trust to the grantor). Specific guidance concerning what transactions are treated as transfers that result in a change in ownership for U.S. federal income tax purposes is outside the scope of these regulations.

Comments also requested guidance on whether a trust’s conversion from grantor status to non-grantor status due to the death of a grantor, regardless of whether the trust is treated as part of the decedent’s estate under section 645, is a triggering event. Section 965(i)(2)(iii) and §1.965–7(c)(3)(ii)(C) are clear that a transfer includes a transfer by reason of death, so a trust’s conversion to non-grantor status due to a death is a triggering event. Accordingly, no further guidance is warranted.

2. Section 962 Elections

A comment requested guidance concerning the interaction of a section 962 election and a section 965(i) election. The Treasury Department and the IRS have determined that it is clear that an eligible taxpayer may make a section 962 election that applies with respect to a section 965(a) inclusion that results in a section 965(i) net tax liability that the taxpayer defers payment of pursuant to a section 965(i) election, because there are no limitations in the section 962 regulations or the section 965 regulations that would preclude the elections. Accordingly, no change is made to the final regulations in this regard.

The comment also requested guidance concerning whether making both the section 962 election and the section 965(i) election would result in the treatment of distributions from a DFIC owned by the S corporation to which the section 965(i) election relates occurring before a triggering event as dividends not excluded from gross income. The Treasury Department and the IRS have determined that it is clear that amounts attributable to a section 965(a) inclusion with respect to which a section 962 election applies that would otherwise be excluded from gross income under section 959 are prevented from being excluded before a triggering event due to the application of section 962(d), because no tax will have been paid with respect to the section 965(a) inclusion. See Part III.D.6 of this Summary of Comments and Explanation of Revisions for a discussion of the application of section 962(d) to section 965(h) elections, the concepts of which apply equally for section 965(i) elections. However, as discussed in Part III.D.6 of this Summary of Comments and Explanation of Revisions with regard to the basis adjustments to be made in the similar case of a domestic pass-through owner that has made a section 962 election applicable to its distributive share of a domestic pass-through entity’s section 965(a) inclusion amount, the issue raised by the comment is a long-standing issue of general applicability within subpart F that is outside of the scope of regulations concerning section 965. Accordingly, the Treasury Department and the IRS decline to adopt the comment.

F. Section 965(m) elections

Section 965(m) allows a real estate investment trust (REIT) to make an election to include its section 965(a) inclusions (and correspondingly deduct its section 965(c) deductions) over an eight-year period, rather than all in one taxable year. The schedule for inclusions over the eight-year period is similar to the schedule for payments for the section 965(h) election. See sections 965(h)(1) and 965(m)(1)(B). A comment requested that REITs making section 965(m) elections be treated the same as taxpayers making section 965(h) elections and be allowed to make adjustments to previously taxed E&P and basis under sections 959 and 961 as if the REIT had included the full section 965(a) inclusion (and deducted the full section 965(c) deduction) in the taxable year or years in which its DFICs had subpart F income as a result of section 965(a). Notwithstanding the similarities in the eight-year schedules for section 965(h)
sections 56(d) and 55(b)(2), respectively, it is clear that the section 965(n) election applies for purposes of the AMT. Similarly, it is clear that the section 965(n) election affects the computations under §1.1411–4(h) if an election under §1.1411–10(g) has been made, and no clarification is needed.

A comment also requested clarification that a section 965(n) election can be made for every year in which a REIT has a section 965(a) inclusion by reason of a section 965(m) election. Given that §1.965–7(e), like proposed §1.965–7(e), provides that a section 965(n) election can be made for a taxable year in which a person has a section 965(a) inclusion, the Treasury Department and the IRS have determined that no additional clarification is necessary.

H. Election to use alternative method of calculating post–1986 earnings and profits

Proposed §1.965–7(f)(5)(i) provides for an election to use an alternative method for calculating post–1986 earnings and profits and provides that the election is made for each specified foreign corporation by its controlling domestic shareholder (as defined in §1.964–1(c)(5)) pursuant to the rules of §1.964–1(c)(3). A comment requested modifications regarding multiple aspects of this election.

First, the comment requested that references to the rules in §1.964–1(c)(3) be deleted because the requirements, particularly with respect to the statement required by §1.964–1(c)(3)(ii) and the notice to minority shareholders required by §1.964–1(c)(3)(iii), are too onerous for this purpose. Second, the comment requested that United States shareholders be allowed to make a blanket election for all of their specified foreign corporations or be allowed to make a single election and specifically provide a schedule of those specified foreign corporations for which they do not want to make the election. Third, the comment requested that the penalties of perjury statement requirement be eliminated.

The Treasury Department and the IRS have determined that requiring a controlling domestic shareholder to file the statement required by §1.964–1(c)(ii) in order to make the election described in proposed §1.965–7(f) is duplicative in light of the requirement to provide an election statement described in proposed §1.965–7(f)(5)(iii). However, the requirement to give notice to minority shareholders is not a duplicative requirement, and it helps ensure that all taxpayers are using the same amounts for post–1986 earnings and profits to calculate their section 965(a) inclusions. Accordingly, §1.965–7(f)(5)(i) retains the reference to §1.964–1(c)(3) but provides that the statement described in §1.964–1(c)(3)(ii) is not required. In addition, proposed §1.965–7(f) provides that the election is made on a specified foreign corporation by specified foreign corporation basis, in part because the ability to use the November 2, 2017, measurement date might differ among specified foreign corporations. While it is important for the IRS to know what method is being used for each specified foreign corporation in order to properly determine the amount of post–1986 earnings and profits, it is not necessary for a separate statement to be filed with respect to each specified foreign corporation. Therefore, the final regulations permit a single election statement to be filed that provides the necessary information with respect to each specified foreign corporation. Finally, the election statement required by proposed §1.965–7(f)(5)(i) contains additional information beyond the making of the election, including the name and taxpayer identification number (if any) of both the person making the election and the specified foreign corporation, so the request that the penalties of perjury statement be eliminated is not adopted. See Part VII.A of this Summary of Comments and Explanation of Revisions for more discussion of the election statements.

I. Total net tax liability under section 965

Section 965(h) elections and section 965(i) elections allow the deferral of payment of amounts based on a taxpayer’s total net tax liability under section 965. See §§1.965–7(b)(1), (c)(1), (g)(4), and (g)(6). Total net tax liability is calculated on the basis of a taxpayer’s net income tax “with” and “without” the application of section 965, which is intended to isolate the portion of a taxpayer’s net income tax attributable to section 965.
1. “Without” prong

The second prong of the definition of total net tax liability under section 965 (the “without” prong) in the proposed regulations calculates the taxpayer’s net income tax without regard to section 965 but also disregards dividends received directly or through a chain of ownership described in section 958(a). Proposed §1.965–7(g)(10)(i)(B)(2). Dividends are disregarded because, absent section 965, they would generally be taxed in the hands of the taxpayer, but such dividends may instead be distributions of previously taxed E&P if section 965 applies, and thus not subject to additional tax if section 965 applies. Therefore, absent this rule, the tax imposed on dividends would be included in the “without” prong but not in the “with” prong, distorting the “with” and “without” calculation so that it no longer isolates the net income tax attributable to section 965. However, this rule does not disregard investments in United States property that would give rise to inclusions under sections 951(a)(1)(B) and 956, even though these inclusions, like dividends, could result in income inclusions that would be taxable in the “without” prong absent section 965, but may instead be sheltered by previously taxed E&P if section 965 applies. Comments recommended that the final regulations disregard inclusions under sections 951(a)(1)(B) and 956 for purposes of the “without” computation in order to ensure that the total net tax liability under section 965 reflects an accurate measure of a taxpayer’s tax due to section 965. The final regulations adopt this recommendation. See §1.965–7(g)(10)(i)(B)(2).

A comment also suggested that the final regulations clarify that the dividends disregarded are limited to those paid by a DFIC during the DFIC’s inclusion year. See id. A comment also noted that the “without” prong of the definition of total net tax liability under section 965 under the proposed regulations disregards credits, as well as income or deductions properly attributable to dividends from a DFIC, even though section 965(h)(6)(A)(i)(II) only specifically disregards income or deductions. The comment suggested that because credits were specifically included in the House version of the rule, but not the Senate version, Congress specifically intended to take into account credits in the “without” prong. However, there is no legislative history explaining the change. A similar comment recommended that the “without” prong of the definition of total net tax liability under section 965 take into account foreign income taxes that the taxpayer would have been able to use as credits in subsequent years had section 965 not been enacted.

The term “net income tax” is defined to mean the regular tax liability reduced by the credits allowed under subparts A, B, and D of part IV of subchapter A of the Code and is not defined as such solely with respect to the “with” prong in section 965(h)(6)(A)(i), but also the “without” prong in section 965(h)(6)(A)(ii). See section 965(h)(6)(B). Subpart B includes section 27, which allows for a foreign tax credit. The disregard of credits clearly follows from the statutory definition of the “without” prong, as there could be no credits attributable to a dividend if income attributable to the dividend were disregarded. Accordingly, the Treasury Department and the IRS have determined that the approach of the proposed regulations is appropriate, and do not adopt the recommendations.

2. Effect on Total Tax Liability

A comment suggested that the rules for determining a total net tax liability under section 965 can result in the total tax liability of a United States person who makes a section 965(i) election being higher than it would have been had a section 965(i) election not been made. However, the Treasury Department and the IRS have determined that because such rules apply only for purposes of the definition of total net tax liability under section 965, and thus for purposes of determining how much can be deferred pursuant to a section 965(h) election or a section 965(i) election, they have no impact on a person’s actual total tax liability. Accordingly, no changes are made in response to the comment.

VIII. Comments and Changes to Proposed §1.965–8 – Affiliated Groups (Including Consolidated Groups)

Proposed §1.965–8 sets forth rules governing the application of section 965 and the section 965 regulations to members of an affiliated group (as defined in section 1504(a)), including members of a consolidated group (as defined in §1.1502–1(h)). The comments and modifications with respect to these rules are discussed in this Part VIII.

A. Treatment of consolidated groups

1. Treatment for Purposes of Determining Aggregate Foreign Cash Position

The proposed regulations provide rules allowing a section 958(a) U.S. shareholder to disregard certain assets for purposes of determining its aggregate foreign cash position. See proposed §1.965–3(b). The proposed regulations further provide that all members of a consolidated group that are section 958(a) U.S. shareholders of a specified foreign corporation are treated as a single section 958(a) U.S. shareholder for certain enumerated purposes that do not include proposed §1.965–3(b). Proposed §1.965–8(e). Section 3 of Notice 2018–78 explained that, to prevent the overstatement of the aggregate foreign cash position, the final regulations would provide that all members of a consolidated group that are section 958(a) U.S. shareholders of a specified foreign corporation would also be treated as a single section 958(a) U.S. shareholder for purposes of §1.965–3(b).

However, comments have noted that treating all members of a consolidated group that are section 958(a) U.S. shareholders of a specified foreign corporation as a single section 958(a) U.S. shareholder for purposes of §1.965–3(b) but not for all
purposes of determining the aggregate foreign cash position could still result in overstatement of the aggregate foreign cash position, if, for example, stock of a specified foreign corporation was transferred between such shareholders between cash measurement dates. Accordingly, the final regulations provide that the consolidated group aggregate foreign cash position is determined as if all members of a consolidated group that are section 958(a) U.S. shareholders of a specified foreign corporation were a single section 958(a) U.S. shareholder. See §1.965–8(e)(1), (e)(3), and (f)(4).

2. Treatment for Other Purposes

Comments also requested that the final regulations treat all members of a consolidated group as a single United States shareholder for all purposes of section 965. One comment highlighted a fact pattern in which it argues that the anti-abuse rule in §1.965–4(b) applies and causes double taxation if the members are treated as separate but would not apply if the members were treated as a single United States shareholder. However, the Treasury Department and the IRS have determined that treatment of members of a consolidated group as a single United States shareholder would not alter the application of the anti-abuse rule in the fact pattern raised. Even if it did, however, broadly changing the consequences of well-established principles concerning the determination of inclusions under section 951 in a consolidated group would not be justified by the application of an anti-abuse rule to a transaction that falls within its parameters. See Part VI.C.5 of this Summary of Comments and Explanation of Revisions for a discussion of why the final regulations do not adopt recommendations to treat all members of a consolidated group that are section 958(a) U.S. shareholders of a specified foreign corporation as a single section 958(a) U.S. shareholder for purposes of determining foreign income taxes deemed paid with respect to section 965(a) inclusions.

B. Treatment of affiliated groups other than consolidated groups

A comment also suggested that section 958(a) U.S. shareholders that are members of an affiliated group that do not file a consolidated U.S. federal income tax return also be treated as a single United States shareholder for purposes of determining the aggregate foreign cash position of each member. It suggested that the statute evidences Congressional intent for such treatment. The Treasury Department and the IRS have determined that the rules in section 965(b)(5) concerning the allocation of an affiliated group member’s aggregate unused E&P deficit to certain members of its affiliated group do not evidence an intent to treat all members of an affiliated, but not consolidated, group as a single United States shareholder and decline to adopt the recommendation.

IX. Other Comments

A. Application to individuals

Numerous comments recommended that guidance exempt individuals from the application of section 965. A comment also recommended that section 965(c)(3)(E), which provides that the cash position of certain noncorporate entities must be taken into account in determining a United States shareholder’s aggregate foreign cash position, not apply with respect to individuals but did not supply any reasoning for the recommendation. The statute applies to increase the subpart F income of all DFICs, with no exception to the extent that a DFIC has one or more United States shareholders that are individuals. See section 965(a). Further, the legislative history expressly provides that all United States shareholders, including individuals, are subject to section 965. See H.R. Rep. No. 115–446, at 606 (2017) (“In contrast to the participation exemption deduction [in section 245A] available only to domestic corporations that are U.S. shareholders under subpart F, the transition rule applies to all U.S. shareholders.”). Accordingly, the final regulations do not adopt these recommendations. The final regulations also do not adopt a related recommendation to permit retroactive entity classification elections to treat DFICs as disregarded for U.S. federal income tax purposes, which would be out of scope and contrary to the legislative history indicating that the Treasury Department and the IRS were expected to prevent the avoidance of section 965. See H.R. Rep. No. 115–466, at 619 (2017).

Another comment disputed the description of the clear application of section 965(c) and the proposed regulations thereunder in Part XI.C.2 of the Explanation of Provisions in the proposed regulations but did not suggest any changes to the rules in the proposed regulations. The Treasury Department and the IRS have determined that the proposed regulations are consistent with the statute and that Part XI.C.2 of the Explanation of Provisions in the proposed regulations accurately describes the rules, and thus that no changes are needed in response to the comment.

B. Section 962 elections

A comment requested that the Treasury Department and the IRS consider providing relief for individuals who make a section 962 election and subsequently receive a distribution of section 965(a) previously taxed earnings and profits or section 965(b) previously taxed earnings and profits from a DFIC to provide parity with corporations. However, as the comment acknowledges, section 962(d) limits the application of section 959 in the case of an individual that has made a section 962 election, and, as discussed in Part II.D.6 of this Summary of Comments and Explanation of Revisions, section 961 similarly limits the availability of basis for a distribution of previously taxed E&P in the case of a section 962 election. Accordingly, the Treasury Department and the IRS have determined that no relief is appropriate.

Another comment requested guidance concerning the interaction of a section 962 election and a §1.1411–10(g) election; specifically, whether tax is imposed under section 1411 on a distribution of previously taxed E&P that are not excluded from an individual’s income as a result of the application of section 959(d) and what the effects are on the section 1411 tax basis in DFIC stock. Because this is an issue of general applicability with respect to previously taxed E&P and not specific to the application of section 965, the final regulations do not address this issue.

C. RICs

A comment requested that guidance affirm that section 965(a) inclusions do not
affect regulated investment company ("RIC") qualification. The application of the RIC qualification rules is outside of the scope of the final regulations.

D. Extension of limitation on assessment

A comment suggested that the final regulations clarify whether the extension of the limitation on the time period for assessment under section 965(k) applies to domestic pass-through owners. The comment also suggested that the final regulations clarify that the extension does not apply for purposes of the alternative minimum tax, the tax under section 1411, the tax under section 4968, or the tax under section 4940. In addition, the comment recommended clarifying the interaction of the extension of the limitation on the time period for collection in section 965(i)(6) with the extension in section 965(k) and the interaction of section 965(k) with partnership audit rules enacted by the Bipartisan Budget Act of 2015, P.L. 114–74, 129 Stat. 587 ("BBA"). The Treasury Department and the IRS have determined that, because section 965(k) applies to the net tax liability under section 965 (as defined in section 965(h)(6)), and §1.965–7(g)(10) defines total net tax liability under section 965 consistently with the definition under section 965(h)(6), it is clear that section 965(k) applies to any total net tax liability under section 965, including that of a domestic pass-through owner. Moreover, the definitions of net tax liability under section 965 in section 965(h)(6) and total net tax liability under section 965 in §1.965–7(g)(10) are clear that they do not include the taxes mentioned by the comment. The Treasury Department and the IRS have also determined that it is clear that section 965(k) does not limit section 965(i)(6). Accordingly, the comment is not adopted. The final regulations do not address the interaction of section 965(k) with the BBA rules, as those are outside of the scope of this rulemaking.

E. Late election relief

Section 965 includes statutory due dates for making section 965(h) elections, section 965(i) elections, section 965(m) elections, and section 965(n) elections. In addition to furnishing guidance with respect to statutory elections, the proposed regulations provide taxpayers with two additional elections in proposed §§1.965–2(f)(2) and 1.965–7(f) and prescribe due dates for making these regulatory elections. The proposed regulations indicate that relief under §301.9100–2 or §301.9100–3 is not available with respect to any election under section 965. A comment recommended that the Treasury Department and the IRS reverse its position in the proposed regulations and grant section 9100 relief for the statutory and regulatory elections with respect to section 965. The IRS does not have the discretion to provide section 9100 relief with respect to an election whose due date is prescribed by statute. Furthermore, in addition to providing additional time for the basis election, as discussed in Part III.D.1 of this Summary of Comments and Explanation of Revisions, Notice 2018–78 provided a postponement for taxpayers affected by Hurricane Florence to make and revoke all elections with respect to section 965. The Treasury Department and the IRS have determined that providing additional election relief would create administrative difficulties and is therefore inappropriate. Accordingly, the recommendation is not adopted.

X. Applicability Dates

No comments were received with respect to the applicability dates of the proposed regulations. The final regulations retain the applicability dates that were in the proposed regulations and, consistent with the applicability date of section 965, generally apply beginning the last taxable year of a foreign corporation that begins before January 1, 2018, and with respect to a United States person, beginning the taxable year in which or with which such taxable year of the foreign corporation ends. See section 7805(b)(2).

Effect on Other Documents


Statement of Availability of IRS Documents


Special Analyses

I. Regulatory Planning and Review

Executive Orders 13563 and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, reducing costs, harmonizing rules, and promoting flexibility. OIRA has designated this rule as an economically significant regulatory action under section 3(f) of Executive Order 12866 and the Memorandum of Agreement (MOA), Review of Tax Regulations under Executive Order 12866 (April 11, 2018). Accordingly, the rule has been reviewed by the Office of Management and Budget.

A. Need for the final regulations

These final regulations implement section 965 of the Code as amended by the Act. The final regulations provide rules for determining the section 965(a) inclusion amount of a United States shareholder of a foreign corporation with accumulated post–1986 deferred foreign income. The final regulations directly implement the statutory requirements. The Senate Committee on Finance stated with respect to section 965:

To ensure that all distributions from foreign subsidiaries are treated in the same manner under the participation exemption system, the Committee believes that it is appropriate to tax
such earnings as if they had been repatriated under present law, but at a reduced rate. The Committee believes the tax on accumulated foreign earnings should apply without requiring an actual distribution of earnings, and further believes that the tax rate should take into account the liquidity of the accumulated earnings.

Senate Committee on Finance, Explanation of the Bill, at 358 (November 22, 2017).

B. Background

The international tax system prior to the Act created strong incentives for U.S. companies to keep their earnings and profits overseas, an action known as deferral, in order to avoid paying a sizeable residual U.S. tax. The Act ended deferral and the resulting “lockout effect.” It introduced a one-time tax on the stock of any deferred E&P not previously taxed by the United States, regardless of whether those earnings are repatriated. Cash or cash-equivalent assets held by a foreign corporation result in a higher rate of repatriation tax than non-cash assets, such as plant, property, and equipment. The tax applies to the accumulated stock of deferred E&P as of the last taxable year of a foreign corporation beginning before January 1, 2018, and with respect to United States shareholders, for taxable years in which or with which the taxable year of the foreign corporation ends; these details are important for understanding the economic impacts of the final regulations.

The final regulations address open questions regarding the application of section 965 and comments received on the proposed regulations. They provide rules related to section 965 described in the four notices issued since December 22, 2017, with certain modifications, as well as additional guidance related to section 965. Specifically, the guidance provides general rules and definitions, as well as rules related to the determination and treatment of section 965(c) deductions, rules that disregard certain transactions in connection with section 965, rules related to foreign tax credits, rules regarding elections and payments, rules regarding the application of the section 965 regulations to affiliated groups, including consolidated groups, rules on dates of applicability, rules relating to section 962 elections, and rules regarding the application of section 986(c) in connection with section 965. These final regulations are designed to provide clarity and reduce unnecessary burdens on taxpayers, including by providing guidance on how to apply particular mechanical rules.

C. Baseline

The baseline constitutes a world in which no regulations pertaining to section 965 had been promulgated. The following qualitative analysis describes the anticipated impacts of the regulations relative to the baseline.

D. Consideration of alternatives

For a discussion of the alternatives considered in the promulgation of the proposed regulations, see Parts II through IX of the Summary of Comments and Explanation of Revisions. For example, see Part II of the Summary of Comments and Explanation of Revisions for a discussion of the alternatives considered with respect to the determination of, among other things, post–1986 earnings and profits, cash measurement dates, and short-term obligations, and Part III.D of the Summary of Comments and Explanation of Revisions for a discussion of the alternatives considered to the rule permitting elective basis adjustments to the stock of certain DFICs and E&P deficit foreign corporations. For a discussion of additional alternatives considered in the promulgation of the final regulations, see Part G of this Special Analyses.

E. Economic analysis of provisions substantially unchanged from the proposed regulations

The final regulations enhance the performance of the U.S. economy by reducing uncertainty and ambiguity over interpretation of the section 965 requirements. Absent these final regulations, different parties would likely interpret the statute in different ways. Such disparate interpretations could lead similarly situated taxpayers to calculate their tax liability differently and therefore possibly to make organizational or investment decisions under different signals of economic value, an economically inefficient outcome. The final regulations, following the proposed regulations with primarily only technical modifications, reduce uncertainty and ambiguity by: (1) providing that all members of a consolidated group that are United States shareholders of a specified foreign corporation are treated as a single United States shareholder for certain purposes; (2) introducing definitions of terminology used; (3) coordinating foreign tax credit rules; (4) providing explicit mechanical rules for applying section 965 in a variety of complex scenarios; (5) making explicit the process for making elections and paying the tax; and (6) providing dates of applicability.

In consultation with taxpayers, the Treasury Department and the IRS also determined that there are multiple instances throughout the statute where the transition tax may be artificially inflated because of double counting of cash and E&P due to multiple testing dates and chains of ownership. Double counting, as well as non-counting, is inequitable because similarly situated taxpayers may differ in terms of the amounts of income that fall into the specific categories that may be subject to double counting or non-counting. As a result of this analysis, the final regulations, following the proposed regulations with only technical modifications, reduce double counting and non-counting and produce more equitable tax outcomes across otherwise similarly situated taxpayers by: (1) preventing double counting in computing the aggregate foreign cash position, for example, by disregarding receivables and payables between related specified foreign corporations with a common U.S. shareholder; and (2) preventing double-counting and non-counting in the computation of deferred earnings arising from amounts paid or incurred between related parties between measurement dates.

F. Responses to comments

The Treasury Department and the IRS received comments from the public in response to the proposed regulations. This section discusses significant issues brought up in the comments for which economic reasoning is insightful. For a full discussion of comments received, see the Summary of Comments and Explanation of Revisions section of this preamble.
1. Basis Election Rules

To understand the basis election, it is useful to understand that when a United States shareholder includes an amount in income related to the subpart F income of its CFC, the CFC’s earnings that are associated with the income inclusion are considered as previously taxed. Thus, when those previously taxed E&P are distributed to the United States shareholder, the United States shareholder generally does not include them in income. Additionally, in general, the subpart F inclusion also causes an upward basis adjustment in the stock of the CFC equal to the amount of the income inclusion. This also prevents double taxation through capital gain recognized in the event that the CFC is sold. Because this increase in basis is only needed to avoid double taxation until the previously taxed E&P are distributed, once the earnings are distributed, there is a corresponding downward adjustment in basis of the CFC. If there is insufficient basis in the stock to account for the decrease, then the United States shareholder must recognize gain equal to the difference between the amount of the basis and the reduction.

When applying the framework laid out above in the context of section 965, there are several places where additional rules were needed. Under section 965(b)(4)(A), earnings of DFICs are treated as previously taxed E&P (“section 965(b) previously taxed earnings and profits”) if a deficit is used to offset those earnings for purposes of determining the United States shareholder’s inclusion under section 965(a). However, the statute does not provide for a basis increase to the stock of the DFIC, even though other provisions of the Code still require a basis decrease when the section 965(b) previously taxed earnings and profits are distributed. Thus, under the statute, there could be a disincentive to distribute section 965(b) previously taxed earnings and profits because the United States shareholder has to reduce its basis in its CFC, and in some instances, recognize gain, because the initial offsetting basis increase did not occur.

Under section 965(b)(4)(B), the deficit in E&P in an E&P deficit foreign corporation is generally eliminated to the extent that it is used to offset earnings of a DFIC. The increase in E&P without a corresponding decrease in the basis of the E&P deficit foreign corporation introduces a distortion into the system because it preserves a loss in the stock of the entity even though the loss in earnings and profits has been utilized and eliminated.

Consistent with the legislative history, under the proposed regulations, a taxpayer could elect to make certain basis adjustments related to the taxpayer’s section 965(b) previously taxed earnings and profits. This election was allowed in order to eliminate the distortions in the basis of the stock of the DFIC and E&P deficit foreign corporations. The proposed regulations allowed the taxpayer to elect to increase the basis of certain stock of its DFICs pro rata by the amount of its section 965(b) previously taxed earnings and profits. However, for consistency, the taxpayer was then also required to reduce the basis of certain stock of its E&P deficit foreign corporations by an equivalent amount, and recognize gain to the extent the reduction exceeded the amount of basis the taxpayer had in the stock. The proposed regulations therefore reduced the disincentive to repatriate section 965(b) previously taxed earnings and profits. However, the forced gain recognition could have discouraged some taxpayers from making the election, which would continue the disincentive to repatriate section 965(b) previously taxed earnings and profits, retaining the distortion in the basis of their E&P deficit foreign corporations and thereby distorting taxpayers’ investment and planning decisions.

The final regulations therefore revise this rule slightly to provide an even more flexible election. The final regulations permit a taxpayer to increase its basis in the stock of its DFICs by the lesser of its section 965(b) previously taxed earnings and profits or the amount it can reduce the stock basis of its E&P deficit foreign corporations without recognizing gain. Additionally, subject to certain limitations, the taxpayer is allowed to designate which stock of a DFIC is increased and by how much. This new election further incentivizes taxpayers to make an election to reduce some of the distortions created by the statute, by providing some basis in the DFICs with section 965(b) previously taxed earnings and profits that can be used to repatriate those earnings, and by reducing some of the basis in the E&P deficit foreign corporations to account for the utilization and elimination of the deficit. Additionally, allowing taxpayers the flexibility to assign basis increases to stock in a way which benefits them the most, rather than merely allocating the increases pro rata among the taxpayers’ DFICs, further neutralizes any negative impact of the statute on the incentive to repatriate section 965(b) previously taxed earnings and profits.

In developing the final regulations, the Treasury Department and the IRS considered a number of options related to the basis election, including retaining the rule in the proposed regulations, requiring that the taxpayer increase the basis in the stock of its DFICs on a pro rata basis rather than by designation, and a more complex rule that would have permitted additional basis adjustments where an E&P deficit foreign corporation had basis in excess of its deficit. The rules in the final regulation balance administrative and compliance concerns, while still allowing the maximum amount of flexibility for taxpayers in their investment and repatriation planning. This increased flexibility and clarity provided by the final regulations helps to ensure that taxpayers face more uniform incentives regarding section 965(b) previously taxed earnings and profits, and minimizes distortions to taxpayer behavior resulting from the adjustments provided for by the statute. See Part III.D of the Summary of Comments and Explanation of Revisions for additional discussion of the considerations taken into account with respect to this issue.

2. Cash Position Calculation

In the case of a domestic corporate United States shareholder, section 965 generally taxes foreign earnings at a 15.5% rate if held in cash, but only at 8% otherwise. The cash definition in the statute and the proposed regulations includes both cash and cash equivalents. A number of comments were received requesting that certain assets be excluded from the list of assets counted as cash equivalents, including commodities held as inventories or supplies and stock of publicly traded companies. The final regulations provide a narrow exception from the definition of “cash position” for certain commodities held by a specified foreign corporation in
the ordinary course of its trade or business as well as for certain privately negotiated contracts to buy or sell such assets.

The Treasury Department and the IRS have determined that assets that would otherwise constitute cash equivalents should not be treated as such for purposes of section 965 if they constitute inventory or supplies under longstanding tax principles. These types of assets have been defined by statute and decades of case law as property used in the ordinary course of a taxpayer’s business, typically for sale to customers or further use via processes such as manufacturing and refinement. In general, these types of assets are not held for investment with the goal of recognizing appreciation over a substantial period of time, but are rather turned over (or used to make property that is turned over) routinely in the ordinary conduct of business.

These well-settled delineations of what constitute inventory or supplies are consistent with the statutory definition of and legislative history explaining cash-equivalent assets in section 965(c)(3)(B)(iii). Moreover, the contours of this category have been carefully defined through common law and are generally well-understood by taxpayers. As a result, an exception from cash-equivalent assets in section 965(c)(3)(B)(iii) would have required the creation of new terms and concepts, led to potential over- or under-inclusiveness, and created uncertainty. For these reasons, the Treasury Department and the IRS determined that the general approach in the proposed regulations was most consistent with the statute and legislative history, subject to the narrow exception added to the final regulations for the reasons discussed above. Further, providing broad exceptions could create complexity and increased administrative and compliance burdens. See Part II.D of the Summary of Comments and Explanation of Revisions for a more complete discussion of the considerations taken into account with respect to this issue.

3. Total Net Tax Liability under Section 965

Section 965(h) elections and section 965(i) elections allow a taxpayer to defer payment of its total net tax liability under section 965. (For section 965(h), the election provides deferral over 8 years, whereas for section 965(i) the election provides indefinite deferral until the occurrence of certain triggering events.) Total net tax liability under section 965, which defines the portion of a taxpayer’s income tax eligible for deferral, is equal to the difference between a taxpayer’s net income tax “with” and “without” the application of section 965; this is intended to isolate the portion of a taxpayer’s net income tax attributable solely to section 965. Under the statute, the “without” prong calculates a taxpayer’s net income tax without regard to section 965, but also disregards dividends received from a foreign subsidiary. Dividends are disregarded because, absent section 965, the dividends generally would be taxed in the hands of the taxpayer, but such dividends would be distributions of previously taxed E&P if section 965 applies, and thus not subject to additional tax.

Absent the provision in the statute that disregards dividends received from a foreign subsidiary in the “without” prong, the tax imposed on dividends would be included in the “without” prong but not in the “with” prong, distorting the “with” and “without” calculation so that it no longer isolates the net income tax attributable to section 965, and under-counting income eligible for deferral.

In response to comments, the final regulations also disregard effective repatriations taxed in a manner similar to dividends under section 951(a)(1)(B) resulting from a foreign subsidiary’s investments in United States property under section 965 for purposes of calculating the “without” prong. In the year that section 965 applies, taxpayers may have chosen to borrow funds from their CFCs instead of receiving a regular dividend distribution, because such loans would not be subject to tax as effective repatriations of previously taxed E&P and their annual cash distribution policies could not be easily adjusted following passage of the Act. Without the final regulations, taxpayers that received these loans from their CFCs would be required to include the loan amount in the “without” calculation, leading to a distortion in the “with” and “without” calculation so that it no longer isolates the net income tax attributable to section 965, resulting in a reduced net income tax attributable to section 965, and a loss of some of the deferral benefit of section 965(h) and (i).

While the Treasury Department and the IRS considered retaining the proposed rule, the final regulations do not do so because the amounts of inbound loans, like dividends, will generally be non-taxable investments of previously taxed E&P “with” section 965, but taxable as effective repatriations “without” section 965, and thus, as stated previously, including these amounts in the “without” calculation would inappropriately decrease the amount of the taxpayer’s net tax liability eligible for the deferral elections and fail to isolate the portion of the taxpayer’s net tax liability attributable solely to section 965. See Part VII.I of the Summary of Comments and Explanation of Revisions for a more complete discussion of the considerations taken into account with respect to this issue.

II. Paperwork Reduction Act

A. Collection of information imposed by the regulations

The collection of information imposed directly by these regulations is contained in §§1.965–2(d)(2)(ii)(B), 1.965–2(f)(2)(ii)(B), 1.965–3(b)(2), 1.965–3(c)(3), 1.965–4(b)(2)(i), 1.965–4(b)(2)(ii)(B), 1.965–7(b)(2), 1.965–7(b)(3)(iii)(B), 1.965–7(c)(2), 1.965–7(c)(3)(iv)(B), 1.965–7(c)(3)(v)(D), 1.965–7(c)(6)(i), 1.965–7(d)(3), 1.965–7(e)(2), 1.965–7(f)(5), and 1.965–8(c). The collection of information provided by these regulations has been reviewed and approved by the Office of Management and Budget under control number 1545-2280. The information is required in order for the IRS to be aware if a taxpayer makes an election, transfers a section 965(h) net tax liability or section 965(i) net tax liability pursuant to a transfer agreement, or takes a position that the anti-abuse rules (described in Part V of the Summary of Comments and Explanation of Revisions section of this preamble) do not apply.

The estimates for the collection of information provided by these final regulations are that 100,000 respondents will require 5 hours per response for a total reporting burden of 500,000 hours. A valuation of the burden hours at $95/hour ($2017) leads to a PRA-based estimate of the reporting costs to taxpayers of
$47,500,000. This is a one-time paperwork burden. The Treasury Department and the IRS anticipate substantially all paperwork burdens related to the final regulations to be incurred only with respect to the inclusion year. Any subsequent reporting (such as in connection with a transfer of a section 965(h) net tax liability or section 965(i) net tax liability) would be negligible burdens that implement elections made and payments calculated in the inclusion year. These burden estimates capture only those burdens imposed by the final regulations and do not include burden estimates for forms associated with the statute.

Comments suggested that the burden reported in connection with the collection of information requirements under the proposed regulations did not appropriately take into account the time necessary for determining net tax liability under section 965 and performing other computations related to the determination of such net tax liability. However, the collections of information under the proposed regulations do not relate to such computations; they relate solely to the making of elections, filing of transfer agreements, and reporting of positions concerning the application of anti-abuse rules. Limited information is required to make such elections, file such transfer agreements, or do such reporting, and accordingly, five hours is an appropriate estimate of the burden imposed by the collections of information in the final regulations.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. The IRS has posted information for taxpayers on their recordkeeping requirements at https://www.irs.gov/taxtopics/tc305. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

B. Forms created or modified to collect information

In addition to the collection of information requirements in the final regulations, the enactment of section 965 necessitated the creation and modification of certain forms, which are needed to capture changes solely made by the Act and do not reflect a burden imposed by the final regulations. The Treasury Department and the IRS intend that the collections of information relating to the reporting and payment of tax under section 965 will be conducted by way of the forms and instructions identified thus far in the following table. As a result, for purposes of the Paperwork Reduction Act (44 U.S.C. 3507(d)), the reporting burden associated with the collection of information in those forms will be reflected in the Form 14029, Paperwork Reduction Act Submission, associated with those forms.

<table>
<thead>
<tr>
<th>Related New or Revised Tax Forms</th>
<th>Number of Respondents (Estimated)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Form 965</strong></td>
<td>50,000–100,000</td>
</tr>
<tr>
<td><strong>Form 965-A</strong></td>
<td>35,000–70,000</td>
</tr>
<tr>
<td><strong>Form 965-B</strong></td>
<td>15,000–30,000</td>
</tr>
<tr>
<td><strong>Form 990-PF</strong></td>
<td>1,000</td>
</tr>
<tr>
<td><strong>Form 990-T</strong></td>
<td>1,000</td>
</tr>
<tr>
<td><strong>Form 1040</strong></td>
<td>27,000–57,000</td>
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<tr>
<td><strong>Form 1041</strong></td>
<td>1,000</td>
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<tr>
<td><strong>Form 1065</strong></td>
<td>8,000–10,000</td>
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<tr>
<td><strong>Form 1120</strong></td>
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<td><strong>Form 1120-C</strong></td>
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<tr>
<td><strong>Form 1120-L</strong></td>
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<tr>
<td><strong>Form 1120-PC</strong></td>
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<tr>
<td><strong>Form 1120-REIT</strong></td>
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<tr>
<td><strong>Form 1120-RIC</strong></td>
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</tr>
<tr>
<td><strong>Form 1120-S</strong></td>
<td>3,000–5,000</td>
</tr>
</tbody>
</table>

The current status of the Paperwork Reduction Act submissions related to the tax forms that will be created or revised as a result of section 965 is provided in the following table. The burdens associated with the information collections in the forms are included in aggregated burden estimates for the OMB control numbers listed in the following table which, in the case of 1545-0123, represents a total estimated burden time, including all other related forms and schedules for corporations, of 3.157 billion hours and total estimated monetized costs of $58.148 billion ($2017) and, in the case of 1545-0074, a total estimated burden time, including all other related forms and schedules for individuals, of 1.784 billion hours and total estimated monetized costs of $31.764 billion ($2017). The burden estimates provided in the OMB control numbers in the following table are aggregate amounts that relate to the entire package of forms associated with the OMB.
control number, and will in the future include but not isolate the estimated burden of only those information collections associated with section 965. These numbers are therefore unrelated to the future calculations needed to assess the burden imposed by these regulations. To guard against over-counting the burden that international tax provisions imposed prior to the Act, the Treasury Department and the IRS urge readers to recognize that these burden estimates have also been cited by regulations (such as the foreign tax credit regulations, 83 Fed. Reg. 63200) that rely on the applicable OMB control numbers in order to collect information from the applicable types of filers. With respect to the final regulations, the only relevant burden estimates are those associated with OMB control number 1545-2280. Future estimates would capture both changes made by the Act and those that arise out of discretionary authority exercised in the regulations. In addition, when available, drafts of IRS forms are posted for comment at https://apps.irs.gov/app/picklist/list/draftTaxForms.htm.

<table>
<thead>
<tr>
<th>Form</th>
<th>Type of Filer</th>
<th>OMB Number(s)</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>Form 965 (including Schedules A–H)</td>
<td>Business (NEW Model)</td>
<td>1545-0123</td>
<td>Published in the FRN on 10/11/18. Public Comment period closed on 12/10/18.</td>
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<tr>
<td>Form 965–B</td>
<td>Business (NEW Model)</td>
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<td>Form 965–A</td>
<td>Individual (NEW Model)</td>
<td>1545-0074</td>
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<tr>
<td>Forms 990–PF, 990-T</td>
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<td>1545-0047</td>
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<td>1545-0123</td>
<td>Published in the FRN on 10/11/18. Public Comment period closed on 12/10/18.</td>
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</table>
In-house estimates of section 965 tax liability and total receipts of small businesses are used to scale the published aggregate figures. In this case, a small business is defined as a multinational corporation with less than $25 million in gross receipts. Data on total sales of all U.S. parented companies are drawn from the Bureau of Economic Analysis Interactive Data accessed at this web address in December, 2018: https://apps.bea.gov/iTable/iTable.cfm?ReqID=688&step=1.

Section 965 and the final regulations generally affect U.S. taxpayers who are at least 10-percent shareholders of a foreign corporation. As an initial matter, foreign corporations are not considered small entities. Nor are U.S. taxpayers considered small entities to the extent the taxpayers are natural persons or entities other than small entities. Although the Treasury Department and the IRS received a number of comments asserting that a substantial number of small entities would be affected by the proposed regulations, those comments were principally concerned with U.S. citizens living abroad that own foreign corporations directly or indirectly through other foreign entities. No small entity is affected in this scenario. Thus, the final regulations generally only affect small entities if a U.S. taxpayer that is a 10-percent shareholder of a foreign corporation is a small entity.

While comprehensive counts of all types of small businesses affected by section 965 and these regulations are not readily available, in-house estimates of section 965 suggest that very roughly 20,000 multinational domestic corporations are potentially subject to section 965, and that about half of these corporations have less than $25 million in gross receipts. Therefore, very roughly 10,000 small multinational corporations (defined as corporations with less than $25 million in gross receipts) are potentially subject to section 965. The in-house estimates further suggest that about 25% of these small multinational corporations would not owe any tax under section 965, because they do not have any accumulated E&P to which the tax would be applied.

Regardless of the number of small entities potentially affected by section 965 or the final regulations, the Treasury Department and the IRS have concluded that there is no significant economic impact on such entities as a result of the final regulations. Based on published information from the Conference Report accompanying the Act, H.R. Rep. No. 115–446, at 688 (2017), and Bureau of Economic Analysis aggregate data, which were adjusted to reflect the tax burden and total sales of small businesses, the projected net tax proceeds from section 965 are estimated to be only a small fraction of the total sales of small U.S. parented multinational enterprises projected to 2027. Additional, the economic impact that is not regarded as significant under the Regulatory Flexibility Act. Moreover, while most affected small entities are likely to pay the tax in (unequal) installments over 8 years, the percentage in any particular year does not exceed 2.2 percent.

### Fiscal Years

<table>
<thead>
<tr>
<th>Fiscal Years</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
<th>2021</th>
<th>2022</th>
<th>2023</th>
<th>2024</th>
<th>2025</th>
<th>2026</th>
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</thead>
<tbody>
<tr>
<td>Net Tax Collected ($ billions)</td>
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<td>0.8</td>
<td>0.2</td>
<td>0.2</td>
<td>0.2</td>
<td>0.4</td>
<td>0.7</td>
<td>1.0</td>
<td>0.5</td>
<td>-0.1</td>
</tr>
<tr>
<td>Total Sales ($ billions)</td>
<td>54.0</td>
<td>56.7</td>
<td>59.6</td>
<td>62.6</td>
<td>65.7</td>
<td>69.0</td>
<td>72.4</td>
<td>76.0</td>
<td>79.8</td>
<td>83.8</td>
</tr>
</tbody>
</table>

**Percent**

- 2.20%
- 1.32%
- 0.42%
- 0.38%
- 0.36%
- 0.60%
- 0.99%
- 1.28%
- 0.63%
- 0.17%

### Notes and References

1. Small Multinational Businesses are not necessarily small entities as defined by the Regulatory Flexibility Act.

   Thus, even if the economic impact of the final regulations is interpreted broadly to include the tax liability due under section 965, which small entities would be required to pay even if the final regulations were not issued, the economic impact should not be regarded as significant under the Regulatory Flexibility Act.

2. In-house estimates of section 965 tax liability and total receipts of small businesses are used to scale the published aggregate figures. In this case, a small business is defined as a multinational corporation with less than $25 million in gross receipts. Data on total sales of all U.S. parented companies are drawn from the Bureau of Economic Analysis Interactive Data accessed at this web address in December, 2018: https://apps.bea.gov/iTable/iTable.cfm?ReqID=688&step=1.

The Treasury Department and the IRS have determined that the average burden associated with these collection of information requirements is 5 hours, which is minimal, particularly in comparison with other regulatory requirements related to owning stock in a specified foreign corporation. Furthermore, these requirements apply only if a taxpayer chooses to make an election or rely on a favorable rule. The comments received regarding the economic impact of the proposed regulations principally focus on burdens imposed by the statute (i.e., the tax due as a result of section 965) rather than any additional burdens resulting from the proposed regulations.

For the reasons explained above, the Treasury Department and the IRS have determined that the final regulations will not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis under the Regulatory Flexibility Act is not required. Pursuant to section 7805(f), the notice of proposed rulemaking preceding these final regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business. No comments were received.

IV. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. In 2018, that threshold is approximately $150 million. This rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

V. Executive Order 13132: Federalism

Executive Order 13132 (entitled “Federalism”) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This final rule does not have federalism implications and does not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

Drafting Information

The principal authors of the final regulations are Leni C. Perkins, Natalie Punchak, and Karen J. Cate of the Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in the development of the final regulations.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and record-keeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding new entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

* * * *

Section 1.962–1 also issued under 26 U.S.C. 965(o).

* * * *

Section 1.965–1 also issued under 26 U.S.C. 965(c)(3)(B)(i)(ii)(V), 965(d)(2), 965(o), 989(c), and 7701(a).

Section 1.965–2 also issued under 26 U.S.C. 965(b)(3)(A)(ii), 965(o), and 961(a) and (b).

Section 1.965–3 also issued under 26 U.S.C. 965(c)(3)(D) and 965(o).

Section 1.965–4 also issued under 26 U.S.C. 965(c)(3)(F) and 965(o).

Sections 1.965–5 through 1.965–6 also issued under 26 U.S.C. 965(o) and 26 U.S.C. 902(c)(8) (as in effect on December 21, 2017).

Section 1.965–7 also issued under 26 U.S.C. 965(h)(3), 965(h)(5), 965(i)(2), 965(i)(8)(B), 965(m)(2)(A), 965(n)(3), and 965(o).

Section 1.965–8 also issued under 26 U.S.C. 965(o).

Section 1.965–9 also issued under 26 U.S.C. 965(o).

* * * *

Section 1.986(c)(1) also issued under 26 U.S.C. 965(o) and 26 U.S.C. 989(c).

* * * *

Par. 2. Section 1.962–1 is amended by:

1. Revising paragraph (b)(1)(i).

2. Redesignating paragraphs (b)(2)(iv)(a) and (b) as paragraph (b)(2)(iv)(A) and (B), respectively.

3. Adding paragraph (d).

The revision and addition read as follows:

§1.962–1 Limitation of tax for individuals on amounts included in gross income under section 951(a).

* * * *

(b) * *

(1) * *

(i) Determination of taxable income.

The term taxable income means the excess of—

(A) The sum of—

(J) All amounts required to be included in his gross income under section 951(a) for the taxable year with respect to a foreign corporation of which he is a United States shareholder, including—

(i) His section 965(a) inclusion amounts (as defined in §1.965–1(f)(38)); and

(ii) His domestic pass-through owner shares (as defined in §1.965–1(f)(21)) of section 965(a) inclusion amounts with respect to deferred foreign income corporations (as defined in §1.965–1(f)(17)) of which he is a United States shareholder; plus

(2) [Reserved]

(3) All amounts which would be required to be included in his gross income under section 78 for the taxable year with respect to the amounts referred to in paragraph (b)(1)(i)(A)(J) and (2) of this sec-
tion if the shareholder were a domestic corporation; over

(B) The sum of the following deductions, but no other deductions or

(1) His section 965(c) deduction amount (as defined in §1.965–1(f)(42)) for the taxable year;

(2) His domestic pass-through owner shares of section 965(c) deduction amounts corresponding to the amounts referred to in paragraph (b)(1)(i)(A)(ii) of this section; and

(3) [Reserved]

* * * * *

(d) Applicability dates. Paragraph (b)(1)(i) of this section applies beginning the last taxable year of a foreign corporation that begins before January 1, 2018, and with respect to a United States person, for the taxable year in which or with which such taxable year of the foreign corporation ends.

Par. 3. Section 1.962–2 is amended by revising paragraph (a) and adding paragraph (d) to read as follows:

§1.962–2 Election of limitation of tax for individuals.

(a) Who may elect. The election under section 962 may be made only by an individual (including a trust or estate) who is a United States shareholder (including an individual who is a United States shareholder because, by reason of section 958(b), he is considered to own stock of a foreign corporation owned (within the meaning of section 958(a)) by a domestic pass-through entity (as defined in §1.965–1(f)(19))).

* * * * *

(d) Applicability dates. Paragraph (a) of this section applies beginning the last taxable year of a foreign corporation that begins before January 1, 2018, and with respect to a United States person, for the taxable year in which or with which such taxable year of the foreign corporation ends.

Par. 4. Sections 1.965–0 through 1.965–9 are added to read as follows:

* * * * *

1.965–0 Outline of section 965 regulations.

1.965–1 Overview, general rules, and definitions.

1.965–2 Adjustments to earnings and profits and basis.

1.965–3 Section 965(c) deductions.

1.965–4 Disregard of certain transactions.

1.965–5 Allowance of credit or deduction for foreign income taxes.

1.965–6 Computation of foreign income taxes deemed paid and allocation and apportionment of deductions.

1.965–7 Elections, payment, and other special rules.

1.965–8 Affiliated groups (including consolidated groups).

1.965–9 Applicability dates.

* * * * *

§1.965–0 Outline of section 965 regulations.

This section lists the headings for §§1.965–1 through 1.965–9.

§1.965–1 Overview, general rules, and definitions.

(a) Overview.

(1) In general.

(2) Scope.

(b) Section 965(a) inclusion amounts.

(1) Inclusion of the pro rata share of the section 965(a) earnings amount.

(2) Reduction by the allocable share of the aggregate foreign E&P deficit.

(c) Section 965(c) deduction amounts.

(d) Treatment of specified foreign corporation as a controlled foreign corporation.

(e) Special rule for certain controlled domestic partnerships.

(1) In general.

(2) Definition of a controlled domestic partnership.

(f) Definitions.

(1) 8 percent rate amount.

(2) 8 percent rate equivalent percentage.

(3) 15.5 percent rate amount.

(4) 15.5 percent rate equivalent percentage.

(5) Accounts payable.

(6) Accounts receivable.


(8) Aggregate foreign cash position.

(9) Aggregate foreign E&P deficit.

(10) Aggregate section 965(a) inclusion amount.

(11) Allocable share.
(44) Specified E&P deficit.
(45) Specified foreign corporation.
(i) General rule.
(ii) Special attribution rule.
(A) In general.
(B) Attribution for purposes of the ten percent standard.
(iii) Passive foreign investment companies.
(46) Spot rate.
(47) United States shareholder.
(g) Examples.
(1) Example 1.
(i) Facts.
(ii) Analysis.
(2) Example 2.
(i) Facts.
(ii) Analysis.
(3) Example 3.
(i) Facts.
(ii) Analysis.
(A) Determination of status as a deferred foreign income corporation.
(B) Determination of status as an E&P deficit foreign corporation.
(6) Example 6.
(i) Facts.
(ii) Analysis.
(7) Example 7.
(i) Facts.
(ii) Analysis.
(8) Example 8.
(i) Facts.
(ii) Analysis.

§1.965–2 Adjustments to earnings and profits and basis.

(a) Scope.
(b) Determination of and adjustments to earnings and profits of a specified foreign corporation for purposes of applying sections 902, 959, 960, and 965.
(c) Adjustments to earnings and profits by reason of section 965(a).
(d) Adjustments to earnings and profits by reason of section 965(b).
(1) Adjustments to earnings and profits described in section 959(c)(2) and (c)(3) of deferred foreign income corporations.
(2) Adjustments to earnings and profits described in section 959(c)(3) of E&P deficit foreign corporations.
   (i) Increase in earnings and profits by an amount equal to the portion of the section 958(a) U.S. shareholder’s pro rata share of the specified E&P deficit.
   (A) In general.
   (B) Reduction of a qualified deficit.
   (ii) Determination of portion of a section 958(a) U.S. shareholder’s pro rata share of a specified E&P deficit taken into account.
      (A) In general.
      (B) Designation of portion of a section 958(a) U.S. shareholder’s pro rata share of a specified E&P deficit taken into account.
      (e) Adjustments to basis by reason of section 965(a).
         (1) General rule.
         (2) Section 962 election.
         (f) Adjustments to basis by reason of section 965(b).
            (1) In general.
            (2) Election to make adjustments to basis to account for the application of section 965(b).
               (i) In general.
               (ii) Basis adjustments.
                  (A) In general.
                  (B) Increase in earnings and profits by an amount equal to the gain reduction amount.
                  (C) Section 965(a) inclusion amount.
                     (1) General rule.
                     (2) Limited basis adjustment.
                     (B) Reduction in basis with respect to an E&P deficit foreign corporation.
                        (1) In general.
                        (2) Limited basis adjustment.
                        (C) Section 962 election.
                           (iii) Rules regarding the election.
                              (A) Consistency requirement.
                              (B) Manner of making election.
                                 (1) Timing.
                                 (i) In general.
                                 (ii) Transition rule.
                                 (2) Election statement.
                                 (g) Gain reduction rule.
                                    (1) Reduction in gain recognized under section 961(b)(2) by reason of distributions attributable to section 965 previously taxed earnings and profits in the inclusion year.
                                       (i) In general.
                                       (ii) Definition of section 965 previously taxed earnings and profits.
                                          (1) In general.
                                          (2) Reduction in basis by an amount equal to the gain reduction amount.
                                          (h) Rules of application for specified basis adjustments.
                                             (1) Timing of basis adjustments.
                                             (2) Netting of basis adjustments.
                                             (3) Gain recognition for reduction in excess of basis.
                                             (4) Adjustments with respect to each share.
                                                (i) Section 958(a) stock.
                                                (ii) Applicable property.
                                                (5) Stock or property for which adjustments are made.
                                                   (i) In general.
                                                   (ii) Special rule for an interest in a foreign pass-through entity.
                                                      (i) Definitions.
                                                      (1) Applicable property.
                                                      (2) Foreign pass-through entity.
                                                      (3) Property.
                                                      (j) Examples.
                                                         (1) Example 1.
                                                            (i) Facts.
                                                            (ii) Analysis.
                                                             (A) Adjustments to section 959(c) classification of earnings and profits for inclusion under section 951(a)(1)(A) without regard to section 965.
                                                                (B) Distributions between specified foreign corporations before January 1, 2018.
                                                                   (C) Section 965(a) inclusion amount.
                                                                      (1) CFC1 section 965(a) earnings amount.
                                                                      (2) CFC2 section 965(a) earnings amount.
                                                                      (3) Effect on earnings and profits described in section 959(c)(2) and (3).
                                                                       (D) Distribution to United States shareholder.
                                                                         (E) Section 902 and section 960 consequences.
                                                                            (1) Distribution by and inclusions with respect to CFC2.
                                                                                (2) Inclusions with respect to CFC1.
                                                                                (2) Example 2.
                                                                                    (i) Facts.
                                                                                    (ii) Analysis.
                                                                 (A) Adjustments to section 959(c) classification of earnings and profits for inclusion under section 951(a)(1)(A) without regard to section 965.
                                                                            (B) Distributions between specified foreign corporations before January 1, 2018.
                                                                                  (C) Section 965(a) inclusion amount.
                                                                                   (1) CFC1 section 965(a) earnings amount.
(2) CFC2 section 965(a) earnings amount.
(3) Effect on earnings and profits described in section 959(c)(2) and (3).
(D) Distribution to United States shareholder.
(3) Example 3.
(i) Facts.
(ii) Analysis.
(A) Adjustments to section 959(c) classification of earnings and profits for inclusion under section 951(a)(1)(A) without regard to section 965.
(B) Distributions between specified foreign corporations before January 1, 2018.
(C) Section 965(a) inclusion amount.
(1) CFC1 section 965(a) earnings amount.
(2) CFC2 section 965(a) earnings amount.
(3) Effect on earnings and profits described in section 959(c)(2) and (3).
(D) Distribution to United States shareholder.
(4) Example 4.
(i) Facts.
(ii) Analysis.
(A) Adjustments to section 959(c) classification of earnings and profits for inclusion under section 1248 inclusion.
(B) Section 965(a) inclusion amount.
(C) Distributions to United States shareholders.
(7) Example 7.
(i) Facts.
(ii) Analysis.
(A) Application of the gain reduction rule.
(B) Adjustments to the basis of CFC1.
(9) Example 9.
(i) Facts.
(ii) Analysis.
(A) Application of the gain reduction rule.
(B) Adjustments to the basis of CFC1 and CFC2.
§1.965–3 Section 965(c) deductions.
(a) Scope.
(b) Rules for disregarding certain assets for determining aggregate foreign cash position.
(1) Disregard of certain obligations between related specified foreign corporations.
(2) Disregard of other assets upon demonstration of double-counting.
(3) Disregard of portion of cash position of noncorporate entities treated as specified foreign corporations.
(4) Examples.
(i) Example 1.
(A) Facts.
(B) Analysis.
(1) Loan from CFC1 to CFC2.
(2) Account receivable of CFC1 held by CFC2.
(3) Loan from CFC1 to CFC3.
(ii) Example 2.
(A) Facts.
(B) Analysis.
(iii) Example 3.
(A) Facts.
(B) Analysis.
(iv) Example 4.
(A) Facts.
(B) Analysis.
(v) Example 5.
(A) Facts.
(B) Analysis.
(1) Treatment of PS1.
(2) Treatment of PS2.
(c) Determination of aggregate foreign cash position for a section 958(a) U.S. shareholder inclusion year.
(1) Single section 958(a) U.S. shareholder inclusion year.
(2) Multiple section 958(a) U.S. shareholder inclusion years.
(i) Allocation to first section 958(a) U.S. shareholder inclusion year.
(ii) Allocation to succeeding section 958(a) U.S. shareholder inclusion years.
(3) Estimation of aggregate foreign cash position.
(4) Examples.
(i) Example 1.
(A) Facts.
(B) Analysis.
(ii) Example 2.
(A) Facts.
(B) Analysis.
(d) Increase of income by section 965(c) deduction of an expatriated entity.
(1) In general.
(2) Definition of expatriated entity.
(3) Definition of surrogate foreign corporation.
(e) Section 962 election.
(1) In general.
(2) Example.
(i) Facts.
(ii) Analysis.
(f) Treatment of section 965(c) deduction under certain provisions of the Internal Revenue Code.
(1) Section 63(d).
(2) Sections 705, 1367, and 1368.
(i) Adjustments to basis
(ii) S corporation accumulated adjustments account.
(iii) Example.
(A) Facts.
(B) Analysis.
(3) Section 1411.
(4) Section 4940.
(g) Domestic pass-through entities.
§1.965–4 Disregard of certain transactions.
(a) Scope.
(b) Transactions undertaken with a principal purpose of changing the amount of a section 965 element.
(1) General rule.
(2) Presumptions and exceptions for the application of the general rule.

(ii) Definitions.
(A) Relatedness.
(B) Transfer.
   (1) In general.
   (2) Indirect transfer.
   (iii) Cash reduction transactions.
   (A) General rule.
   (B) Per se rules for certain distributions.
      (iv) E&P reduction transactions.
         (A) Facts.
         (B) Analysis.
         (v) Example 4.

§1.965-5 Allowance of credit or deduction for foreign income taxes.

(a) Scope.
(b) Rules for foreign income taxes paid or accrued.
(c) Rules for foreign income taxes treated as paid or accrued. 
   (i) Disallowed credit.
   (ii) Foreign income taxes deemed paid under section 960(a)(3) (as in effect on December 21, 2017).
   (iii) [Reserved]
   (2) Disallowed deduction.
   (3) Coordination with section 78.
      (i) In general.
      (ii) Domestic corporation that is a domestic pass-through owner.
      (d) Applicable percentage.
         (i) In general.
         (2) No section 965(a) inclusion amount.
         (3) Applicable percentage for domestic pass-through owners.
         (4) Applicable percentage with respect to certain distributions of previously taxed earnings and profits.

§1.965-6 Computation of foreign income taxes deemed paid and allocation and apportionment of deductions.

(a) Scope.
(b) Computation of foreign income taxes deemed paid.
   (1) In general.
   (2) Dividend or inclusion in excess of post-1986 undistributed earnings.
      (3) Treatment of adjustment under section 965(b)(4)(B).
   (4) Section 902 fraction.
   (c) Allocation and apportionment of deductions.
      (d) Hovering deficits.
(2) Manner of making election.
   (i) Eligibility.
   (ii) Timing.
   (iii) Election statement.

(3) Triggering events.
   (i) In general.
   (ii) Triggering events.
   (iii) Partial transfers.
   (iv) Eligible section 965(i) transferee.

(a) Exception.

(b) Denomination event.

(c) Agreement.

(d) Transferor.

(e) Omissions.

(f) Election.

(ii) Liability.

(iii) Coordination with section 965(h).

(4) Coordination with section 965(m).

(3) Manner of making election.

(i) Eligibility.

(ii) Timing.

(iii) Election statement.

(iv) [Reserved]

(5) Coordination with section 965(h).

(a) In general.

(b) Net income tax.

(c) Foreign tax credits.

§1.965–8 Affiliated groups (including consolidated groups).

(a) Scope.

(b) Reduction of E&P net surplus shareholder’s pro rata share of the section 965(a) earnings amount of a deferred foreign income corporation by the allocable share of the applicable share of the aggregate unused E&P deficit.

(1) In general.

(2) Consolidated group as part of an affiliated group.

(c) Designation of portion of excess aggregate foreign E&P deficit taken into account.

(1) In general.

(2) Consolidated group as part of an affiliated group.

(d) [Reserved]

(1) [Reserved]

(2) Consolidated groups.

(e) Treatment of a consolidated group as a single section 958(a) U.S. shareholder or a single person.

(1) In general.

(2) Limitation.

(3) Determination of section 965(c) deduction amount.

(f) Definitions.

(1) Aggregate unused E&P deficit.

(ii) [Reserved]

(1) [Reserved]

(2) Consolidated groups.

(e) Treatment of a consolidated group as a single section 958(a) U.S. shareholder or a single person.

(1) In general.

(2) Limitation.

(3) Determination of section 965(c) deduction amount.

(f) Definitions.

(1) Aggregate unused E&P deficit.

(ii) Reduction with respect to E&P net deficit shareholders that are not wholly owned by the affiliated group.

(2) Allocable share.

(3) Applicable share.

(4) Consolidated group aggregate foreign cash position.

(5) E&P net deficit shareholder.

(6) E&P net surplus shareholder.

(7) Excess aggregate foreign E&P deficit.

(8) Group cash ratio.

(9) Group ownership percentage.
(g) Examples.

(1) Example 1.

(i) Facts.

(A) In general.

(B) Facts relating to section 965.

(ii) Analysis.

(A) Section 965(a) inclusion amounts before application of section 965(b)(5).

(B) Application of section 965(b)(5).

(1) Determination of E&P net surplus shareholders and E&P net deficit shareholders.

(2) Determining section 965(a) inclusion amounts under section 965(b)(5).

(C) Aggregate foreign cash position.

(D) Section 965(c) deduction amount.

(2) Example 2.

(i) Facts.

(ii) Analysis.

(A) Section 965(a) inclusion amount.

(1) Single section 958(a) U.S. shareholder treatment.

(2) Determination of inclusion amount.

(B) Consolidated group aggregate foreign cash position.

(C) Section 965(a) deduction amount.

§1.965–9 Applicability dates.

(a) In general.

(b) Applicability dates for rules disregarding certain transactions.

§1.965–1 Overview, general rules, and definitions.

(a) Overview—(1) In general. This section provides general rules and definitions under section 965. Section 1.965–2 provides rules relating to adjustments to earnings and profits and basis to determine and account for the application of section 965 and a rule that limits the amount of gain recognized under section 961(b)(2) by reason of distributions attributable to section 965 previously taxed earnings and profits (as defined in §1.965–2(g)(1)(ii)) in the inclusion year. Section 1.965–3 provides rules regarding the determination of section 965(c) deductions. Section 1.965–4 sets forth rules that disregard certain transactions for purposes of section 965. Sections 1.965–5 and 1.965–6 provide rules with respect to foreign tax credits. Section 1.965–7 provides rules regarding elections and payments. Section 1.965–8 provides rules regarding affiliated groups, including consolidated groups. Section 1.965–9 provides dates of applicability. See also §§1.962–1 and 1.962–2 (providing rules regarding the application of section 962) and 1.986(c)–1 (providing rules regarding the application of section 986(c)).

(2) Scope. Paragraph (b) of this section provides the general rules concerning section 965(a) inclusion amounts. Paragraph (c) of this section provides the general rule concerning section 965(c) deduction amounts. Paragraph (d) of this section provides a rule for specified foreign corporations that are not controlled foreign corporations. Paragraph (e) of this section treats certain controlled domestic partnerships as foreign partnerships for purposes of section 965. Paragraph (f) of this section provides definitions applicable for the section 965 regulations and §§1.962–1, 1.962–2, and 1.986(c)–1. Paragraph (g) of this section contains examples illustrating the general rules and definitions set forth in this section.

(b) Section 965(a) inclusion amounts—(1) Inclusion of the pro rata share of the section 965(a) earnings amount. For an inclusion year of a deferred foreign income corporation, the subpart F income of the deferred foreign income corporation (as otherwise determined for the inclusion year under section 952 and §1.962–1, 1.962–2, and 1.986(c)–1) is increased by the section 965(a) earnings amount of the deferred foreign income corporation. See section 965(a). Accordingly, a section 958(a) U.S. shareholder with respect to a deferred foreign income corporation generally includes in gross income under section 951(a)(1) for the section 958(a) U.S. shareholder inclusion year its pro rata share of the section 965(a) earnings amount of the deferred foreign income corporation, translated (if necessary) into U.S. dollars using the spot rate on December 31, 2017, and reduced (if necessary) into U.S. dollars using the spot rate on December 31, 2017, is reduced by the deferred foreign income corporation’s allocable share of the section 958(a) U.S. shareholder’s aggregate foreign E&P deficit. See section 965(b). If the section 958(a) U.S. shareholder is a member of a consolidated group, under §1.965–8(e), all section 958(a) U.S. shareholders that are members of the consolidated group are treated as a single section 958(a) U.S. shareholder for purposes of this paragraph (b)(2).

(c) Section 965(c) deduction amounts. For a section 958(a) U.S. shareholder inclusion year, a section 958(a) U.S. shareholder is generally allowed a deduction in an amount equal to the section 965(c) deduction amount.

(d) Treatment of specified foreign corporation as a controlled foreign corporation. A specified foreign corporation described in section 965(e)(1)(B) and paragraph (f)(45)(i)(B) of this section that is not otherwise a controlled foreign corporation is treated as a controlled foreign corporation solely for purposes of paragraph (b) of this section and sections 951, 961, and §1.1411–10. See 965(e)(2).

(e) Special rule for certain controlled domestic partnerships—(1) In general. For purposes of the section 965 regulations, a controlled domestic partnership is treated as a foreign partnership for purposes of determining the section 958(a) U.S. shareholder of a specified foreign corporation and the section 958(a) stock of the specified foreign corporation owned by the section 958(a) U.S. shareholder if the following conditions are satisfied—

(i) Without regard to this paragraph (e), the controlled domestic partnership is a section 958(a) U.S. shareholder of the specified foreign corporation and thus owns section 958(a) stock of the specified
holder of the specified foreign corporation; and

(B) At least one United States shareholder of the specified foreign corporation—

(1) Would be treated as a section 958(a) U.S. shareholder of the specified foreign corporation; and

(2) Would be treated as owning (within the meaning of section 958(a)) stock of the specified foreign corporation through another foreign corporation that is a direct or indirect partner in the controlled domestic partnership.

(2) Definition of a controlled domestic partnership. For purposes of paragraph (e)(1) of this section, the term controlled domestic partnership means a domestic partnership that is controlled by a United States shareholder described in paragraph (e)(1)(ii)(B) of this section and persons related to the United States shareholder. For purposes of this paragraph (e)(2), control is determined based on all the facts and circumstances, except that a partnership will be deemed to be controlled by a United States shareholder and related persons if those persons, in the aggregate, own (directly or indirectly through one or more partnerships) more than 50 percent of the interests in the partnership capital or profits. For purposes of this paragraph (e)(2), a related person is, with respect to a United States shareholder, a person that is related (within the meaning of section 267(b) or 707(b)(1)) to the United States shareholder.

(f) Definitions. This paragraph (f) provides definitions that apply for purposes of the section 965 regulations and §§1.962–1, 1.962–2, and 1.986(c)–1. Unless otherwise indicated, all amounts are expressed as positive numbers.

(1) 8 percent rate amount. The term 8 percent rate amount means, with respect to a section 958(a) U.S. shareholder and a section 958(a) U.S. shareholder inclusion year, the excess, if any, of the section 958(a) U.S. shareholder’s aggregate section 965(a) inclusion amount for the section 958(a) U.S. shareholder inclusion year over the amount of the section 958(a) U.S. shareholder’s aggregate foreign cash position for the section 958(a) U.S. shareholder inclusion year as determined under §1.965–3(c).

(2) 8 percent rate equivalent percentage. The term 8 percent rate equivalent percentage means, with respect to a section 958(a) U.S. shareholder and a section 958(a) U.S. shareholder inclusion year, the percentage that would result in the 8 percent rate amount being subject to an 8 percent rate of tax determined by only taking into account a deduction equal to such percentage of such amount and the highest rate of tax specified in section 11 for the section 958(a) U.S. shareholder inclusion year. In the case of a section 958(a) U.S. shareholder inclusion year of a section 958(a) U.S. shareholder to which section 15 applies, the highest rate of tax under section 11 before the effective date of the change in rates and the highest rate of tax under section 11 after the effective date of such change will each be taken into account under the preceding sentence in the same proportions as the portion of the section 958(a) U.S. shareholder inclusion year that is before and after such effective date, respectively.

(3) 15.5 percent rate amount. The term 15.5 percent rate amount means, with respect to a section 958(a) U.S. shareholder and a section 958(a) U.S. shareholder inclusion year, the amount of the section 958(a) U.S. shareholder’s aggregate foreign cash position for the section 958(a) U.S. shareholder inclusion year as determined under §1.965–3(c) to the extent it does not exceed the section 958(a) U.S. shareholder’s aggregate section 965(a) inclusion amount for the section 958(a) U.S. shareholder inclusion year.

(4) 15.5 percent rate equivalent percentage. The term 15.5 percent rate equivalent percentage, with respect to a section 958(a) U.S. shareholder and a section 958(a) U.S. shareholder inclusion year, has the meaning provided for the term “8 percent rate equivalent percentage” applied by substituting “15.5 percent rate amount” for “8 percent rate amount” and “15.5 percent rate of tax” for “8 percent rate of tax.”

(5) Accounts payable. The term accounts payable means payables arising from the purchase of property described in section 1221(a)(1) or section 1221(a)(8) or the receipt of services from vendors or suppliers, provided the payables have a term upon issuance of less than one year.

(6) Accounts receivable. The term accounts receivable means receivables described in section 1221(a)(4) that have a term upon issuance of less than one year.

(7) Accumulated post–1986 deferred foreign income—(i) In general. The term accumulated post–1986 deferred foreign income means, with respect to a specified foreign corporation, the post–1986 earnings and profits of the specified foreign corporation except to the extent such earnings and profits—

(A) Are attributable to income of the specified foreign corporation that is effectively connected with the conduct of a trade or business within the United States and subject to tax under chapter 1;

(B) If distributed, would, in the case of a controlled foreign corporation, be excluded from the gross income of a United States shareholder under section 959; or

(C) If distributed, would, in the case of a controlled foreign corporation that has shareholders that are not United States shareholders on an E&P measurement date, be excluded from the gross income of such shareholders under section 959 if such shareholders were United States shareholders, determined by applying the principles of Revenue Ruling 82–16, 1982–1 C.B. 106.

(ii) Earnings and profits attributable to subpart F income in the same taxable year as an E&P measurement date. For purposes of determining the accumulated post–1986 deferred foreign income of a specified foreign corporation as of an E&P measurement date, earnings and profits of the specified foreign corporation that are or would be, applying the principles of Revenue Ruling 82–16, 1982–1 C.B. 106, described in section 959(c)(2) by reason of subpart F income (as defined in section 952 without regard to section 965) are described in section 965(d)(2)(B) and paragraph (f)(7)(i)(B) or (f)(7)(i)(C) of this section only to the extent that such income has been accrued by the specified foreign corporation as of that E&P measurement date. For rules regarding the interaction of sections 951,
In general

In general (i) 2(b). 956, 959, and 965 generally, see §1.965–2(b).

(8) Aggregate foreign cash position—(i) In general. The term aggregate foreign cash position means, with respect to a section 958(a) U.S. shareholder that is not a member of a consolidated group, the greater of—

(A) The aggregate of the section 958(a) U.S. shareholder’s pro rata share of the cash position of each specified foreign corporation determined as of the final cash measurement date of the specified foreign corporation; or

(B) One half of the sum of—

(1) The aggregate described in paragraph (f)(8)(i)(A) of this section determined as of the second cash measurement date of each specified foreign corporation, plus

(2) The aggregate described in paragraph (f)(8)(i)(A) of this section determined as of the first cash measurement date of each specified foreign corporation.

(ii) Other rules. For rules for determining the aggregate foreign cash position for a section 958(a) U.S. shareholder inclusions year of the section 958(a) U.S. shareholder, see §1.965–3(c). For the rule for determining the aggregate foreign cash position of a section 958(a) U.S. shareholder that is a member of a consolidated group, see §1.965–8(e)(3). For rules disregarding certain assets for purposes of determining the aggregate foreign cash position of a section 958(a) U.S. shareholder, see §1.965–3(b).

(9) Aggregate foreign E&P deficit. The term aggregate foreign E&P deficit means, with respect to a section 958(a) U.S. shareholder, the lesser of—

(i) The aggregate of the section 958(a) U.S. shareholder’s pro rata share of the specified E&P deficit of each E&P deficit foreign corporation, translated (if necessary) into U.S. dollars using the spot rate on December 31, 2017, or

(ii) The aggregate of the section 958(a) U.S. shareholder’s pro rata share of the section 965(a) earnings amount of each deferred foreign income corporation, translated (if necessary) into U.S. dollars using the spot rate on December 31, 2017, or

(iii) The specified foreign corporation, translated (if necessary) into U.S. dollars using the spot rate on December 31, 2017.

(10) Aggregate section 965(a) inclusion amount. The term aggregate section 965(a) inclusion amount means, with respect to a section 958(a) U.S. shareholder, the sum of all of the section 958(a) U.S. shareholder’s section 965(a) inclusion amounts.

(11) Allocable share. The term allocable share means, with respect to a deferred foreign income corporation and an aggregate foreign E&P deficit of a section 958(a) U.S. shareholder, the product of the aggregate foreign E&P deficit and the ratio determined by dividing—

(i) The section 958(a) U.S. shareholder’s pro rata share of the section 965(a) earnings amount of the deferred foreign income corporation, translated (if necessary) into U.S. dollars using the spot rate on December 31, 2017, by

(ii) The amount described in paragraph (f)(9)(ii) of this section with respect to the section 958(a) U.S. shareholder.

(12) Bona fide hedging transaction. The term bona fide hedging transaction means a hedging transaction that meets (or that would meet if the specified foreign corporation were a controlled foreign corporation) the requirements of a bona fide hedging transaction described in §1.954–2(a)(4)(ii), except that in the case of a specified foreign corporation that is not a controlled foreign corporation, the identification requirements of §1.954–2(a)(4)(ii)(B) do not apply.

(13) Cash-equivalent asset—(i) In general. The term cash-equivalent asset means any of the following assets—

(A) Personal property which is of a type that is actively traded and for which there is an established financial market, other than a specified commodity;

(B) Commercial paper, certificates of deposit, the securities of the Federal government and of any State or foreign government;

(C) Any foreign currency;

(D) A short-term obligation; or

(E) Derivative financial instruments, other than bona fide hedging transactions.

(ii) Specified commodity. The term specified commodity means a commodity held by a specified foreign corporation that, in the hands of the specified foreign corporation, is property described in section 1221(a)(1) or 1221(a)(8). This paragraph (f)(13)(ii) does not apply with respect to a specified foreign corporation that is a dealer or trader in commodities.

(14) Cash-equivalent asset hedging transaction—(i) In general. The term cash-equivalent asset hedging transaction means a bona fide hedging transaction identified on a specified foreign corporation’s books and records as hedging a cash-equivalent asset.

(ii) Aggregate hedging transactions. For purposes of paragraph (f)(14)(i) of this section, the amount of a bona fide hedging transaction described in §1.1221–2(c)(3) (an aggregate hedging transaction) that is treated as a cash-equivalent asset hedging transaction is the amount that bears the same proportion to the fair market value of the aggregate hedging transaction as the value of the cash-equivalent assets being hedged by the aggregate hedging transaction bears to the value of all assets being hedged by the aggregate hedging transaction.

(15) Cash measurement dates. The term cash measurement dates means, with respect to a specified foreign corporation, the first cash measurement date, the second cash measurement date, and the final cash measurement date, collectively, and each a cash measurement date.

(16) Cash position—(i) General rule. The term cash position means, with respect to a specified foreign corporation, the sum of—

(A) Cash held by the corporation;

(B) The net accounts receivable of the corporation; and

(C) The fair market value of the cash-equivalent assets held by the corporation.

(ii) Fair market value of cash-equivalent assets. For purposes of determining the fair market value of a cash-equivalent asset of a specified foreign corporation, the value of the cash-equivalent asset must be adjusted by the fair market value of any cash-equivalent asset hedging transaction with respect to the cash-equivalent asset, but only to the extent that the cash-equivalent asset hedging transaction does not reduce the fair market value of the cash-equivalent asset below zero.

(iii) Measurement of derivative financial instruments. The amount of derivative financial instruments taken into account in determining the cash position of a specified foreign corporation is the aggregate fair market value of its financial instruments that constitute cash-equivalent assets, provided such amount is not less than zero.
(iv) Translation of cash position amounts. The cash position of a specified foreign corporation with respect to a cash measurement date must be expressed in U.S. dollars. For this purpose, the amounts described in paragraph (f)(16)(i) of this section must be translated (if necessary) into U.S. dollars using the spot rate on the relevant cash measurement date.

(17) Deferred foreign income corporation—(i) In general. The term deferred foreign income corporation means a specified foreign corporation that has accumulated post–1986 deferred foreign income greater than zero as of an E&P measurement date.

(ii) Priority rule. If a specified foreign corporation satisfies the definition of a deferred foreign income corporation under section 965(d)(1) and paragraph (f)(17)(i) of this section, it is classified solely as a deferred foreign income corporation and not also as an E&P deficit foreign corporation even if it otherwise satisfies the requirements of section 965(b)(3)(B) and paragraph (f)(22) of this section.

(18) Derivative financial instrument. The term derivative financial instrument includes a financial instrument that is one of the following—

(i) A notional principal contract, 
(ii) An option contract, 
(iii) A forward contract, other than a forward contract with respect to a specified commodity (as defined in paragraph (f)(13)(ii) of this section), but solely to the extent that the specified foreign corporation identified, or could have identified, the forward contract as a hedging transaction (within the meaning of §1.1221–2(b)) with respect to one or more specified commodities held by the specified foreign corporation, 
(iv) A futures contract, 
(v) A short position in securities or commodities, other than a forward contract with respect to a specified commodity, but solely to the extent that the specified foreign corporation identified, or could have identified, the forward contract as a hedging transaction (within the meaning of §1.1221–2(b)) with respect to one or more specified commodities held by the specified foreign corporation, or 
(vi) Any financial instrument similar to one described in paragraphs (f)(18)(i) through (v) of this section.

(19) Domestic pass-through entity. The term domestic pass-through entity means a pass-through entity that is a United States person (as defined in section 7701(a)(30)).

(20) Domestic pass-through owner. The term domestic pass-through owner means, with respect to a domestic pass-through entity, a United States person (as defined in section 7701(a)(30)) that is a partner, shareholder, beneficiary, grantor, or owner, as the case may be, in the domestic pass-through entity. Notwithstanding the preceding sentence, the term does not include a partner, shareholder, beneficiary, grantor, or owner of the domestic pass-through entity that is itself a domestic pass-through entity but does include any other United States person that is an indirect partner, shareholder, beneficiary, grantor, or owner of the domestic pass-through entity through one or more other pass-through entities.

(21) Domestic pass-through owner share. The term domestic pass-through owner share means, with respect to a domestic pass-through owner and a domestic pass-through entity, the domestic pass-through owner’s share of the aggregate section 965(a) inclusion amount and the section 965(c) deduction amount, as applicable, of the domestic pass-through entity, including the domestic pass-through owner’s share of the aggregate section 965(a) inclusion amount and section 965(c) deduction amount, as applicable, of a domestic pass-through entity owned indirectly by the domestic pass-through owner through one or more other pass-through entities.

(22) E&P deficit foreign corporation—(i) In general. The term E&P deficit foreign corporation means, with respect to a section 958(a) U.S. shareholder, a specified foreign corporation, other than a deferred foreign income corporation, if, as of November 2, 2017—

(A) The specified foreign corporation had a deficit in post–1986 earnings and profits, 
(B) The corporation was a specified foreign corporation, and 
(C) The shareholder was a United States person (as defined in section 7701(a)(30)) that is a domestic pass-through owner through one or more other pass-through entities. 

(ii) Determination of deficit in post–1986 earnings and profits. In the case of a specified foreign corporation that has post–1986 earnings and profits that include earnings and profits described in section 959(c)(1) or 959(c)(2) (or both) and a deficit in earnings and profits (including hovering deficits, as defined in §1.367(b)–7(d)(2)(i)), the specified foreign corporation has a deficit in post–1986 earnings and profits described in paragraph (f)(22)(i)(A) of this section only to the extent the deficit in post–1986 earnings and profits exceeds the aggregate of its post–1986 earnings and profits described in section 959(c)(1) and 959(c)(2).

(23) E&P measurement dates. The term E&P measurement dates means November 2, 2017, and December 31, 2017, collectively, and each an E&P measurement date.

(24) Final cash measurement date. The term final cash measurement date means, with respect to a specified foreign corporation, 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.

(25) First cash measurement date. The term first cash measurement date means, with respect to a specified foreign corporation, 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.

(26) Inclusion year. The term inclusion year means, with respect to a deferred foreign income corporation, the last taxable year of the deferred foreign income corporation that begins before January 1, 2018.

(27) Net accounts receivable. The term net accounts receivable means, with respect to a specified foreign corporation, the excess (if any) of—

(i) The corporation’s accounts receivable, over 
(ii) The corporation’s accounts payable (determined consistent with the rules of section 461).

(28) Pass-through entity. The term pass-through entity means a partnership, S corporation, or any other person (whether domestic or foreign) other than a corporation to the extent that the income or deductions of the person are included in the income of one or more direct or indirect owners or beneficiaries of the person. For example, if a domestic trust is subject to federal income tax on a portion of its section 965(a) inclusion amount and its
domestic pass-through owners are subject to tax on the remaining portion, the domestic trust is treated as a domestic pass-through entity with respect to such remaining portion.

(29) Post–1986 earnings and profits—
(i) General rule. The term post–1986 earnings and profits means, with respect to a specified foreign corporation and an E&P measurement date, the earnings and profits (including earnings and profits described in section 959(c)(1) and 959(c)(2)) of the specified foreign corporation (computed in accordance with sections 964(a) and 986, subject to §1.965–4(f), and by taking into account only periods when the foreign corporation was a specified foreign corporation) accumulated in taxable years beginning after December 31, 1986, and determined—
(A) As of the E&P measurement date, except as provided in paragraph (f)(29)(ii) of this section, and
(B) Without diminution by reason of dividends distributed during the last taxable year of the foreign corporation that begins before January 1, 2018, other than dividends distributed to another specified foreign corporation to the extent the dividends increase the post–1986 earnings and profits of the distributee specified foreign corporation.

(ii) Foreign income taxes. For purposes of determining a specified foreign corporation’s post–1986 earnings and profits as of the E&P measurement date on November 2, 2017, in the case in which foreign income taxes (as defined in section 901(m)(5)) of the specified foreign corporation accrue after November 2, 2017, but on or before December 31, 2017, and during the specified foreign corporation’s U.S. taxable year that includes November 2, 2017, the specified foreign corporation’s post–1986 earnings and profits as of November 2, 2017, are reduced by the applicable portion of such foreign income taxes. For purposes of the preceding sentence, the applicable portion of the foreign income taxes is the amount of the taxes that are attributable to the portion of the taxable income (as determined under foreign law) that accrues on or before November 2, 2017.

(iii) Deficits in earnings and profits. Any deficit related to post–1986 earnings and profits, including a hovering deficit (as defined in §1.367(b)–7(d)(2)(i)), of a specified foreign corporation is taken into account for purposes of determining the post–1986 earnings and profits (including a deficit) of the specified foreign corporation.

(30) Pro rata share. The term pro rata share means, with respect to a section 958(a) U.S. shareholder of a specified foreign corporation, a deferred foreign income corporation, or an E&P deficit foreign corporation, as applicable—
(i) With respect to the section 965(a) earnings amount of a deferred foreign income corporation, the portion of the section 965(a) earnings amount that would be treated as distributed to the section 958(a) U.S. shareholder under §1.951–1(e), determined as of the last day of the inclusion year of the deferred foreign income corporation on which it is a specified foreign corporation;

(ii) With respect to the specified E&P deficit of an E&P deficit foreign corporation, the portion of the specified E&P deficit allocated to the section 958(a) U.S. shareholder, determined by allocating the specified E&P deficit among the shareholders of the corporation’s common stock in proportion to the liquidation value of the common stock held by the shareholders, determined as of the last day of the last taxable year of the E&P deficit foreign corporation that begins before January 1, 2018, provided that—
(A) If the corporation’s common stock has a liquidation value of zero and there is at least one other class of equity with a liquidation preference relative to the common stock, then the specified E&P deficit is allocated as if it were distributed in a hypothetical distribution described in §1.951–1(e)(1)(i) with respect to the most junior class of equity with a positive liquidation value to the extent of such liquidation value, and then to the next most junior class of equity to the extent of its liquidation value, and so on, applying §1.951–1(e) by substituting “specified E&P deficit” for “subpart F income” each place it appears and treating the amount of current earnings and profits of the corporation for the year as being equal to the specified E&P deficit of the corporation for the year; and

(B) If the corporation’s common stock has a liquidation value of zero and there is no other class of equity with a liquidation preference relative to the common stock, the specified E&P deficit is allocated among the common stock using any reasonable method consistently applied; and

(iii) With respect to the cash position of a specified foreign corporation on a cash measurement date, the portion of the cash position that would be treated as distributed to the section 958(a) U.S. shareholder under §1.951–1(e) if the cash position were subpart F income, determined as of the close of the cash measurement date and without regard to whether the section 958(a) U.S. shareholder is a section 958(a) U.S. shareholder of the specified foreign corporation as of any other cash measurement date of the specified foreign corporation, including the final cash measurement date of the specified foreign corporation.

(31) Second cash measurement date. The term second cash measurement date means, with respect to a specified foreign corporation, 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.

(32) Section 958(a) stock. The term section 958(a) stock means, with respect to a specified foreign corporation, a deferred foreign income corporation, or an E&P deficit foreign corporation, as applicable, stock of the corporation owned (directly or indirectly) by a United States shareholder within the meaning of section 958(a).

(33) Section 958(a) U.S. shareholder. The term section 958(a) U.S. shareholder means, with respect to a specified foreign corporation, a deferred foreign income corporation, or an E&P deficit foreign corporation, as applicable, a United States shareholder of such corporation that owns section 958(a) stock of the corporation.

(34) Section 958(a) U.S. shareholder inclusion year. The term section 958(a) U.S. shareholder inclusion year means the taxable year of a section 958(a) U.S. shareholder in which or with which the last day of the inclusion year of a deferred foreign income corporation on which it is a specified foreign corporation occurs.

(35) Section 965 regulations. The term section 965 regulations means the regulations under §§1.965–1 through 1.965–9, collectively.
(36) Section 965(a) earnings amount. The term section 965(a) earnings amount means, with respect to a deferred foreign income corporation, the greater of the accumulated post–1986 deferred foreign income of the deferred foreign income corporation as of the E&P measurement date on November 2, 2017, or the accumulated post–1986 deferred foreign income of the deferred foreign income corporation as of the E&P measurement date on December 31, 2017, determined in each case in the functional currency of the specified foreign corporation. If the functional currency of a specified foreign corporation changes between the two E&P measurement dates, the comparison must be made in the functional currency of the specified foreign corporation as of December 31, 2017, by translating the specified foreign corporation’s accumulated post–1986 deferred foreign income as of November 2, 2017, into the new functional currency using the spot rate on November 2, 2017.

(37) Section 965(a) inclusion. The term section 965(a) inclusion means, with respect to a person and a deferred foreign income corporation, an amount included in income by the person by reason of section 965 with respect to the deferred foreign income corporation, whether because the person is a section 958(a) U.S. shareholder of the deferred foreign income corporation with a section 965(a) inclusion amount with respect to the deferred foreign income corporation or because the person is a domestic pass-through owner with respect to a domestic pass-through entity that is a section 958(a) U.S. shareholder and the person takes into account its domestic pass-through owner share of the section 965(c) deduction amount of the domestic pass-through entity.

(38) Section 965(a) inclusion amount. The term section 965(a) inclusion amount has the meaning provided in paragraph (b)(1) of this section.

(39) Section 965(a) previously taxed earnings and profits. The term section 965(a) previously taxed earnings and profits has the meaning provided in §1.965–2(c).

(40) Section 965(b) previously taxed earnings and profits. The term section 965(b) previously taxed earnings and profits has the meaning provided in §1.965–2(d).

(41) Section 965(c) deduction. The term section 965(c) deduction means, with respect to a person, an amount allowed as a deduction to the person by reason of section 965(c), whether because the person is a section 958(a) U.S. shareholder with a section 965(c) deduction amount or because the person is a domestic pass-through owner with respect to a domestic pass-through entity that is a section 958(a) U.S. shareholder and the person takes into account its domestic pass-through owner share of the section 965(c) deduction amount of the domestic pass-through entity.

(42) Section 965(c) deduction amount. The term section 965(c) deduction amount means an amount equal to the sum of—

(i) A section 958(a) U.S. shareholder’s 8 percent rate equivalent percentage of the section 958(a) U.S. shareholder’s 8 percent rate amount for the section 958(a) U.S. shareholder inclusion year, plus

(ii) The section 958(a) U.S. shareholder’s 15.5 percent rate equivalent percentage of the section 958(a) U.S. shareholder’s 15.5 percent rate amount for the section 958(a) U.S. shareholder inclusion year.

(43) Short-term obligation. The term short-term obligation means any obligation with a term upon issuance that is less than one year and any loan that must be repaid at the demand of the lender (or that must be repaid within one year of such demand), but does not include any accounts receivable.

(44) Specified E&P deficit. The term specified E&P deficit means, with respect to an E&P deficit foreign corporation, the amount of the deficit described in paragraph (f)(22)(i)(A) of this section.

(45) Specified foreign corporation—(i) General rule. Except as provided in paragraph (f)(45)(iii) of this section, the term specified foreign corporation means—

(A) A controlled foreign corporation, or

(B) A foreign corporation of which one or more domestic corporations is a United States shareholder.

(ii) Special attribution rule—(A) In general. Solely for purposes of determining whether a foreign corporation is a specified foreign corporation within the meaning of section 965(e)(1)(B) and paragraph (f)(45)(ii)(B) of this section, stock owned, directly or indirectly, by or for—

(1) A partner (tested partner) will not be considered as being owned by a partnership under sections 958(b) and 318(a) (3)(A) and §1.958–2(d)(1)(ii) if the tested partner owns less than ten percent of the interests in the partnership’s capital and profits; and

(2) A beneficiary (tested beneficiary) will not be considered as being owned by a trust under sections 958(b) and 318(a)(3)(B) and §1.958–2(d)(1)(ii) if the value of the interest of the tested beneficiary, computed actuarially, whether vested or contingent, current or remainder, is less than ten percent of the value of the trust property, assuming the maximum exercise of discretion in favor of the beneficiary.

(B) Attribution for purposes of the ten percent standard. For purposes of paragraph (f)(45)(ii)(A) of this section, an interest in a partnership or trust owned by a partner or beneficiary other than the tested partner or tested beneficiary will be considered as being owned by the tested partner or tested beneficiary under the principles of sections 958(b) and 318, as modified by this paragraph (f)(45)(ii), as if interests in a partnership or trust were stock.

(iii) Passive foreign investment companies. A foreign corporation that is a passive foreign investment company (as defined in section 1297) with respect to a United States shareholder and that is not a controlled foreign corporation is not a specified foreign corporation of the United States shareholder.

(46) Spot rate. The term spot rate has the meaning provided in §1.988–1(d).

(47) United States shareholder. The term United States shareholder has the meaning provided in section 951(b).

(g) Examples. The following examples illustrate the definitions and general rules set forth in this section.

(1) Example 1. Definition of specified foreign corporation. (i) Facts. A, an individual, owns 1% of the interests in a partnership, PS, and 10% by vote and value of the stock of a foreign corporation, FC. PS owns 100% of the stock of a domestic corporation, DC. A United States citizen, USI, owns an additional 10% by vote and value of the stock of FC. The remaining 80% by vote and value of the stock of FC is owned by non-United States persons that are unrelated to A, USI, DC, and PS.
(ii) **Analysis.** (A) Absent the application of sections 958(b), 318(a)(3)(A), and 318(a)(3)(C), and §1.958–2(d)(1)(ii), FC would not be a specified foreign corporation because FC is not a controlled foreign corporation and there would be no domestic corporation that is a United States shareholder of FC. However, under sections 958(b) and 318(a)(3)(A), and §1.958–2(d)(1)(ii), absent the specific attribution rule in paragraph (f)(45)(ii) of this section, PS would be treated as owning 10% of the stock of FC. As a result, under sections 958(b), 318(a)(5)(A), and 318(a)(3)(C), and §1.958–2(f)(1)(i) and (d)(1)(iii), DC would be treated as owning the stock of FC treated as owned by PS, and thus DC would be a United States shareholder with respect to FC, causing FC to be a specified foreign corporation within the meaning of section 965(c)(1)(B) and paragraph (f)(45)(i)(B) of this section. The results would be the same whether A or PS or both are domestic or foreign persons.

(B) Under the special attribution rule in paragraph (f)(45)(ii) of this section, solely for purposes of determining whether a foreign corporation is a specified foreign corporation within the meaning of section 965(c)(1)(B) and paragraph (f)(45)(i)(B) of this section, the stock of FC owned by A is not considered as being owned by PS under sections 958(b) and 318(a)(3)(A) and §1.958–2(d)(1)(ii) because A owns less than 10% of the interests in PS’s capital and profits. Accordingly, FC is not a specified foreign corporation within the meaning of section 965(c)(1)(B) and paragraph (f)(45)(i)(B) of this section.

(2) **Example 2. Definition of specified foreign corporation.** (i) **Facts.** The facts are the same as in paragraph (g)(1)(i) of this section (the facts in Example 1), except that A is a foreign corporation wholly owned by B, a foreign corporation, and B directly owns 9% of the interests in PS.

(ii) **Analysis.** Applying the principles of sections 958(b) and 318, as modified by paragraph (f)(45)(ii) of this section, if the interest in PS were stock, A is treated as owning the interests in PS owned by B (in addition to the 1% interest in PS that A owns directly), and thus A is not treated as owning less than 10% of the interests in PS’s capital and profits. Accordingly, FC is not a specified foreign corporation because FC is not a controlled foreign corporation within the meaning of section 965(c)(1)(B) and paragraph (f)(45)(i)(B) of this section.

(3) **Example 3. Determination of accumulated post–1986 deferred foreign income.** (i) **Facts.** USP, a domestic corporation, and FP, a foreign corporation unrelated to USP, have owned 70% and 30% respectively, by vote and value, of the only class of stock of FS, a foreign corporation, from January 1, 2016, until December 31, 2017. USP and FS both have a calendar year taxable year. FS had no income until its taxable year ending December 31, 2016, in which it had 100u of income, all of which constituted subpart F income, and USP included 70u in income with respect to FS under section 951(a)(1) for such year. FS earned no income in 2017. Therefore, FS’s post–1986 earnings and profits are 100u as of both E&P measurement dates.

(ii) **Analysis.** Because USP included 70u in income with respect to FS under section 951(a)(1), 70u of post–1986 earnings and profits would, if distributed, be excluded from dividends paid by USP under section 959. Thus, FS’s accumulated post–1986 deferred foreign income would be reduced by 70u pursuant to section 965(d)(2)(B) and paragraph (f)(7)(ii)(B) of this section. Furthermore, under paragraph (f)(7)(ii)(C) of this section, the accumulated post–1986 deferred foreign income of FS is reduced by amounts that would be excluded from the gross income of FP if FP were a United States shareholder, consistent with the principles of Revenue Ruling 82–16. Accordingly, FS’s accumulated post–1986 deferred foreign income is reduced by the remaining 30u of the 100u of post–1986 earnings and profits to which USP’s 70u of section 951(a)(1) income inclusions were attributable. As a result, FS’s accumulated post–1986 deferred foreign income is 0u (100u minus 70u minus 30u).

(4) **Example 4. Determination of status as a deferred foreign income corporation or an E&P deficit foreign corporation; specified foreign corporation or solely a deferred foreign income corporation.** (i) **Facts.** USP, a domestic corporation, owns all of the stock of FS, a foreign corporation. As of November 2, 2017, FS has a deficit in post–1986 earnings and profits of 150u. As of December 31, 2017, FS has 200u of post–1986 earnings and profits. FS does not have earnings and profits that are attributable to income of the specified foreign corporation that is effectively connected with the conduct of a trade or business within the United States and subject to tax under chapter 1, or that, if distributed, would be excluded from the gross income of a United States shareholder under section 959 or from the gross income of another shareholder if such shareholder were a United States shareholder.

(ii) **Analysis.** FS’s accumulated post–1986 deferred foreign income is equal to its post–1986 earnings and profits because no adjustment to post–1986 earnings and profits is made under section 965(d)(2) of this section. Because FS is a deferred foreign income corporation, a determination must be made whether FS is a deferred foreign income corporation or an E&P deficit foreign corporation. Accordingly, FS is neither a deferred foreign income corporation nor an E&P deficit foreign corporation.

(5) **Example 5. Determination of status as a deferred foreign income corporation or an E&P deficit foreign corporation; specified foreign corporation or not a deferred foreign income corporation.** (i) **Facts.** USP, a domestic corporation, owns all of the stock of FS, a foreign corporation. As of both November 2, 2017, and December 31, 2017, FS has 100u of earnings and profits described in section 959(c)(2) and a deficit of 90u in earnings and profits described in section 959(c)(3), all of which were accumulated in taxable years beginning after December 31, 1986, while FS was a specified foreign corporation. Accordingly, as of both November 2, 2017, and December 31, 2017, FS has 10u of post–1986 earnings and profits.

(ii) **Analysis.** (A) Determination of status as a deferred foreign income corporation. Under paragraph (f)(17) of this section, for purposes of determining whether FS is a deferred foreign income corporation, a determination must be made whether FS has accumulated post–1986 deferred foreign income greater than zero as of either the E&P measurement date on November 2, 2017, or the E&P measurement date on December 31, 2017. Under section 965(d)(2) and paragraph (f)(7) of this section, FS’s accumulated post–1986 deferred foreign income is its post–1986 earnings and profits, except to the extent such earnings and profits are attributable to income of the specified foreign corporation that is effectively connected with the conduct of a trade or business within the United States and subject to tax under chapter 1, or that, if distributed, would be excluded from the gross income of a United States shareholder under section 959 or from the gross income of another shareholder if such shareholder were a United States shareholder. Disregarding FS’s 10u of post–1986 earnings and profits, described in paragraph (f)(7)(ii)(B) of this section, FS has a 90u deficit in accumulated post–1986 deferred foreign income as of both E&P measurement dates. Accordingly, FS does not have accumulated post–1986 deferred foreign income greater than zero as of either E&P measurement date, and, therefore, FS is not a deferred foreign income corporation.

(B) Determination of status as an E&P deficit foreign corporation. Under paragraph (f)(22)(i) of this section, for purposes of determining whether FS is an E&P deficit foreign corporation, a determination must be made whether FS has a deficit in post–1986 earnings and profits as of the E&P measurement date on November 2, 2017. Under paragraph (f)(22)(ii) of this section, because the deficit in the earnings and profits of FS described in section 959(c)(3) of 90u does not exceed the earnings and profits of FS described in section 959(c)(2) of 100u, FS does not have a deficit in post–1986 earnings and profits that would be attributable to income of the specified foreign corporation under section 959. Accordingly, FS is not an E&P deficit foreign corporation.

(6) **Example 6. Application of currency translation rules.** (i) **Facts.** As of November 2, 2017, and December 31, 2017, USP, a domestic corporation, owns all of the stock of CFC1, an E&P deficit foreign corporation with the “u” as its functional currency; CFC2, an E&P deficit foreign corporation with the “v” as its functional currency; CFC3, a deferred foreign income corporation with the “y” as its functional currency; and CFC4, a deferred foreign income corporation with the “z” as its functional currency. CFC1 has a specified E&P deficit of 100u, CFC2 has specified E&P deficit of 120u, CFC3 has a section 965(a) earnings amount of 50u, and CFC4 has a section 965(a) earnings amount of 75z.
(8) Example 8. Determination of section 958(a) U.S. shareholder in case of a controlled domestic partnership. (i) Facts. USP, a domestic corporation, owns all of the stock of CFC1 and CFC2. CFC1 and CFC2 own 60% and 40%, respectively, of the interests in the capital and profits of DPS, a domestic partnership. DPS owns all of the stock of CFC3 and CFC4. This ownership structure has existed since the date of formation of CFC1, CFC2, CFC3, and CFC4. CFC1, CFC2, CFC3, and CFC4 are each a foreign corporation. USP, DPS, CFC1, CFC2, CFC3, and CFC4 have calendar year taxable years. Both E&P measurement dates, CFC4 has 50% of accumulated post-1986 deferred foreign income. On both E&P measurement dates, CFC4 has a deficit in post-1986 earnings and profits of 30u.

(ii) Analysis. DPS is a controlled domestic partnership with respect to USP within the meaning of paragraph (e)(2) of this section because more than 50% of the interests in its capital and profits are owned by persons related to USP within the meaning of section 965(a) inclusion amounts with respect to CFC3 and CFC4, the section 965(a) earnings amount of each of CFC3 and CFC4 is translated into U.S. dollars at the spot rate on December 31, 2017, which equals $100 (50u at .50y at .50u = $1) and $300 (75u at .25z at .25z = $1), respectively.

(ii) Analysis. (A) Under paragraph (f)(38) of this section, for purposes of determining USP’s section 965(a) inclusion amounts with respect to CFC3 and CFC4, the section 965(a) earnings amount of each of CFC3 and CFC4 is translated into U.S. dollars at the spot rate on December 31, 2017, which equals $100 (100u at 1u = $1) and $160 (120u at .75v = $1), respectively. Furthermore, USP’s pro rata share of the section 965(a) earnings amounts, as translated, is $100 and $300, respectively, or 100% of each section 965(a) earnings amount.

(B) Under paragraph (f)(9) of this section, for purposes of determining USP’s aggregate foreign E&P deficit, the specified E&P deficit of each of CFC1 and CFC2 is translated into U.S. dollars at the spot rate on December 31, 2017, which equals $100 (100u at 1u = $1) and $160 (120u at .75v = $1), respectively. Furthermore USP’s pro rata share of each specified E&P deficit, as translated, is $100 and $160, respectively, or 100% of each specified E&P deficit. Therefore, USP’s aggregate foreign E&P deficit is $260.

(C) Under section 965(b)(1) and paragraph (b)(2) of this section, for purposes of determining USP’s section 965(a) inclusion amount with respect to each of CFC3 and CFC4, the U.S. dollar amount of USP’s pro rata share of the section 965(a) earnings amount of each of CFC3 and CFC4 is reduced by each of CFC3 and CFC4’s allocable share of USP’s aggregate foreign E&P deficit. Under section 965(b)(2) and paragraph (f)(11) of this section, CFC3’s allocable share of USP’s aggregate foreign E&P deficit of $260 is $65 ($260 x ($100/$400)) and CFC4’s allocable share of USP’s aggregate foreign E&P deficit is $195 ($260 x ($300/$400)). After reduction under section 965(b)(1) and paragraph (b)(2) of this section, the section 965(a) inclusion amount of USP with respect to CFC3 is $35 ($100-$65) and the section 965(a) inclusion amount of USP with respect to CFC4 is $105 ($300-$195). Under §1.965–2(c), the section 965(a) previously taxed earnings and profits of each of CFC3 and CFC4, translated into the respective functional currencies of CFC3 and CFC4 and CFC3 at the spot rate on December 31, 2017, are 17.5y ($35 at .50y = $1) and 26.25z ($105 at .25z = $1), respectively. Under §1.965–2(b)(1), for purposes of applying section 960(a)(1), the amounts treated as a dividend paid by each of CFC3 and CFC4, translated into the respective functional currencies of CFC3 and CFC4 at the spot rate on December 31, 2017, are 17.5y ($35 at .50y = $1) and 26.25z ($105 at .25z = $1).

(D) For purposes of determining the section 965(b) previously taxed earnings and profits of each of CFC3 and CFC4 under section 965(b)(4)(A) and §1.965–2(d)(1) as a result of the reduction to USP’s section 965(a) inclusion amounts with respect to CFC3 and CFC4, the amount of the aggregate foreign E&P deficit of USP allocated to each of CFC3 and CFC4 under section 965(b)(2) and paragraph (f)(11) of this section, translated into the respective functional currencies of CFC3 and CFC4 at the spot rate on December 31, 2017, is 32.5y ($65 at .50y = $1) and 48.75z ($195 at .25z = $1), respectively.

§1.965–2 Adjustments to earnings and profits and basis. (a) Scope. This section provides rules relating to adjustments to earnings and profits and basis to determine and account for the application of section 965(a) and (b) and §1.965–1(b) and a rule that limits the amount of gain recognized under section 961(b)(2) by reason of distributions attributable to section 965 previously taxed earnings and profits (as defined in paragraph (g)(1)(ii) of this section) in the inclusion year. Paragraph (b) of this section provides rules relating to adjustments to earnings and profits of a specified foreign corporation for purposes of applying sections 902, 959, 960, and 965. Paragraph (c) of this section provides rules regarding adjustments to earnings and
profits by reason of section 965(a). Paragraph (d) of this section provides rules regarding adjustments to earnings and profits by reason of section 965(b). Paragraph (e) provides rules regarding adjustments to basis by reason of section 965(a). Paragraph (f) of this section provides an election to make certain adjustments to basis corresponding to adjustments to earnings and profits by reason of section 965(b). Paragraph (g) of this section provides rules that limit the amount of gain recognized in connection with the application of section 961(b)(2) and that require related reductions in basis. Paragraph (h) of this section provides rules regarding basis adjustments. Paragraph (i) of this section provides definitions that apply for purposes of this section. Paragraph (j) of this section provides examples illustrating the application of this section.

(b) Determination of and adjustments to earnings and profits of a specified foreign corporation for purposes of applying sections 902, 959, 960, and 965. For the taxable year of a specified foreign corporation in which an E&P measurement date occurs, and the last taxable year of a specified foreign corporation that begins before January 1, 2018, and the taxable year of a section 958(a) U.S. shareholder in which or with which any such year ends, the adjustments to earnings and profits described in paragraphs (b)(1) through (b)(5) of this section apply in sequence. For purposes of determining the consequences under sections 902 and 960 of a distribution or an inclusion under section 951(a)(1), after the application of those paragraphs, the ordering rule in §1.965–1(f)(7)(ii) applies except that section 902 is applied with respect to any distributions from the specified foreign corporation described in paragraph (b)(2) of this section that are not disregarded under §1.965–4 before section 960 is applied with respect to an inclusion or distribution described in paragraph (b)(3), (b)(4), or (b)(5) of this section.

(1) Each of the subpart F income of the specified foreign corporation and the amount required to be included in income under section 1248, if any, are determined without regard to section 965(a), but taking into account any relevant distributions, and earnings and profits of the specified foreign corporation that are described in section 959(c)(2) with respect to the section 958(a) U.S. shareholder are increased to the extent of the section 958(a) U.S. shareholder’s inclusion under section 951(a)(1)(B) without regard to section 965(a) (including to the extent provided in section 959(e)).

(2) The treatment of a distribution by the specified foreign corporation to another specified foreign corporation that is made before January 1, 2018, is determined under section 959.

(3) Each of the post–1986 earnings and profits (including a deficit) of the specified foreign corporation, the accumulated post–1986 deferred foreign income of the specified foreign corporation, the section 965(a) earnings amount of the specified foreign corporation, and the section 965(a) inclusion amount with respect to the specified foreign corporation, if any, is determined, taking into account the rules of §1.965–4, and the earnings and profits (including a deficit) of the specified foreign corporation are adjusted as provided in paragraphs (c) and (d) of this section. For a rule disregarding subpart F income earned after an E&P measurement date for purposes of calculating accumulated post–1986 deferred foreign income as of the E&P measurement date, see §1.965–1(f)(7)(ii).

(4) The treatment of distributions described in paragraph (b)(2) of this section that are disregarded under §1.965–4 is redetermined and the treatment of all distributions from the specified foreign corporation other than those described in paragraph (b)(2) of this section is determined under section 959.

(5) An amount is determined under section 956 with respect to the specified foreign corporation and the section 958(a) U.S. shareholder; earnings and profits of the specified foreign corporation described in section 959(c)(2) with respect to the section 958(a) U.S. shareholder are reclassified as earnings and profits described in section 959(c)(1) with respect to the section 958(a) U.S. shareholder to the extent the amount determined under section 956 would, but for section 959(a)(2), be included by the section 958(a) U.S. shareholder under section 951(a)(1)(B); and earnings and profits described in section 959(c)(1) with respect to the section 958(a) U.S. shareholder are further increased to the extent of the section 958(a) U.S. shareholder’s inclusion under section 951(a)(1)(B).

(c) Adjustments to earnings and profits by reason of section 965(a). The earnings and profits of a deferred foreign income corporation described in section 959(c)(2) with respect to a section 958(a) U.S. shareholder are increased by an amount equal to the section 965(a) inclusion amount of the section 958(a) U.S. shareholder with respect to the deferred foreign income corporation, if any, translated (if necessary) into the functional currency of the deferred foreign income corporation using the spot rate on December 31, 2017, provided the section 965(a) inclusion amount is included in income by the section 958(a) U.S. shareholder. For purposes of the section 965 regulations, the earnings and profits described in section 959(c)(2) by reason of this paragraph (c) and the earnings and profits initially described in section 959(c)(2) by reason of this paragraph (c) but subsequently reclassified as earnings and profits described in section 959(c)(1), if any, are referred to as section 965(a) previously taxed earnings and profits. Furthermore, the earnings and profits (including a deficit) of the deferred foreign income corporation that are described in section 959(c)(3) (or that would be described in section 959(c)(3) but for the application of section 965(a) and the section 965 regulations) are reduced (or, in the case of a deficit, increased) by an amount equal to the section 965(a) previously taxed earnings and profits.

(d) Adjustments to earnings and profits by reason of section 965(b)—(1) Adjustments to earnings and profits described in section 959(c)(2) and (c)(3) of deferred foreign income corporations. The earnings and profits of a deferred foreign income corporation described in section 959(c)(2) with respect to a section 958(a) U.S. shareholder are increased by an amount equal to the reduction to the section 958(a) U.S. shareholder’s pro rata share of the section 965(a) earnings amount of the deferred foreign income corporation under section 965(b), §1.965–1(b)(2), and §1.965–8(b), as applicable, translated (if necessary) into the functional currency of the deferred foreign income corporation using the spot rate on December 31, 2017, provided the section 958(a) U.S. shareholder includes the section 965(a) inclusion amount (if any) with respect to the deferred foreign income
corporation in income. For purposes of the section 965 regulations, the earnings and profits described in section 959(c)(2) by reason of this paragraph (d) and the earnings and profits initially described in section 959(c)(2) by reason of this paragraph (d) but subsequently reclassified as earnings and profits described in section 959(c)(1) are referred to as section 965(b) previously taxed earnings and profits, and are treated as having been previously included in the gross income of the section 958(a) U.S. shareholder under section 951 for purposes of section 1248(d)(1). Furthermore, the earnings and profits (including a deficit) described in section 959(c)(3) of the deferred foreign income corporation (or that would be described in section 959(c)(3) but for the application of section 965(b) and the section 965 regulations) are reduced (or, in the case of a deficit, increased) by an amount equal to the section 965(b) previously taxed earnings and profits.

(2) Adjustments to earnings and profits described in section 959(c)(3) of E&P deficit foreign corporations—(i) Increase in earnings and profits by an amount equal to the portion of the section 958(a) U.S. shareholder’s pro rata share of the specified E&P deficit taken into account—(A) In general. For an E&P deficit foreign corporation’s last taxable year that begins before January 1, 2018, the earnings and profits of the E&P deficit foreign corporation described in section 959(c)(3) are increased by an amount equal to the portion of a section 958(a) U.S. shareholder’s pro rata share of the specified E&P deficit foreign corporation taken into account under section 965(b), §1.965–1(b)(2), or §1.965–8(b), as applicable, determined under paragraph (d)(2)(ii) of this section, translated (if necessary) into the functional currency of the E&P deficit foreign corporation using the spot rate on December 31, 2017, and such increase is attributable to the same activity to which the deficit so taken into account was attributable.

(ii) Determination of portion of a section 958(a) U.S. shareholder’s pro rata share of a specified E&P deficit taken into account—(A) In general. The portion of a section 958(a) U.S. shareholder’s pro rata share of a specified E&P deficit of an E&P deficit foreign corporation taken into account under section 965(b), §1.965–1(b)(2), or §1.965–8(b), as applicable, is 100 percent of the section 958(a) U.S. shareholder’s pro rata share of the specified E&P deficit if either of the following conditions is satisfied:

(1) The section 958(a) U.S. shareholder (including a consolidated group of which the section 958(a) U.S. shareholder is a member) does not have an excess aggregate foreign E&P deficit (as defined in §1.965–8(f)(7)(i)), or

(2) If the section 958(a) U.S. shareholder is a member of an affiliated group in which not all members are members of the same consolidated group, the amount described in §1.965–8(f)(1)(i)(B) with respect to the affiliated group is equal to or greater than the amount described in §1.965–8(f)(1)(i)(A).

(B) Designation of portion of a section 958(a) U.S. shareholder’s pro rata share of a specified E&P deficit taken into account. If neither the condition in paragraph (d)(2)(ii)(A)(1) nor the condition in paragraph (d)(2)(ii)(A)(2) is satisfied with respect to a section 958(a) U.S. shareholder, then the section 958(a) U.S. shareholder must designate the portion taken into account by reporting to each E&P deficit foreign corporation of the section 958(a) U.S. shareholder, and maintaining, in its books and records, a statement setting forth the following information—

(1) The portion of the section 958(a) U.S. shareholder’s pro rata share of the specified E&P deficit of the E&P deficit foreign corporation taken into account under section 965(b), §1.965–1(b)(2), or §1.965–8(b), as designated under §1.965–8(c), as applicable, and

(2) In the case of an E&P deficit foreign corporation that has a qualified deficit (as determined under section 952 and §1.952–1), the portion (if any) of the section 958(a) shareholder’s pro rata share of the specified E&P deficit of the E&P deficit foreign corporation taken into account under paragraph (d)(2)(ii)(B)(1) of this section that is attributable to a qualified deficit, including the qualified activities to which such portion is attributable.

(A) General rule. Except as provided in paragraph (e)(2) of this section, a section 958(a) U.S. shareholder’s basis in section 958(a) stock of a deferred foreign income corporation, or a section 958(a) U.S. shareholder’s basis in applicable property with respect to a deferred foreign income corporation, is increased by the section 958(a) U.S. shareholder’s section 965(a) inclusion amount with respect to the deferred foreign income corporation included in income by the section 958(a) U.S. shareholder. See section 961(a).

(2) Section 962 election. In the case of a section 958(a) U.S. shareholder who has made an election under section 962 for a section 958(a) U.S. shareholder’s inclusion year, the increase in basis in the section 958(a) U.S. shareholder’s section 958(a) stock of, or applicable property with respect to, a deferred foreign income corporation cannot exceed an amount equal to the amount of tax paid under paragraph 1 of the Code with respect to the section 958(a) U.S. shareholder’s section 958(a) inclusion amount with respect to the deferred foreign income corporation, taking into account any section 965(h) election made by the section 958(a) U.S. shareholder.

(f) Adjustments to basis by reason of section 965(b)—(1) In general. Except as provided in paragraph (f)(2) of this section, no adjustments to basis of stock or property are made under section 961 (or...
any other provision of the Code) to take into account the reduction to a section 958(a) U.S. shareholder’s pro rata share of the section 965(a) earnings amount of a deferred foreign income corporation under section 965(b), §1.965–1(b)(2), or §1.965–8(b), as applicable.

(2) Election to make adjustments to basis to account for the application of section 965(b)—(i) In general. If a section 958(a) U.S. shareholder makes the election as provided in this paragraph (f)(2), the adjustments to basis described in paragraph (f)(2)(ii) of this section are made with respect to each deferred foreign income corporation and each E&P deficit foreign corporation in which the section 958(a) U.S. shareholder owns section 958(a) stock.

(ii) Basis adjustments—(A) Increase in basis with respect to a deferred foreign income corporation—(1) In general. Except as provided in paragraphs (f)(2)(ii)(A)(2) and (C) of this section, a section 958(a) U.S. shareholder’s basis in section 958(a) stock of a deferred foreign income corporation, or a section 958(a) U.S. shareholder’s basis in applicable property with respect to a deferred foreign income corporation, is increased by an amount equal to the section 965(b) previously taxed earnings and profits of the deferred foreign income corporation with respect to the section 958(a) U.S. shareholder, translated (if necessary) into U.S. dollars using the spot rate on December 31, 2017.

(2) Limited basis adjustment. A section 958(a) U.S. shareholder may, in lieu of applying paragraph (f)(2)(ii)(A)(1) of this section, designate the amount by which it increases its basis in section 958(a) stock of, or applicable property with respect to, a deferred foreign income corporation, provided that—

(i) The increase does not exceed the section 965(b) previously taxed earnings and profits of the deferred foreign income corporation with respect to the section 958(a) U.S. shareholder, translated (if necessary) into U.S. dollars using the spot rate on December 31, 2017; and

(ii) The aggregate amount of a section 958(a) U.S. shareholder’s increases in basis with respect to stock or applicable property pursuant to paragraph (f)(2)(ii)(A)(2) of this section does not exceed the aggregate amount of the section 958(a) U.S. shareholder’s reductions in basis pursuant to paragraph (f)(2)(ii)(B) of this section subject to the limitation under paragraph (f)(2)(ii) (B)(2) of this section.

(B) Reduction in basis with respect to an E&P deficit foreign corporation—(1) In general. Except as provided in paragraphs (f)(2)(ii)(B)(2) and (f)(2)(ii)(C) of this section, a section 958(a) U.S. shareholder’s basis in section 958(a) stock of an E&P deficit foreign corporation, or a section 958(a) U.S. shareholder’s basis in applicable property with respect to an E&P deficit foreign corporation, is reduced by an amount equal to the portion of the section 958(a) U.S. shareholder’s pro rata share of the specified E&P deficit of the E&P deficit foreign corporation taken into account under section 965(b), §1.965–1(b)(2), and §1.965–8(b), as applicable, as determined under paragraph (d)(2)(ii) of this section, translated (if necessary) into U.S. dollars using the spot rate on December 31, 2017. For rules requiring gain recognition, see paragraph (h)(3) of this section.

(ii) Transition rule. If the due date referred to in paragraph (f)(2)(ii)(B)(1)(i) of this section occurs before May 6, 2019, the election must be made by May 6, 2019. In the case of an election made before February 5, 2019, the election may be revoked by attaching a statement, signed under penalties of perjury, to an amended return filed by May 6, 2019. The statement must contain the section 958(a) U.S. shareholder’s name and taxpayer identification number and a statement that the section 958(a) U.S. shareholder and all related persons, as defined in paragraph (f)(2)(iii)(A) of this section, that are section 958(a) U.S. shareholders of E&P deficit foreign corporations or of deferred foreign income corporations with respect to which the section 958(a) U.S. shareholder’s pro rata share of the section 965(a) earnings amount is reduced under section 965(b),
§1.965–1(b)(2), or §1.965–8(b) revoke the election provided in this paragraph (f)(2).

(2) Election statement. Except as otherwise provided in publications, forms, instructions, or other guidance, to make the election provided in this paragraph (f)(2), a section 958(a) U.S. shareholder must attach a statement, signed under penalties of perjury consistent with the rules for signatures applicable to the section 958(a) U.S. shareholders return, to its return for the first taxable year that includes the last day of the last taxable year of a deferred foreign income corporation or E&P deficit foreign corporation of the shareholder that begins before January 1, 2018. The statement must include the section 958(a) U.S. shareholder’s name, taxpayer identification number, and a statement that the section 958(a) U.S. shareholder and all related persons, as defined in paragraph (f)(2)(iii)(A) of this section, that are section 958(a) U.S. shareholders of E&P deficit foreign corporations or of deferred foreign income corporations with respect to which the section 958(a) U.S. shareholder increases its pro rata share of the section 965(a) earnings amount is reduced under section 965(b), §1.965–1(b)(2), or §1.965–8(b) make the election provided in this paragraph (f)(2). If the section 958(a) U.S. shareholder increases its basis in stock or applicable property under paragraph (f)(2)(ii)(A)(2) of this section and decreases its basis in stock or applicable property pursuant to paragraph (f)(2)(ii)(B) of this section subject to the limitation under paragraph (f)(2)(ii)(B)(2) of this section, the election statement must so indicate. The attachment of an unsigned copy of the election statement to the timely-filed return for the relevant taxable year satisfies the signature requirement of this paragraph (f)(2)(iii)(B)(2) if the section 958(a) U.S. shareholder retains the original signed election statement in the manner specified by §1.6001–1(e).

(g) Gain reduction rule—(1) Reduction in gain recognized under section 961(b)(2) by reason of distributions attributable to section 965 previously taxed earnings and profits in the inclusion year—(i) In general. If a section 958(a) U.S. shareholder receives a distribution from a deferred foreign income corporation (including through a chain of ownership described under section 958(a)) during the inclusion year of the deferred foreign income corporation that is attributable to section 965 previously taxed earnings and profits of the deferred foreign income corporation, then the amount of gain that otherwise would be recognized under section 961(b)(2) by the section 958(a) U.S. shareholder with respect to the section 958(a) U.S. shareholder’s section 958(a) stock of the deferred foreign income corporation or interest in applicable property with respect to the deferred foreign income corporation is reduced (but not below zero) by an amount equal to the section 965 previously taxed earnings and profits of the deferred foreign income corporation with respect to the section 958(a) U.S. shareholder, translated (if necessary) into U.S. dollars at the spot rate on December 31, 2017.

(ii) Definition of section 965 previously taxed earnings and profits. For purposes of paragraph (g)(1)(i) of this section, the term section 965 previously taxed earnings and profits means, with respect to a deferred foreign income corporation and a section 958(a) U.S. shareholder, the sum of the section 965(a) previously taxed earnings and profits of the deferred foreign income corporation with respect to the section 958(a) U.S. shareholder, and, if the section 958(a) U.S. shareholder has made the election described in paragraph (f)(2) of this section, the section 965(b) previously taxed earnings and profits of the deferred foreign income corporation with respect to the section 958(a) U.S. shareholder.

(2) Reduction in basis by an amount equal to the gain reduction amount. If a section 958(a) U.S. shareholder does not recognize gain under section 961(b)(2) by reason of paragraph (g)(1) of this section with respect to a distribution from a deferred foreign income corporation (including through a chain of ownership described under section 958(a)), the section 958(a) U.S. shareholder’s basis in the section 958(a) stock of the deferred foreign income corporation, or the section 958(a) U.S. shareholder’s basis in the applicable property with respect to the deferred foreign income corporation, is reduced by the amount of gain that would otherwise be recognized by the section 958(a) U.S. shareholder without regard to paragraph (g)(1) of this section.

(h) Rules of application for specified basis adjustments. This paragraph (h) applies for purposes of making any adjustment to the basis of section 958(a) stock or applicable property with respect to a specified foreign corporation described in paragraph (e), (f)(2), or (g)(2) of this section (collectively, specified basis adjustments, and each a specified basis adjustment).

(1) Timing of basis adjustments. Except as provided in paragraph (e)(2) of this section, a specified basis adjustment to section 958(a) stock or applicable property with respect to a specified foreign corporation is made as of the last day of the last taxable year of the specified foreign corporation that begins before January 1, 2018, on which it is a specified foreign corporation.

(2) Netting of basis adjustments. If one or more specified basis adjustments occur on the same day with respect to the same section 958(a) stock or applicable property, a single basis adjustment is made as of the close of such day with respect to such stock or applicable property in an amount equal to the net amount, if any, of the increase or reduction, as applicable.

(3) Gain recognition for reduction in excess of basis. The excess (if any) of a net reduction in basis with respect to section 958(a) stock or applicable property of a section 958(a) U.S. shareholder by reason of one or more specified basis adjustments over the section 958(a) U.S. shareholder’s basis in such stock or applicable property without regard to the specified basis adjustments is treated as gain from the sale or exchange of property.

(4) Adjustments with respect to each share—(i) Section 958(a) stock. If a specified basis adjustment is made with respect to section 958(a) stock, the specified basis adjustment is made with respect to each share of the section 958(a) stock in a manner consistent with the section 958(a) U.S. shareholder’s pro rata share of the section 965(a) earnings amount or specified E&P deficit, as applicable, by reason of such share.

(ii) Applicable property. If a specified basis adjustment is made with respect to applicable property, the adjustment is made with respect to the applicable property in a manner consistent with the ap-
fillation of paragraph (h)(4)(i) of this section.

(5) Stock or property for which adjustments are made—(i) In general. Except as provided in paragraph (h)(5)(ii) of this section, a specified basis adjustment is made solely with respect to section 958(a) stock owned by the section 958(a) U.S. shareholder within the meaning of section 958(a)(1)(A) or applicable property owned directly by the section 958(a) U.S. shareholder.

(ii) Special rule for an interest in a foreign pass-through entity. If the applicable property of the section 958(a) U.S. shareholder described in paragraph (h)(5)(i) of this section is an interest in a foreign pass-through entity, then, for purposes of determining the foreign pass-through entity’s basis in section 958(a) stock or applicable property, as applicable, with respect to the section 958(a) U.S. shareholder, a specified basis adjustment is made with respect to section 958(a) stock or applicable property of the section 958(a) U.S. shareholder owned through the foreign pass-through entity in the same manner as if the section 958(a) stock or applicable property were owned directly by the section 958(a) U.S. shareholder. In the case of tiered foreign pass-through entities, this paragraph (h)(5)(ii) applies with respect to each foreign pass-through entity.

(i) Definitions. This paragraph (i) provides definitions that apply for purposes of this section.

(1) Applicable property. The term applicable property means, with respect to a section 958(a) U.S. shareholder and a specified foreign corporation, property owned by the section 958(a) U.S. shareholder (including through one or more foreign pass-through entities) by reason of which the section 958(a) U.S. shareholder is considered under section 958(a)(2) as owning section 958(a) stock of the specified foreign corporation.

(2) Foreign pass-through entity. The term foreign pass-through entity means a foreign partnership or a foreign estate or trust (as defined in section 7701(a)(31)) (including a controlled domestic partnership treated as a foreign partnership pursuant to §1.965–1(e)).

(3) Property. The term property has the meaning provided in §1.961–1(b)(1).

(j) Examples. The following examples illustrate the application of this section.

(1) Example 1. Determination of accumulated post–1986 deferred foreign income with subpart F income earned before E&P measurement date on November 2, 2017. (i) Facts. USP, a domestic corporation, owns all of the stock of CFC1, a foreign corporation, which owns all of the stock of CFC2, also a foreign corporation. USP, CFC1, and CFC2 all have taxable years ending December 31, 2017. As of January 1, 2017, CFC1 has no earnings and profits, and CFC2 has 100u of earnings and profits described in section 959(c)(3) that were accumulated in taxable years beginning after December 31, 1986, while CFC2 was a specified foreign corporation, and 21,210u of post–1986 foreign income taxes. None of CFC2’s earnings and profits are attributable to income treated as effectively connected with the conduct of a trade or business within the United States. On March 1, 2017, CFC1 earns 30u of subpart F income (as defined in section 952), and CFC2 earns 20u of subpart F income. No foreign income tax is imposed on CFC1’s or CFC2’s subpart F income. For purposes of section 904, the post–1986 undistributed earnings, subpart F income, and post–1986 foreign income taxes are in the general category. On July 1, 2017, CFC2 distributes 40u to CFC1. On November 1, 2017, CFC1 distributes 60u to USP. USP does not have an aggregate foreign E&P deficit. USP includes in gross income all amounts that it is required to include under section 951. No foreign income tax is imposed or withheld on the distribution by CFC2 to CFC1 or the distribution by CFC1 to USP.

(ii) Analysis. (A) Adjustments to section 959(c) classification of earnings and profits for inclusion under section 951(a)(1)(A) without regard to section 956. The distribution from CFC2 to CFC1 does not give rise to subpart F income to CFC1 due to the application of section 954(c)(6). Accordingly, USP’s inclusion under section 951(a)(1)(A) without regard to section 956(a) is 30u with respect to CFC1 and 20u with respect to CFC2 for their taxable years ending December 31, 2017. As a result of the inclusions under section 951(a)(1)(A), CFC1 and CFC2 increase their earnings and profits described in section 959(c)(2) by 30u and 20u, respectively.

(B) Distributions between specified foreign corporations before January 1, 2018. The distribution of 40u from CFC2 to CFC1 is treated as a distribution of 20u out of earnings and profits described in section 959(c)(2) attributable to inclusions under section 951(a)(1)(A) without regard to section 956(a) and 20u out of earnings and profits described in section 959(c)(3).

(C) Section 965(a) inclusion amount. USP determines whether CFC1 and CFC2 are deferred foreign income corporations and, if so, determines its section 965(a) inclusion amount with respect to CFC1 and CFC2. CFC1 and CFC2 are specified foreign corporations, and CFC1 and CFC2 each have accumulated post–1986 deferred foreign income greater than zero as of an E&P measurement date. Accordingly, CFC1 and CFC2 are deferred foreign income corporations. USP’s section 965(a) inclusion amount with respect to each of CFC1 and CFC2, respectively, equals the section 965(a) earnings amount of CFC1 and CFC2, respectively.

(2) CFC1 section 965(a) earnings amount. The section 965(a) earnings amount with respect to CFC1 is 20u, the amount of its accumulated post–1986 deferred foreign income as of both November 2, 2017, and December 31, 2017, which is equal to 70u of post–1986 earnings and profits (30u earned and 40u attributable to the CFC2 distribution) reduced by 50u of such post–1986 earnings and profits described in section 959(c)(2) (30u earned and 20u attributable to the CFC2 distribution) under section 965(d)(2)(B) and §1.965–1(f)(7)(i)(B). Under section 965(d)(3)(B) and §1.965–1(f)(29)(i)(B), the post–1986 earnings and profits of CFC1 are not reduced by the 60u distribution to USP.

(2) CFC2 section 965(a) earnings amount. The section 965(a) earnings amount with respect to CFC2 is 80u, the amount of its accumulated post–1986 deferred foreign income as of both November 2, 2017, and December 31, 2017, which is equal to the amount of CFC2’s post–1986 earnings and profits of 80u. CFC2’s accumulated post–1986 deferred foreign income is equal to its post–1986 earnings and profits because CFC2 does not have earnings and profits that are attributable to income of the specified foreign corporation that is effectively connected with the conduct of a trade or business within the United States and subject to tax under chapter 1, or that, if distributed, would be excluded from the gross income of a United States shareholder under section 959 or from the gross income of another shareholder if such shareholder were a United States shareholder, and, therefore, no adjustment is made under section 965(d)(2) or §1.965–1(f)(7). CFC2’s 80u of post–1986 earnings and profits consists of 120u of earnings and profits that it earned, reduced by the 40u distribution to CFC1 under section 965(d)(3)(B) and §1.965–1(f)(29)(i)(B). The amount of the reduction to the post–1986 earnings and profits of CFC2 for the 40u distribution is not limited by §1.965–1(f)(29)(i)(B) because CFC1’s post–1986 earnings and profits are increased by 40u as a result of the distribution. Furthermore, the 40u distribution was made on July 1, 2017, which is before the E&P measurement date on November 2, 2017, §1.965–4(f) is not relevant.

(3) Effect on earnings and profits described in section 959(c)(2) and (3). CFC1 and CFC2 increase their earnings and profits described in section 959(c)(2) by 30u and 20u, respectively, and reduce their earnings and profits described in section 959(c)(3) by an equivalent amount.

(D) Distribution to United States shareholder. The distribution from CFC1 to USP is treated as a distribution of 60u out of the earnings and profits of CFC1 described in section 959(c)(2), which include earnings and profits attributable to the section 965(a) inclusion amount taken into account by USP.

(E) Section 902 and section 960 consequences. (1) Distribution by and inclusions with respect to CFC2. Under section 960, USP is deemed to pay $3.50x (21,210u x (20u/120u)) of CFC2’s post–1986 foreign income taxes as a result of its inclusion under section 959(c)(2) without regard to section 965(a) with respect to CFC2. As a result of the distribution from CFC2 to CFC1, CFC2’s post–1986 foreign income taxes are reduced, and CFC1’s post–
1986 foreign income taxes are increased, by the foreign income taxes deemed paid by CFC1 under section 92 of $3.50x (($21x-$3.50x) x 20u/(30u–20u)). Under section 960, USP is deemed to pay $14x (($21x-$3.50x-$3.50x) x 80u/(120u–40u)) of CFC2’s post–1986 foreign income taxes as a result of its section 965(a) inclusion with respect to CFC2. The taxes deemed paid by USP as a result of its section 965(a) inclusion with respect to CFC2 are subject to the applicable percentage disallowance under section 965(g).

(2) Inclusions with respect to CFC1. As determined in paragraph (j)(1)(iii)(E)(1) of this section (paragraph (E)(1) in the analysis in Example 1), as a result of the distribution from CFC2 to CFC1, CFC1 is deemed under section 920 to pay $3.50x of CFC2’s post–1986 foreign income taxes. Under section 960, USP is deemed to pay $2.10x ($3.50x x (30u/30u+20u)) of CFC1’s post–1986 foreign income taxes as a result of its inclusion under section 951(a)(1)(A) without regard to section 965(a) with respect to CFC1. Under section 960, USP is deemed to pay $1.40x ($3.50x–$2.10x) x 20u/(30u+20u–30u)) of CFC1’s post–1986 foreign income taxes. Under section 965(d)(3)(i)(B) and §1.965–1(f)(7)(i)(B) and (ii), and

(i) The amount of its accumulated post–1986 deferred foreign income as of November 2, 2017, 20u, which is equal to 70u of post–1986 earnings and profits (30u earned and 40u attributable to the CFC2 distribution) reduced by 50u of such post–1986 earnings and profits described in section 959(c)(2) with regard to the subpart F income earned after December 31, 2017 (30u earned and 20u attributable to the CFC2 distribution) under section 965(d)(2)(B) and §1.965–1(f)(7)(ii)(B) and (ii),

(ii) The amount of its accumulated post–1986 deferred foreign income as of December 31, 2017, 20u, which is equal to 120u of post–1986 earnings and profits (80u earned and 40u attributable to the CFC2 distribution) reduced by 100u of such post–1986 earnings and profits described in section 959(c)(2) with regard to the subpart F income earned on or before December 31, 2017 (80u earned and 20u attributable to the CFC2 distribution) under section 965(d)(2)(B) and §1.965–1(f)(7)(ii)(B) and (ii).

(2) CFC2 section 965(a) earnings amount. The analysis is the same as in paragraph (j)(1)(ii)(C)(2) of this section (paragraph (C)(2) in the analysis in Example 1).

(i) Effect on earnings and profits described in section 959(c)(2) and (3). The analysis is the same as in paragraph (j)(1)(ii)(C)(3) of this section (paragraph (C)(3) in the analysis in Example 1).

(ii) Distribution to United States shareholder. The analysis is the same as in paragraph (j)(1)(ii)(D) of this section (paragraph (D) in the analysis in Example 1).

(3) Example 3. Determination of accumulated post–1986 deferred foreign income with subpart F income earned after E&P measurement date on November 2, 2017, but previously taxed earnings and profits attributable to the subpart F income distributed before E&P measurement date on November 2, 2017. (i) Facts. The facts are the same as in paragraph (j)(1)(i) of this section (the facts in Example 1), except that on December 1, 2017, CFC1 earns an additional 50u of subpart F income (as defined in section 952), and neither CFC1 nor CFC2 has any post–1986 foreign income taxes.

(ii) Analysis. (A) Adjustments to section 959(c) classification of earnings and profits for inclusion under section 951(a)(1)(A) without regard to section 965. USP determines its inclusion under section 951(a)(1)(A) without regard to section 965(a), which is 80u with respect to both CFC1 and CFC2. Because USP wholly owns CFC1 and CFC2, and CFC1 and CFC2 are specified foreign corporations, and if so, determines its section 965(a) inclusion amounts with respect to both CFC1 and CFC2.

(i) The amount of its accumulated post–1986 deferred foreign income as of November 2, 2017, 20u, which is equal to 70u of post–1986 earnings and profits (30u earned and 40u attributable to the CFC2 distribution) reduced by 50u of such post–1986 earnings and profits described in section 959(c)(2) without regard to the subpart F income earned after December 31, 2017 (30u earned and 20u attributable to the CFC2 distribution) under section 965(d)(2)(B) and §1.965–1(f)(7)(ii)(B) and (ii),

(ii) The amount of its accumulated post–1986 deferred foreign income as of December 31, 2017, 20u, which is equal to 120u of post–1986 earnings and profits (80u earned and 40u attributable to the CFC2 distribution) reduced by 100u of such post–1986 earnings and profits described in section 959(c)(2) with regard to the subpart F income earned on or before December 31, 2017 (80u earned and 20u attributable to the CFC2 distribution) under section 965(d)(2)(B) and §1.965–1(f)(7)(ii)(B) and (ii).

(2) CFC2 section 965(a) earnings amount. The section 965(a) earnings amount with respect to CFC2 is 100u, the greater of the amounts in paragraph (j)(3)(ii)(C)(2)(i) and (ii) of this section (paragraph (C)(2)(i) and (ii) in the analysis in Example 3).

(i) The amount of its accumulated post–1986 deferred foreign income as of November 2, 2017, 80u. CFC2’s 80u of accumulated post–1986 deferred foreign income as of November 2, 2017, is equal to its 80u of post–1986 earnings and profits because no adjustment is made under section 965(d)(2) or §1.965–1(f)(7), as CFC2 does not have earnings and profits that are attributable to income of the specified foreign corporation that is effectively connected with the conduct of a trade or business within the United States and subject to tax under chapter 1, or that, if distributed, would be excluded from the gross income of a United States shareholder under section 959 or from the gross income of another shareholder if such shareholder were a United States shareholder, without regard to the subpart F income earned after November 2, 2017. CFC2’s 80u of post–1986 earnings and profits consists of 120u of earnings and profits that it earned, reduced by the 40u distribution to CFC1 under section 965(d)(3)(B) and §1.965–1(f)(29)(i)(B). The amount of the reduction to the post–1986 foreign income taxes is not limited by §1.965–1(f)(29)(i)(B) because CFC1’s post–1986 earnings and profits are increased by 40u as a result of the distribution. Furthermore, because the 40u distribution was made on July 1, 2017, which is before any E&P measurement date, §1.965–4(j) is not relevant.

(ii) The amount of its accumulated post–1986 deferred foreign income as of December 31, 2017, 100u, which is equal to 130u of post–1986 earnings and profits reduced by 30u of such post–1986 earnings and profits described in section 959(c)(2) with regard to the subpart F income earned before December 31, 2017, under section 965(d)(2)(B) and §1.965–1(f)(7)(i)(B) and (ii). CFC2’s 130u of post–1986 earnings and profits consists of 170u of earnings and profits that it earned, reduced by the 40u distribution to CFC1 under section 965(d)(3)(B) and §1.965–1(f)(29)(i)(B).

(3) Effect on earnings and profits described in section 959(c)(2) and (3). CFC2 increases its earnings.
ings and profits described in section 959(c)(2) by USP’s section 965(a) inclusion amount with respect to CFC2, 100u, and reduces its earnings and profits described in section 959(c)(3) by an equivalent amount.

(D) Distribution to United States shareholder. The analysis is the same as in paragraph (j)(1)(ii)(D) of this section (paragraph (D) in the analysis in Example 1).

(4) Example 4. Determination of accumulated post–1986 deferred foreign income with distribution made after E&P measurement date on November 2, 2017. (i) Facts. USP, a domestic corporation, owns all of the stock of CFC1, a foreign corporation, which owns all of the stock of CFC2, also a foreign corporation. USP, CFC1, and CFC2 all have taxable years ending December 31, 2017. As of January 1, 2017, CFC1 has 10u of earnings and profits described in section 959(c)(3) that were accumulated in taxable years beginning after December 31, 1986, while CFC1 was a specified foreign corporation, and $2x of post–1986 foreign income taxes; and CFC2 has 100u of earnings and profits described in section 959(c)(3) that were accumulated in taxable years beginning after December 31, 1986, while CFC2 was a specified foreign corporation and $10x of post–1986 foreign income taxes. For purposes of section 959, the post–1986 undistributed earnings and profits attributable to the section 965(a) inclusion amount taken into account by USP. USP deter-

1.5 Distribution to United States shareholder. The analysis is the same as in paragraph (j)(1)(ii)(D) of this section (paragraph (D) in the analysis in Example 1).

(ii) Analysis. (A) Adjustments to section 959(c) classification of earnings and profits for inclusion under section 951(a)(1)(A) without regard to section 956. The distribution from CFC2 to CFC1 does not give rise to any F income to CFC1 due to the application of section 954(c)(6). Accordingly, USP does not have an inclusion under section 951(a)(1)(A) without regard to section 956(a) with respect to CFC1 or CFC2 for their taxable years ending December 31, 2017. As a result, neither CFC1 nor CFC2 has earnings and profits described in section 959(c)(2).

(B) Distributions between specified foreign corporations before January 1, 2018. The distribution of 100u from CFC2 to CFC1 is initially treated as a distribution out of earnings and profits described in section 959(c)(3).

(C) Section 965(a) inclusion amount. USP determines whether CFC1 and CFC2 are deferred foreign income corporations, and, if so, determines its section 965(a) inclusion amounts with respect to CFC1 and CFC2. CFC1 and CFC2 are deferred foreign corporations, and CFC1 and CFC2 each have accumulated post–1986 deferred foreign income greater than zero as of an E&P measurement date. Accord-

ingly, CFC1 and CFC2 are deferred foreign income corporations. USP’s section 965(a) inclusion amount with respect to each of CFC1 and CFC2, respectively, equals the section 965(a) earnings amount of CFC1 and CFC2, respectively.

(1) CFC1 section 965(a) earnings amount. The section 965(a) earnings amount with respect to CFC1 is 10u, the amount of its accumulated post–1986 deferred foreign income as of both November 2, 2017, and December 31, 2017, which is equal to the amount of CFC1’s post–1986 earnings and profits of 10u. CFC1’s accumulated post–1986 deferred foreign income is equal to its post–1986 earnings and profits because CFC1 does not have earnings and profits that are attributable to income of the specified foreign corporation that is effectively connected with the conduct of a trade or business within the United States and subject to tax under chapter 1, or that, if distributed, would be excluded from the gross income of a United States shareholder under section 959 or from the gross income of another shareholder if such shareholder were a United States shareholder, and therefore no adjustment is made under section 965(d)(2) or $10x. But for $10x, CFC1’s post–1986 earnings and profits as of December 31, 2017, would be 110u, but be- cause the distribution from CFC2 is a specified payment, it is disregarded in determining CFC1’s post–1986 earnings and profits as of December 31, 2017, under §1.965–4(f). Under section 965(d)(3)(B) and $10x, CFC1’s post–1986 earnings and profits are not reduced by the 10u distribution to USP.

(2) CFC2 section 965(a) earnings amount. The section 965(a) earnings amount with respect to CFC2 is 100u, the amount of its accumulated post–1986 deferred foreign income as of both November 2, 2017, and December 31, 2017, which is equal to the amount of CFC2’s post–1986 earnings and profits of 100u. CFC2’s accumulated post–1986 deferred foreign income is equal to its post–1986 earnings and profits because CFC2 does not have earnings and profits that are attributable to income of the specified foreign corporation that is effectively connected with the conduct of a trade or business within the United States and subject to tax under chapter 1, or that, if distributed, would be excluded from the gross income of a United States shareholder under section 959 or from the gross income of another shareholder if such shareholder were a United States share-

(D) Effect on earnings and profits described in section 959(c)(2) and (3). CFC1 and CFC2 increase their earnings and profits described in section 959(c)(2) by USP’s section 965(a) inclusion amounts with respect to CFC1 and CFC2, 10u and 100u, respectively, and reduce their earnings and profits described in section 959(c)(3) by an equivalent amount.

(E) Distributions—(1) Distribution that is a specified payment. The distribution from CFC2 to CFC1 is recharacterized as a distribution of 100u out of the earnings and profits of CFC2 described in section 959(c)(2), which include earnings and profits attributable to the section 965(a) inclusion amount taken into account by USP.

(ii) Analysis. (A) Section 965(a) inclusion amount. USP determines whether CFC is a deferred foreign income corporation, and, if so, determines its section 965(a) inclusion amount with respect to CFC. USP, a United States shareholder, owns all of the stock of CFC, a foreign corporation. CFC has $10u of earnings and profits described in section 959(c)(3) that were accumulated in taxable years beginning after December 31, 1986, while CFC was a specified foreign corporation, and CFC has 110u of earnings and profits described in section 959(c)(3) that were accumulated in taxable years beginning after December 31, 1986, while CFC was a specified foreign corporation. CFC holds 150u of United States property throughout its taxable year ending November 30, 2017, but disposes of it on December 1, 2017, recognizing no gain or loss on the property. Between December 1, 2017, and December 31, 2017, CFC earns an additional 10u of income that does not constitute subpart F income or income treated as effectively connected with the conduct of a trade or business within the United States that gives rise to 10u of earnings and profits. USP includes in income all amounts that it is re-

quired to include under section 951.

(1) CFC section 965(a) earnings amount. The section 965(a) earnings amount with respect to CFC is 110u, the greater of the amount of its accumulated post–1986 deferred foreign income as of November 2, 2017, which is 110u, and the amount of its accumulated post–1986 deferred foreign income as of December 31, 2017, which is 110u. CFC’s accumulated post–1986 deferred foreign income greater than zero as of an E&P measurement date. Accordingly, CFC is a deferred foreign income corporation. USP’s section 965(a) inclusion amount with respect to CFC equals the section 965(a) earnings amount of CFC.

(2) CFC section 965(a) inclusion amount. The section 965(a) inclusion amount with respect to CFC is $10x, the amount of its accumulated post–1986 deferred foreign income as of both November 2, 2017, and December 31, 2017, which is equal to the amount of CFC’s post–1986 earnings and profits of 100u. CFC’s accumulated post–1986 deferred foreign income is equal to its post–1986 earnings and profits because CFC does not have earnings and profits that are attributable to income of the specified foreign corporation that is effectively connected with the conduct of a trade or business within the United States and subject to tax under chapter 1, or that, if distributed, would be excluded from the gross income of a United States shareholder, and therefore no adjustment is made under section 965(d)(2) or $10x. But for $10x, CFC’s post–1986 earnings and profits as of December 31, 2017, would be 110u, but be- cause the distribution from CFC2 is a specified payment, it is disregarded in determining CFC1’s post–1986 earnings and profits as of December 31, 2017, under §1.965–4(f). Under section 965(d)(3)(B) and $10x, CFC1’s post–1986 earnings and profits are not reduced by the 10u distribution to USP.

(3) Effect on earnings and profits described in section 959(c)(2). CFC1 and CFC2 increase their earnings and profits described in section 959(c)(2) by USP’s section 965(a) inclusion amounts with respect to CFC1 and CFC2, 10u and 100u, respectively, and reduce their earnings and profits described in section 959(c)(3) by an equivalent amount.
under section 959 under section 965(d)(2) or $1.965–1(i)(7) if distributed on November 2, 2017. CFC’s accumulated post–1986 deferred foreign income as of December 31, 2017, is equal to its 120u of post–1986 earnings and profits reduced by the 110u of earnings and profits described in section 959(c)(1) as a result of USP’s section 951(a)(1)(B) inclusion with respect to CFC as of December 31, 2017, which would be excluded from the gross income of a United States shareholder under section 959 under section 965(d)(2) or $1.965–1(i)(7) if distributed on December 31, 2017.

(2) Effect on earnings and profits described in section 959(c)(2) and (3). In USP’s taxable year ending December 31, 2018, CFC increases its earnings and profits described in section 959(c)(2) by USP’s section 965(a) inclusion amount with respect to CFC, 110u, and reduces its earnings and profits described in section 959(c)(3) by an equivalent amount.

(B) Section 956 inclusion. In USP’s taxable year ending December 31, 2017, USP increases its earnings and profits described in section 959(c)(1) by USP’s amount included under sections 951(a)(1)(B) and 956 with respect to CFC, 110u, and reduces its earnings and profits described in section 959(c)(3) by an equivalent amount.

(6) Example 6. Section 1248 inclusion. (i) Facts. USP1, a domestic corporation, owns all of the stock of CFC1, a foreign corporation, until it sells all of such stock to USP2, a domestic corporation, on December 1, 2017, in a sale on which USP1 recognizes $100x of gain. Throughout 2017, 1u=$1x. USP1, USP2, and CFC all have taxable years ending December 31, 2017. As of January 1, 2017, CFC has 100u of earnings and profits described in section 959(c)(3) that were accumulated in taxable years beginning after December 31, 1986, while CFC was wholly owned by USP1. On March 1, 2017, CFC distributes 20u to USP1. None of CFC’s earnings and profits are attributable to income treated as effectively connected with the conduct of a trade or business within the United States. USP2 does not have an aggregate foreign E&P deficit. USP1 and USP2 include in income all amounts that they are required to include under sections 951 and 1248.

(ii) Analysis. Under paragraph (c) of this section, CFC2 has $100x of section 965(a) previously taxed earnings and profits with respect to USP. USP receives a distribution from CFC2 through a chain of ownership described in section 958(a) during the inclusion year of CFC2 that is attributable to the $100x of section 965(a) previously taxed earnings and profits of CFC2. Under paragraph (g)(1) of this section, the amount of gain that USP otherwise would recognize with respect to the stock of CFC1 under section 961(b)(2) is reduced (but not below zero) by $100x, the amount of CFC2’s section 965(b) previously taxed earnings and profits with respect to USP under paragraph (d)(1) of this section.

(B) Adjustments to the basis of CFC1. Because USP makes the election described in paragraph (f)(2) of this section, as of the close of November 30, 2018, USP’s basis in CFC1 is increased under paragraph (f)(2)(iii)(A) of this section by an amount equal to the section 965(b) previously taxed earnings and profits with respect to USP under paragraph (d)(1) of this section ($100x), reduced under paragraph (f)(2)(ii)(B) of this section by an amount equal to the portion of the specified E&P deficit of CFC1 taken into account in determining USP’s section 965(a) inclusion amount with respect to CFC2 ($100x), and reduced under paragraph (g)(2) of this section by the amount of gain that would have been recognized by USP with respect to the stock of CFC1 under section 961(b)(2) but for the application of paragraph (g)(1) of this section ($100x). Under paragraph (h)(2) and (3) of this section, the excess of the net reduction from the adjustments under paragraphs (f) and (g) of this section over USP’s basis in the stock of CFC1 (in this case, $100x) is treated as gain recognized by USP from the sale or exchange of property.

Example 7. Distribution attributable to section 965(a) previously taxed earnings and profits. (i) Facts. USP, a domestic corporation, owns all of the stock of CFC1, a specified foreign corporation that has no post–1986 earnings and profits (or deficit in post–1986 earnings and profits), and CFC1 owns all the stock of CFC2, a deferred foreign income corporation. USP is a calendar year taxpayer. CFC1’s last taxable year beginning before January 1, 2018, ends on November 30, 2018; CFC2 has an inclusion year that ends on November 30, 2018. The functional currency of CFC1 and CFC2 is the U.S. dollar. USP’s adjusted basis in the stock of CFC1 is zero. On January 1, 2018, CFC2 distributes $100x to CFC1, and CFC1 distributes $100x to USP. USP has a section 965(a) inclusion amount of $100x with respect to CFC2 that is taken into account for USP’s taxable year ending December 31, 2018. CFC2 has no earnings and profits described in section 959(c)(1) or (2) other than section 965(a) previously taxed earnings and profits.

(ii) Analysis. Under paragraph (c) of this section, CFC2 has $100x of section 965(a) previously taxed earnings and profits with respect to USP. USP receives a distribution from CFC2 through a chain of ownership described in section 958(a) during the inclusion year of CFC2 that is attributable to the $100x of section 965(a) previously taxed earnings and profits of CFC2. Under paragraph (g)(1) of this section, the amount of gain that USP otherwise would recognize with respect to the stock of CFC1 under section 961(b)(2) is reduced (but not below zero) by $100x, the amount of CFC2’s section 965(a) previously taxed earnings and profits with respect to USP under paragraph (d)(2) of this section.

Example 8. Distribution attributable to section 965(b) previously taxed earnings and profits; parent-subsidiary. (i) Facts. The facts are the same as in paragraph (g)(7)(i) of this section (the facts in Example 7), except that CFC1 has a specified E&P deficit of $100x. Because of the specified E&P deficit of CFC1, USP’s section 965(a) inclusion amount with respect to CFC2 is reduced to zero pursuant to section 965(b)(1) and $1.965–1(b)(2). USP makes the election described in paragraph (f)(2) of this section.
§1.965–3 Section 965(c) deductions.

(a) Scope. This section provides rules regarding section 965(c) deductions and section 965(c) deduction amounts. Paragraph (b) of this section provides rules for disregarding certain assets for purposes of determining the aggregate foreign cash position of a section 958(a) U.S. shareholder. Paragraph (c) of this section provides rules for determining the aggregate foreign cash position for a section 958(a) U.S. shareholder inclusion year. Paragraph (d) of this section provides a rule regarding certain expatriated entities. Paragraph (e) of this section provides a rule for the treatment of section 965(c) deductions in connection with an election under section 962. Paragraph (f) of this section provides rules regarding the treatment of a section 965(c) deduction under certain provisions of the Internal Revenue Code. Paragraph (g) of this section provides a rule for domestic pass-through entities.

(b) Rules for disregarding certain assets for determining aggregate foreign cash position—(1) Disregard of certain obligations between related specified foreign corporations. In determining the aggregate foreign cash position of a section 958(a) U.S. shareholder, any account receivable, account payable, short-term obligation, or derivative financial instrument between a specified foreign corporation with respect to which the section 958(a) U.S. shareholder owns section 958(a) stock and a related specified foreign corporation on corresponding cash measurement dates is disregarded to the extent of the smallest of the product of the amount of the item on such corresponding cash measurement dates of each specified foreign corporation and the section 958(a) U.S. shareholder’s ownership percentage of section 958(a) stock of the specified foreign corporation owned by the section 958(a) U.S. shareholder on such dates. For purposes of this paragraph (b)(1)(i), a specified foreign corporation is treated as a related specified foreign corporation with respect to another specified foreign corporation if, as of the cash measurement date referred to in the preceding sentence of each specified foreign corporation, the specified foreign corporations are related persons within the meaning of section 954(d)(3), substituting the term “specified foreign corporation” for “controlled foreign corporation” in each place that it appears.

(2) Disregard of other assets upon demonstration of double-counting. For purposes of determining the aggregate foreign cash position of a section 958(a) U.S. shareholder, the section 958(a) U.S. shareholder’s pro rata share of the cash position of a specified foreign corporation on a cash measurement date is reduced by amounts of net accounts receivable, actively traded property, and short-term obligations to the extent such amounts are attributable to amounts taken into account in determining the section 958(a) U.S. shareholder’s pro rata share of the cash position of another specified foreign corporation on the corresponding cash measurement date of such other specified corporation and to the extent not disregarded pursuant to paragraph (b)(1) of this section. However, the preceding sentence applies only if the section 958(a) U.S. shareholder attaches a statement containing the information outlined in paragraphs (b)(2)(i) through (v) of this section to its timely filed return (taking into account extensions, if any) for the section 958(a) U.S. shareholder inclusion year, or, if the section 958(a) U.S. shareholder has multiple section 958(a) U.S. shareholder inclusion years, the later of such years. Relief is not available under §301.9100–2 or §301.9100–3 to allow late filing of the statement. The statement must contain the following information with respect to each specified foreign corporation for which the cash position is reduced under this paragraph (b)(2)—

(i) A description of the asset that would be taken into account with respect to both specified foreign corporations,

(ii) A statement of the amount by which its pro rata share of the cash position of one specified foreign corporation is reduced,

(iii) A detailed explanation of why there would otherwise be double-counting, including the computation of the amount taken into account with respect to the other specified foreign corporation, and

(iv) An explanation of why paragraph (b)(1) of this section does not apply to disregard such amount.

(3) Disregard of portion of cash position of noncorporate entities treated as specified foreign corporations. If an entity is treated as a specified foreign corporation of a section 958(a) U.S. shareholder pursuant to section 965(c)(3)(E), for purposes of determining the aggregate foreign cash position of the section 958(a) U.S. shareholder, the section 958(a) U.S. shareholder’s pro rata share of the cash position of the entity (determined taking into account paragraphs (b)(1) and (b)(2) of this section) is reduced by the amount of the pro rata share attributable to deemed stock of the entity not owned (within the meaning of section 958(a), applied by treating domestic pass-through entities as foreign) by a specified foreign corporation of the section 958(a) U.S. shareholder (determined without taking into account section 965(c)(3)(E)).

(4) Examples. The following examples illustrate the application of this paragraph (b).

(i) Example 1. (A) Facts. USP, a domestic corporation, owns all of the stock of CFC1, a foreign corporation. CFC1 owns 95% of the only class of stock of CFC2, also a foreign corporation, and 40% of the only class of stock of CFC3, also a foreign corporation. The remaining 5% of the only class of stock of CFC2 is owned by a person unrelated to USP, CFC1, and CFC2; and the remaining 60% of the only class of stock of CFC3 is owned by a person unrelated to USP and CFC1. USP, CFC1, and CFC3 have calendar year taxable years. CFC2 has a taxable year ending on November 30. On November 15, 2015, CFC1 makes a loan of $100x to CFC2, which is required to be and is, in fact, repaid on January 1, 2016. On November 15, 2016, CFC2 sells inventory to CFC1 in exchange for an account receivable of $200x, which is required to be and is, in fact, repaid on December 15, 2016. On August 1, 2017, CFC1...
makes a loan of $300x to CFC3, which is required to be and is, in fact, repaid on January 31, 2018.

(B) Analysis—(i) Loan from CFC1 to CFC2.

For purposes of determining the aggregate foreign cash position of USP, a section 958(a) U.S. shareholder of CFC1, under paragraph (b)(1) of this section, because CFC1 and CFC2 are related within the meaning of paragraph (b)(1) of this section, the short-term obligation of CFC2 held by CFC1 outstanding on the first cash measurement date of each specified foreign corporation, November 30, 2015, and December 31, 2015, respectively, is disregarded to the extent of 95%, the smallest ownership percentage of section 958(a) stock of CFC1 and CFC2 owned by USP on such first cash measurement dates. Accordingly, USP only takes into account $5 ($100 - 95% of $100) of the short-term obligation in determining CFC1’s cash position for purposes of determining its aggregate foreign cash position.

(ii) Example 2. (A) Facts. The facts are the same as in paragraph (b)(4)(i)(A) of this section (the facts in Example 1), except that on December 1, 2015, CFC1 sells 5% of the stock of CFC2 to an unrelated person.

(B) Analysis. The analysis is the same as in paragraph (b)(4)(ii)(B) of this section (the analysis in Example 1), except that the short-term obligation of CFC2 held by CFC1 outstanding on both of their first cash measurement dates, November 30, 2015, and December 31, 2015, respectively, is disregarded under paragraph (b)(1) of this section to the extent of 90%, the smallest ownership percentage of section 958(a) stock of CFC1 and CFC2 by USP on such first cash measurement dates. Accordingly, USP takes into account 90% of the short-term obligation in determining CFC1’s cash position for purposes of determining its aggregate foreign cash position.

(iii) Example 3. (A) Facts. USP, a domestic corporation, owns all of the stock of CFC1, a foreign corporation, which owns 45% of the only class of stock of CFC2, also a foreign corporation. The remainder of the CFC2 stock is actively traded on an established financial market but is not owned by any person related to USP or CFC1. USP, CFC1, and CFC2 have calendar year taxable years. The value of the CFC2 stock owned by CFC1 is $500x on each of the cash measurement dates. Also on each of the cash measurement dates, CFC2 has $300x of assets described in section 965(c)(3)(B) and 1.965–1(f)(16) that are taken into account in determining its cash position.

(B) Analysis. For purposes of determining USP’s aggregate foreign cash position, USP’s pro rata share of the cash position of CFC1 on each cash measurement date may be reduced by the amount of the stock of CFC2 to the extent attributable to amounts taken into account in determining USP’s pro rata share of the cash position of CFC2 on such cash measurement date (that is, to the extent of the $135x taken into account with respect to CFC2), provided USP attaches a statement to its timely filed return (taking into account extensions, if any) containing the following: a description of each of the CFC2 stock and the assets of CFC2 taken into account in determining its cash position; a statement that USP’s pro rata share of the cash position of CFC1 is being reduced by $135x; the computation of the $135x taken into account with respect to CFC2; and an explanation of why paragraph (b)(1) of this section does not apply to disregard such amount.

(iv) Example 4. (A) Facts. USP, a domestic corporation, owns all of the stock of CFC1 and CFC2, each a foreign corporation. USP, CFC1, and CFC2 have calendar year taxable years. CFC1 buys goods on credit from a third party for $100x and thus has an account payable of $100x. CFC1 modifies the goods and sells to CFC2 for $105x in exchange for an account receivable of $105x. CFC2 modifies the goods and sells to another third party for $110x in exchange for an account receivable of $110x. All of the accounts payable and accounts receivable are outstanding on the final cash measurement date.

(B) Analysis. For purposes of determining USP’s aggregate foreign cash position, on the final cash measurement date, CFC1 has net accounts receivable of $0 because, pursuant to paragraph (b)(1) of this section, CFC1’s account receivable from CFC2 is disregarded, and CFC2 has net accounts receivable of $110x because, pursuant to paragraph (b)(1) of this section, CFC2’s account payable to CFC1 is disregarded. USP cannot rely on the rule in paragraph (b)(2) of this section because no amounts attributable to CFC2’s net accounts receivable are taken into account with respect to another specified foreign corporation.

(c) Determination of aggregate foreign cash position for a section 958(a) U.S. shareholder inclusion year—(1) Single section 958(a) U.S. shareholder inclusion year. If a section 958(a) U.S. shareholder has a single section 958(a) U.S. shareholder inclusion year, then the section 958(a) U.S. shareholder’s aggregate foreign cash position for the section 958(a) U.S. shareholder inclusion year is equal to the aggregate foreign cash position of the section 958(a) U.S. shareholder.

(2) Multiple section 958(a) U.S. shareholder inclusion years. If a section 958(a) U.S. shareholder has multiple section 958(a) U.S. shareholder inclusion years, then the section 958(a) U.S. shareholder’s aggregate foreign cash position for each section 958(a) U.S. shareholder inclusion year is determined by allocating the aggregate foreign cash position to a section 958(a) U.S. shareholder inclusion year under paragraphs (c)(2)(i) and (c)(2)(ii) of this section.

(i) Allocation to first section 958(a) U.S. shareholder inclusion year. A portion of the aggregate foreign cash position of the section 958(a) U.S. shareholder is allocated to the first section 958(a) U.S. shareholder inclusion year in an amount...
equal to the lesser of the section 958(a) U.S. shareholder’s aggregate foreign cash position or the section 958(a) U.S. shareholder’s aggregate section 965(a) inclusion amount for the section 958(a) U.S. shareholder inclusion year.

(ii) Allocation to succeeding section 958(a) U.S. shareholder inclusion years.

The amount of the section 958(a) U.S. shareholder’s aggregate foreign cash position allocated to any succeeding section 958(a) U.S. shareholder inclusion year equals the lesser of the excess, if any, of the section 958(a) U.S. shareholder’s aggregate foreign cash position over the aggregate amount of its aggregate foreign cash position allocated to preceding section 958(a) U.S. shareholder inclusion years under paragraph (c)(2)(i) of this section and this paragraph (c)(2)(ii) or the section 958(a) U.S. shareholder’s aggregate section 965(a) inclusion amount for such succeeding section 958(a) U.S. shareholder inclusion year.

(3) Estimation of aggregate foreign cash position.

For purposes of determining the aggregate foreign cash position of a section 958(a) U.S. shareholder, the section 958(a) U.S. shareholder may assume that its pro rata share of the cash position of any specified foreign corporation whose last taxable year beginning before January 1, 2018, ends after the date the return for such section 958(a) U.S. shareholder inclusion year is timely filed (taking into account extensions, if any) is zero as of the cash measurement date with which the taxable year of such specified foreign corporation ends. If a section 958(a) U.S. shareholder’s pro rata share of the cash position of a specified foreign corporation is treated as zero pursuant to the preceding sentence, the amount described in §1.965–1(f)(8)(i)(A) with respect to such section 958(a) U.S. shareholder in fact exceeds the amount described in §1.965–1(f)(8)(i)(B) with respect to such section 958(a) U.S. shareholder, and the aggregate section 965(a) inclusion amount for the estimated section 958(a) U.S. shareholder inclusion year to account for the correct aggregate foreign cash position for the year. The amended return must be filed by the due date (taking into account extensions, if any) for the return for the year after the estimated section 958(a) U.S. shareholder inclusion year.

(4) Examples.

The following examples illustrate the application of this paragraph (c).

(i) Example 1. Estimation of aggregate foreign cash position for a section 958(a) U.S. shareholder inclusion year.—(A) Facts. USP, a domestic corporation, owns all of the stock of CFC1, a foreign corporation, which owns all of the stock of CFC2, also a foreign corporation. USP is a calendar year taxpayer. CFC1 has a taxable year ending on December 31, and CFC2 has a taxable year ending on November 30. The cash position of CFC1 on each of December 31, 2015, December 31, 2016, and December 31, 2017, is $100x. The cash position of CFC2 on each of November 30, 2015, and November 30, 2016, is $200x. USP has a section 965(a) inclusion amount of $300x with respect to CFC1.

(B) Analysis. In determining its aggregate foreign cash position for its 2017 taxable year, USP may assume that its pro rata share of the cash position of CFC2 will be zero as of November 30, 2018, for purposes of filing its return due on April 18, 2018 (or due on October 15, 2018, with extension). Therefore, USP’s aggregate foreign cash position is treated as $300x, which is the greater of (a) $300x, 50% of the sum of USP’s pro rata shares of the cash position of CFC1 as of December 31, 2015, and December 31, 2016, and of the cash position of CFC2 as of November 30, 2015, and November 30, 2016, and (b) $100x, USP’s pro rata share of the cash position of CFC1 as of December 31, 2017.

(ii) Example 2. Allocation of aggregate foreign cash position among section 958(a) U.S. shareholder inclusion years.—(A) Facts. The facts are the same as in paragraph (c)(4)(i)(A) of this section (the facts in Example 1), except that the cash position of each of CFC1 and CFC2 on all relevant cash measurement dates is $200x, with the result that USP has an aggregate foreign cash position determined under §1.965–1(f)(8)(i) of $400x. For its 2017 taxable year, USP has a section 965(a) inclusion amount with respect to CFC1 of $300x, and for its 2018 taxable year, USP has a section 965(a) inclusion amount with respect to CFC2 of $300x.

(B) Analysis. Under paragraph (c)(2)(i) of this section, USP’s aggregate foreign cash position for 2017 is $300x, which is the lesser of USP’s aggregate foreign cash position determined under §1.965–1(f)(8)(i) of $400x or the section 965(a) inclusion amount ($300x) that USP takes into account in 2017. Under paragraph (c)(2)(ii) of this section, the amount of USP’s aggregate foreign cash position for 2018 is $100x. USP’s aggregate foreign cash position determined under §1.965–1(f)(8)(i) of $400x reduced by the amount of its aggregate foreign cash position for 2017 ($300x) under paragraph (c)(2)(i) of this section.

(d) Increase of income by section 965(c) deduction of an expatriated entity.—(1) In general. If a person is allowed a section 965(c) deduction and the person (or a successor) first becomes an expatriated entity, with respect to a surrogate foreign corporation, at any time during the 10-year period beginning on December 22, 2017, then the tax imposed by chapter 1 of the Internal Revenue Code is increased for the first taxable year in which such person becomes an expatriated entity by an amount equal to 35 percent of the person’s section 965(c) deductions, and no credits are allowed against such increase in tax. The preceding sentence applies only if the surrogate foreign corporation first becomes a surrogate foreign corporation on or after December 22, 2017.

(2) Definition of expatriated entity. For purposes of paragraph (d)(1) of this section, the term expatriated entity has the same meaning given such term under section 8774(a)(2), except that such term does not include an expatriated entity if the surrogate foreign corporation with respect to the expatriated entity is treated as a domestic corporation under section 8774(b).

(3) Definition of surrogate foreign corporation.

For purposes of paragraph (d)(1) of this section, the term surrogate foreign corporation has the meaning given such term in section 8774(a)(2)(B).

(e) Section 962 election.—(1) In general. In the case of an individual (including a trust or estate) that makes an election under section 962, any section 965(c) deduction taken into account under §1.962–1(b)(1)(i)(B) in determining taxable income as used in section 11 is not taken into account for purposes of determining the individual’s taxable income under section 1.

(2) Example. The following example illustrates the application of the rule in this paragraph (e).

(i) Facts. USI, a United States citizen, owns 10% of the capital and profits of USPRS, a domestic partnership that has a calendar year taxable year, the remainder of which is owned by foreign persons unrelated to USI or USPRS. USPRS owns all of the
stock of FS, a foreign corporation that is a controlled foreign corporation with a calendar year taxable year. USPRS has a section 965(a) inclusion amount with respect to FS of $1,000x and has a section 965(c) deduction amount of $700x. FS has no post-1986 foreign income taxes. USI makes a valid election under section 962 for 2017.

(ii) Analysis. USI’s “taxable income” described in §1.962–1(b)(1)(i) equals $100x (USI’s domestic pass-through owner share of USPRS’s section 965(a) inclusion amount) minus $70x (USI’s domesttic pass-through owner share of USPRS’s section 965(c) deduction amount), or $30x. No other deductions are allowed in determining this amount. USI’s tax on the $30x section 965(a) inclusion will be equal to the tax that would be imposed on such amount under section 11 if USI were a domestic corporation. Under paragraph (e)(1) of this section, USI cannot deduct $70x for purposes of determining USI’s taxable income that is subject to tax under section 1.

(i) Treatment of section 965(c) deduction under certain provisions of the Internal Revenue Code—(1) Sections 62(a) and 63(d). A section 965(c) deduction is treated as a deduction described in section 62(a) and is not treated as an itemized deduction for any purpose of the Internal Revenue Code.

(2) Sections 705, 1367, and 1368—(i) Adjustments to basis. In the case of a domestic partnership or S corporation—

(A) The aggregate amount of its section 965(a) inclusions net of the aggregate amount of its section 965(c) deductions is treated as a separately stated item of net income solely for purposes of calculating basis under section 705(a) and §1.705–1(a) and section 1367(a)(1) and §1.1367–1(f), and

(B) The aggregate amount of its section 965(a) inclusions equal to the aggregate amount of its section 965(c) deductions is treated as income exempt from tax solely for purposes of calculating basis under sections 705(a)(1)(B), 1367(a)(1)(A), and §1.1367–1(f).

(ii) S corporation accumulated adjustments account. In the case of an S corporation, the aggregate amount of its section 965(a) inclusions equal to the aggregate amount of its section 965(c) deductions is treated as income not exempt from tax solely for purposes of determining whether an adjustment is made to an accumulated adjustments account under section 1368(e)(1)(A) and §1.1368–2(a)(2).

(iii) Example. The following example illustrates the application of this paragraph (f)(2).

(A) Facts. USI, a United States citizen, owns all of the stock of S Corp, an S corporation, which owns all of the stock of FS, a foreign corporation. S Corp has a section 965(a) inclusion of $1,000x with respect to FS and has a $700x section 965(c) deduction.

(B) Analysis. As a result of the application of paragraph (f)(2)(i)(A) of this section, solely for purposes of calculating basis under section 1367(a)(1) and §1.1367–1(f), USI treats as a separately stated item of net income $300x (its pro rata share of the net of S Corp’s $1,000x aggregate section 965(a) inclusion and S Corp’s $700x aggregate section 965(c) deduction). Accordingly, USI’s basis in S Corp is increased under section 1367(a)(1) by $300x. As a result of the application of paragraph (f)(2)(i)(B) of this section, an amount of S Corp’s aggregate section 965(a) inclusion equal to its aggregate section 965(c) deduction, $700x, is treated as tax exempt income solely for purposes of calculating basis under section 1367(a)(1)(A) and §1.1367–1(f), and accordingly, USI’s basis in S Corp is further increased by its pro rata share of such amount, $700x. S Corp’s accumulated adjustments account ("AAA") is increased under section 1368(e)(1)(A) by the $1,000x section 965(a) inclusion taken into account and reduced by the $700x section 965(c) deduction taken into account. In addition, as a result of the application of paragraph (f)(2)(ii) of this section, S Corp’s AAA is further increased by an amount of S Corp’s aggregate section 965(a) inclusion equal to its aggregate section 965(c) deduction, $700x, which is not treated as tax-exempt income for purposes of §1.1368–2(a)(2).

(2) Sections 705, 1367, and 1368—(i) Adjustments to basis. In the case of a domestic partnership or S corporation—

(A) The aggregate amount of its section 965(a) inclusions net of the aggregate amount of its section 965(c) deductions is treated as a separately stated item of net income solely for purposes of calculating basis under section 705(a) and §1.705–1(a) and section 1367(a)(1) and §1.1367–1(f), and

(B) The aggregate amount of its section 965(a) inclusions equal to the aggregate amount of its section 965(c) deductions is treated as income exempt from tax solely for purposes of calculating basis under sections 705(a)(1)(B), 1367(a)(1)(A), and §1.1367–1(f).

(ii) S corporation accumulated adjustments account. In the case of an S corporation, the aggregate amount of its section 965(a) inclusions equal to the aggregate amount of its section 965(c) deductions is treated as income not exempt from tax solely for purposes of determining whether an adjustment is made to an accumulated adjustments account under section 1368(e)(1)(A) and §1.1368–2(a)(2).

(iii) Example. The following example illustrates the application of this paragraph (f)(2).

(A) Facts. USI, a United States citizen, owns all of the stock of S Corp, an S corporation, which owns all of the stock of FS, a foreign corporation. S Corp has a section 965(a) inclusion of $1,000x with respect to FS and has a $700x section 965(c) deduction.

(B) Analysis. As a result of the application of paragraph (f)(2)(i)(A) of this section, solely for purposes of calculating basis under section 1367(a)(1) and §1.1367–1(f), USI treats as a separately stated item of net income $300x (its pro rata share of the net of S Corp’s $1,000x aggregate section 965(a) inclusion and S Corp’s $700x aggregate section 965(c) deduction). Accordingly, USI’s basis in S Corp is increased under section 1367(a)(1) by $300x. As a result of the application of paragraph (f)(2)(i)(B) of this section, an amount of S Corp’s aggregate section 965(a) inclusion equal to its aggregate section 965(c) deduction, $700x, is treated as tax exempt income solely for purposes of calculating basis under section 1367(a)(1)(A) and §1.1367–1(f), and accordingly, USI’s basis in S Corp is further increased by its pro rata share of such amount, $700x. S Corp’s accumulated adjustments account ("AAA") is increased under section 1368(e)(1)(A) by the $1,000x section 965(a) inclusion taken into account and reduced by the $700x section 965(c) deduction taken into account. In addition, as a result of the application of paragraph (f)(2)(ii) of this section, S Corp’s AAA is further increased by an amount of S Corp’s aggregate section 965(a) inclusion equal to its aggregate section 965(c) deduction, $700x, which is not treated as tax-exempt income for purposes of §1.1368–2(a)(2).

(3) Section 1411. For purposes of section 1411 and §1.1411–4(f)(6), a section 965(c) deduction is not treated as being properly allocable to any section 965(a) inclusion.

(4) Section 4940. For purposes of section 4940(c)(3)(A), a section 965(c) deduction is not treated as an ordinary and necessary expense paid or incurred for the production or collection of gross investment income.

(g) Domestic pass-through entities. For purposes of determining a domestic pass-through owner share, a section 965(c) deduction amount of a domestic pass-through entity must be allocated to a domestic pass-through owner in the same proportion as an aggregate section 965(a) inclusion amount of the domestic pass-through entity for a section 958(a) U.S. shareholder inclusion year is allocated to the domestic pass-through owner.

$1,965–4 Disregard of certain transactions.

(a) Scope. This section provides rules that disregard certain transactions for purposes of applying section 965 to a United States shareholder. Paragraph (b) of this section provides rules that disregard transactions undertaken with a principal purpose of changing the amount of a section 965 element of a United States shareholder. Paragraph (c) of this section provides rules that disregard certain changes in method of accounting and entity classification elections that would otherwise change the amount of a section 965 element. Paragraph (d) of this section defines the term section 965 element. Paragraph (e) of this section provides rules of application concerning paragraphs (b) and (c) of this section. Paragraph (f) of this section provides rules that disregard certain transactions occurring between E&P measurement dates. Paragraph (g) of this section provides examples illustrating the application of this section.

(b) Transactions undertaken with a principal purpose of changing the amount of a section 965 element—(1) General rule. Except as otherwise provided in paragraph (e)(3) of this section, a transaction is disregarded for purposes of determining the amounts of all section 965 elements of a United States shareholder if each of the following conditions is satisfied with respect to any section 965 element of the United States shareholder—

(i) The transaction occurs, in whole or in part, on or after November 2, 2017 (the specified date);

(ii) The transaction is undertaken with a principal purpose of changing the amount of a section 965 element of the United States shareholder; and

(iii) The transaction would, without regard to this paragraph (b)(1), change the amount of the section 965 element of the United States shareholder.

(2) Presumptions and exceptions for the application of the general rule—(i) Overview. Under paragraphs (b)(2)(iii) through (v) of this section, certain transactions are presumed to be undertaken with a principal purpose of changing the amount of a section 965 element of a United States shareholder for purposes of paragraph (b)(1) of this section. The presumptions described in paragraphs (b)(2)(iii) through (v) of this section may be rebutted only if facts and circumstances clearly establish that the transaction was not undertaken with a principal purpose of changing the amount of a sec-
tion 965 element of a United States shareholder. A taxpayer that takes the position that the presumption is rebutted must attach a statement to its 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. In the case of a transaction described in paragraph (b)(2)(iii) or (iv) of this section, if the presumption does not apply because the transaction occurs in the ordinary course of business, whether the transaction was undertaken with a principal purpose of changing the amount of a section 965 element of a United States shareholder must be determined under all the facts and circumstances. Under paragraphs (b)(2)(ii) through (v) of this section, certain transactions are treated per se as being undertaken with a principal purpose of changing the amount of a section 965 element of a United States shareholder, and, therefore, such transactions are disregarded under paragraph (b)(1) of this section if the conditions of paragraphs (b)(1)(i) and (iii) of this section are satisfied. Further, under paragraph (b)(2)(iii) of this section, certain distributions are treated per se as not being undertaken with a principal purpose of changing the amount of a section 965 element of a United States shareholder and therefore are not disregarded under paragraph (b)(1) of this section.

(ii) Definitions—(A) Relatedness. For purposes of paragraphs (b)(2)(ii) through (v) of this section, a person is treated as related to a United States shareholder if, either immediately before or immediately after the transaction (or series of related transactions), the person bears a relationship to the United States shareholder described in section 267(b) or section 707(b).

(B) Transfer—(1) In general. For purposes of paragraphs (b)(2)(iii) and (v) of this section, the term transfer includes any disposition of stock or property, including a sale or exchange, contribution, distribution, issuance, redemption, recapitalization, or loan of stock or property, and includes an indirect transfer of stock or property.

(2) Indirect transfer. For purposes of paragraph (b)(2)(ii)(B)(I) of this section, the term indirect transfer includes a transfer of property or stock owned by an entity through a transfer of an interest in such entity (or an interest in an entity that has a direct or indirect interest in such entity), and a transfer of property or stock to a person through a transfer of property or stock to a pass-through entity of which such person is a direct or indirect owner.

(iii) Cash reduction transactions—(A) General rule. For purposes of paragraph (b)(1) of this section, a cash reduction transaction is presumed to be undertaken with a principal purpose of changing the amount of a section 965 element of a United States shareholder. For this purpose, the term cash reduction transaction means a transfer of cash, accounts receivable, or cash-equivalent assets by a specified foreign corporation to a United States shareholder of the specified foreign corporation or a person related to a United States shareholder, and, therefore, such transactions are not disregarded under paragraph (b)(1) of this section if the transaction is presumed to be undertaken with a principal purpose of changing the amount of a section 965 element of a United States shareholder.

(iv) E&P reduction transactions—(A) General rule. For purposes of paragraph (b)(1) of this section, an E&P reduction transaction is presumed to be undertaken with a principal purpose of changing the amount of a section 965 element of a United States shareholder. For purposes of this paragraph (b)(2)(iv), the term E&P reduction transaction means a transaction between a specified foreign corporation and any of a United States shareholder of the specified foreign corporation, another specified foreign corporation of a United States shareholder of the specified foreign corporation, and any person related to a United States shareholder of the specified foreign corporation, another specified foreign corporation of a United States shareholder of the specified foreign corporation, or an entity, or loan of stock or property, and includes an indirect transfer of stock or property.

(2) Indirect transfer. For purposes of paragraph (b)(2)(ii)(B)(I) of this section, the term indirect transfer includes a transfer of property or stock owned by an entity through a transfer of an interest in such entity (or an interest in an entity that has a direct or indirect interest in such entity), and a transfer of property or stock to a person through a transfer of property or stock to a pass-through entity of which such person is a direct or indirect owner.

(iv) E&P reduction transactions—(A) General rule. For purposes of paragraph (b)(1) of this section, an E&P reduction transaction is presumed to be undertaken with a principal purpose of changing the amount of a section 965 element of a United States shareholder. For purposes of this paragraph (b)(2)(iv), the term E&P reduction transaction means a transaction between a specified foreign corporation and any of a United States shareholder of the specified foreign corporation, another specified foreign corporation of a United States shareholder of the specified foreign corporation, and any person related to a United States shareholder of the specified foreign corporation, another specified foreign corporation of a United States shareholder of the specified foreign corporation, or an entity, or loan of stock or property, and includes an indirect transfer of stock or property.
does not apply to an E&P reduction transaction that occurs in the ordinary course of business.

(B) Per se rule for specified transactions. A specified transaction is treated per se as being undertaken with a principal purpose of changing the amount of a section 965 element of a United States shareholder for purposes of paragraph (b)(1) of this section. For purposes of the preceding sentence, the term specified transaction means an E&P reduction transaction that involves one or more of the following: a complete liquidation of a specified foreign corporation to which section 331 applies; a sale or other disposition of stock by a specified foreign corporation; or a distribution by a specified foreign corporation that reduces the earnings and profits of the specified foreign corporation pursuant to section 312(a)(3).

(v) Pro rata share transactions—(A) General rule. For purposes of paragraph (b)(1) of this section, a pro rata share transaction is presumed to be undertaken with a principal purpose of changing the amount of a section 965 element of a United States shareholder. For this purpose, the term pro rata share transaction means either a pro rata share reduction transaction or an E&P deficit transaction.

(I) Definition of pro rata share reduction transaction. For purposes of this paragraph (b)(2)(v)(A), the term pro rata share reduction transaction means a transfer of the stock of a specified foreign corporation by either a United States shareholder of the specified foreign corporation or a person related to a United States shareholder of the specified foreign corporation (including by the specified foreign corporation itself) to a person related to the United States shareholder if the transfer would, without regard to paragraph (b)(1) of this section, reduce the United States shareholder’s pro rata share of the section 965(a) earnings amount of the specified foreign corporation, reduce the United States shareholder’s pro rata share of the cash position of the specified foreign corporation, or both.

(2) Definition of E&P deficit transaction. For purposes of this paragraph (b)(2)(v)(A), the term E&P deficit transaction means a transfer to either a United States shareholder or a person related to the United States shareholder of the stock of an E&P deficit foreign corporation by a person related to the United States shareholder (including by the E&P deficit foreign corporation itself) if the transfer would, without regard to paragraph (b)(1) of this section, increase the United States shareholder’s pro rata share of the specified E&P deficit of the E&P deficit foreign corporation.

(B) Per se rule for internal group transactions. An internal group transaction is treated per se as being undertaken with a principal purpose of changing the amount of a section 965 element of a United States shareholder for purposes of paragraph (b)(1) of this section. For purposes of the preceding sentence, the term internal group transaction means a pro rata share transaction if, immediately before or after the transfer, the transferor of the stock of the specified foreign corporation and the transferee of such stock are members of an affiliated group in which the United States shareholder is a member. For this purpose, the term affiliated group has the meaning set forth in section 1504(a), determined without regard to paragraphs (1) through (8) of section 1504(a), determined without regard to paragraphs (1) through (8) of section 1504(b), and the term members of an affiliated group means entities included in the same affiliated group. For purposes of identifying an affiliated group and the members of such group, each partner in a partnership, as determined without regard to this sentence, is treated as holding its proportionate share of the stock held by the partnership, as determined under the rules and principles of sections 701 through 777, and if one or more members of an affiliated group own, in the aggregate, at least 80 percent of the interests in a partnership’s capital or profits, the partnership will be treated as a corporation that is a member of the affiliated group.

(C) Example. The following example illustrates the application of the rules in this paragraph (b)(2)(v).

(I) Facts. FP, a foreign corporation, owns all of the stock of USP, a domestic corporation. USP owns all of the stock of FS, a foreign corporation. USP has a calendar year taxable year; FS’s taxable year ends November 30. On January 2, 2018, USP transfers all of the stock of FS to FP in exchange for cash. On January 3, 2018, FS makes a distribution with respect to the stock transferred to FP. USP treats the transaction as a taxable sale of the FS stock and claims a dividends received deduction under section 245A with respect to its deemed dividend under section 1248(j) as a result of the sale. FS has post-1986 earnings and profits as of December 31, 2017, and no post-1986 earnings and profits that are attributable to income effectively connected with the conduct of a trade or business within the United States and subject to tax under chapter 1 or that, if distributed, would be excluded from the gross income of a United States shareholder under section 959.

(2) Analysis. The transfer of the stock of FS is a pro rata share reduction transaction and thus a pro rata share transaction because such transfer is by USP, a United States shareholder, to FP, a person related to USP, and the transfer would, without regard to the rule in paragraph (b)(1) of this section, reduce USP’s pro rata share of the section 965(a) earnings amount of FS. Because USP and FP are also members of an affiliated group within the meaning of paragraph (b)(2)(v)(B) of this section, the transfer of the stock of FS is also an internal group transaction and is treated per se as being undertaken with a principal purpose of changing the amount of a section 965 element of USP. Accordingly, because the transfer occurs after the specified date and reduces USP’s section 965(a) inclusion amount with respect to FS, the transfer is disregarded for purposes of determining any section 965 element of USP with the result that, among other things, USP’s pro rata share of FS’s section 965(a) earnings amount is determined as if USP owned (within the meaning of section 958(a)) 100% of the stock of FS on the last day of FS’s inclusion year and no other person received a distribution with respect to such stock during such year. See section 951(a)(2)(A) and (B).

(c) Disregard of certain changes in method of accounting and entity classification elections—(1) Changes in method of accounting. Any change in method of accounting made for a taxable year of a specified foreign corporation that ends in 2017 or 2018 is disregarded for purposes of determining the amounts of all section 965 elements with respect to a United States shareholder if the change in method of accounting would, without regard to this paragraph (c)(1), change the amount of any section 965 element described in paragraph (d)(1) or (2) of this section with respect to the United States shareholder, or change the amount of the section 965 element described in paragraph (d)(3) of this section other than by reason of an increase in a section 965(a) inclusion amount with respect to the specified foreign corporation, regardless of whether the change in method of accounting is made with a principal purpose of changing the amount of a section 965 element with respect to the United States shareholder. The rule described in the preceding sentence applies regardless of whether the change in method of accounting was made in accordance with the procedures described in Rev. Proc. 2015–13, 2015–5
I.R.B. 419 (or successor), and regardless of whether the change in method of accounting was properly made, but it does not apply to a change in method of accounting for which the original and/or duplicate copy of any Form 3115, “Application for Change in Accounting Method,” requesting the change was filed before the specified date (as defined in paragraph (b)(1) of this section).

(2) Entity classification elections. Except as otherwise provided in paragraph (e)(3) of this section, an election under §301.7701–3 to change the classification of an entity that is filed on or after the specified date (as defined in paragraph (b)(1) of this section) is disregarded for purposes of determining the amounts of all section 965 elements of a United States shareholder if the election would, without regard to this paragraph (c)(2), change the amount of any section 965 element of the United States shareholder, regardless of whether the election is made with a principal purpose of changing the amount of a section 965 element of the United States shareholder. An election filed on or after the specified date is subject to the preceding sentence even if the election was filed with an effective date that is before the specified date.

(d) Definition of a section 965 element. For purposes of paragraphs (b) and (c) of this section, the term section 965 element means, with respect to a United States shareholder, any of the following amounts (collectively, section 965 elements)—

(1) The United States shareholder’s section 965(a) inclusion amount with respect to a specified foreign corporation;
(2) The aggregate foreign cash position of the United States shareholder; or
(3) The amount of foreign income taxes of a specified foreign corporation deemed paid by the United States shareholder under section 960 as a result of a section 965(a) inclusion.

(e) Rules for applying paragraphs (b) and (c) of this section—(1) Determination of whether there is a change in the amount of a section 965 element. For purposes of paragraphs (b) and (c) of this section, there is a change in the amount of a section 965 element of a United States shareholder as a result of a transaction, change in accounting method, or election to change an entity’s classification, if, with-out regard to paragraph (b)(1), (c)(1), or (c)(2) of this section, the transaction, change in accounting method, or change in entity classification would—

(i) Reduce the amount described in paragraph (d)(1) of this section,
(ii) Reduce the amount described in paragraph (d)(2) of this section, but only if such amount is less than the United States shareholder’s aggregate section 965(a) inclusion amount, or
(iii) Increase the amount described in paragraph (d)(3) of this section.

(2) Treatment of domestic pass-through owners as United States shareholders. For purposes of paragraphs (b) and (c) of this section, if a domestic pass-through entity is a United States shareholder, then a domestic pass-through owner with respect to the domestic pass-through entity that is not otherwise a United States shareholder is treated as a United States shareholder.

(3) Exception for certain incorporation transactions—(i) In general. Paragraphs (b) and (c)(2) of this section do not apply to disregard a transfer of stock of a specified foreign corporation by a United States shareholder to a domestic corporation (for this purpose, including an S corporation), provided that—

(A) The transferee’s section 965(a) inclusion amount with respect to the transferred stock of the specified foreign corporation is no lower than the transferor’s section 965(a) inclusion amount with respect to the transferred stock of the specified foreign corporation, determined without regard to the transfer; and
(B) The transferee and the transferor determine their aggregate foreign cash position under paragraph (e)(3)(ii) of this section.

(ii)Aggregate foreign cash position. In the case of a transfer described in paragraph (e)(3)(i) of this section, in order to rely on the exception in paragraph (e)(3)(i) of this section—

(A) The transferee must treat its pro rata share of the cash position of a specified foreign corporation as of a cash measurement date as of which it did not own the transferred stock of the specified foreign corporation as including the transferor’s pro rata share of the cash position of the specified foreign corporation with respect to the transferred stock of the specified foreign corporation as of such cash measurement date for purposes of determining its aggregate foreign cash position; and
(B) The transferor must treat its pro rata share of the cash position of a specified foreign corporation as of a cash measurement date as of which it did not own the transferred stock of the specified foreign corporation as including the transferor’s pro rata share of the cash position of the specified foreign corporation with respect to the transferred stock of the specified foreign corporation as of such cash measurement date for purposes of determining its aggregate foreign cash position.

(4) Consequences of liquidation—(i) Specified liquidation date. The term specified liquidation date means, in the case of a liquidation of a specified foreign corporation that is disregarded for purposes of determining the amounts of the section 965 elements of a United States shareholder, the date that is treated as the last day of the taxable year of the specified foreign corporation.

(A) The date of the liquidation; and
(B) The specified liquidation date, if any.

(ii) Specified liquidation date. The term specified liquidation date means, in the case of a liquidation of a specified foreign corporation pursuant to an entity classification election that is disregarded for purposes of determining the amounts of the section 965 elements of a United States shareholder—

(A) November 30, 2017, with respect to a United States shareholder that must include in income under §1.367(b)— as a deemed dividend the all earnings and profits amount with respect to the United States shareholder’s stock of the liquidating specified foreign corporation; or
(B) The date of filing of the entity classification election, with respect to all other United States shareholders.

(f) Disregard of certain transactions occurring between E&P measurement dates—(1) Disregard of specified payments. Except as provided in paragraph (f)(3) of this section, a specified payment made by a specified foreign corporation (payor specified foreign corporation) to another specified foreign corporation (payee specified foreign corporation) is
disregarded for purposes of determining the post–1986 earnings and profits of each of the payor specified foreign corporation and the payee specified foreign corporation as of the E&P measurement date on December 31, 2017.

(2) Definition of specified payment. For purposes of paragraph (f)(1) of this section, the term specified payment means any amount paid or accrued by the payor specified foreign corporation, including a distribution by the payor specified foreign corporation with respect to its stock, if each of the following conditions are satisfied:

(i) Immediately before or immediately after the payment or accrual of the amount, the payor specified foreign corporation and the payee specified foreign corporation are related within the meaning of section 954(d)(3), substituting the term “specified foreign corporation” for “controlled foreign corporation” in each place that it appears;

(ii) The payment or accrual of the amount occurs after November 2, 2017, and on or before December 31, 2017; and

(iii) The payment or accrual of the amount would, without regard to the application of paragraph (f)(1) of this section, reduce the post–1986 earnings and profits of the payor specified foreign corporation as of the E&P measurement date on December 31, 2017.

(3) Non-application of disregard rule.

A section 958(a) U.S. shareholder may determine the post–1986 earnings and profits of a specified foreign corporation without regard to paragraph (f)(1) of this section, provided that it and every section 958(a) U.S. shareholder related to the first section 958(a) U.S. shareholder determines the post–1986 earnings and profits of each of its specified foreign corporations without regard to paragraph (f)(1) of this section. For purposes of this paragraph (f)(3), a person is treated as related to a section 958(a) U.S. shareholder if the person bears a relationship to the section 958(a) U.S. shareholder described in section 267(b) or 707(b).

(4) Examples. The following examples illustrate the application of the rules in this paragraph (f).

Example 1. Deductible payment between wholly owned specified foreign corporations is a specified payment. (A) Facts. USP, a domestic corporation, owns all of the stock of CFC1, a foreign corporation, which owns all of the stock of CFC2, also a foreign corporation. USP, CFC1, and CFC2 have calendar year taxable years. On November 2, 2017, each of CFC1 and CFC2 has post–1986 earnings and profits of 100u. Neither CFC1 nor CFC2 has post–1986 earnings and profits that are attributable to income of the specified foreign corporation that is effectively connected with the conduct of a trade or business within the United States and subject to tax under chapter 1 or that, if distributed, would be excludable from the gross income of a United States shareholder under section 959 or from the gross income of another shareholder if such shareholder were a United States shareholder; therefore, no adjustment is made under section 965(d)(2) or §1.965–1(f)(7), and each of CFC1’s and CFC2’s accumulated post–1986 deferred foreign income is equal to such corporation’s post–1986 earnings and profits. On November 3, 2017, CFC2 makes a deductible payment of 10u to CFC1. The payment does not constitute part F income. CFC1 and CFC2 have no other items of income or deduction.

(B) Analysis. The payment from CFC2 to CFC1 is a specified payment because (1) CFC1 and CFC2 are related specified foreign corporations; (2) the payment occurs after November 2, 2017, and on or before December 31, 2017; and (3) the payment would, without regard to the application of the rule in paragraph (f)(1) of this section, reduce the post–1986 earnings and profits of CFC2 as of the E&P measurement date on December 31, 2017. Under paragraph (f)(1) of this section, the payment is disregarded, and CFC1 and CFC2 each have post–1986 earnings and profits of 100u as of December 31, 2017. Accordingly, the section 965(a) earnings amount of each of CFC1 and CFC2 is 100u.

Example 2. Distribution is a specified payment. (A) Facts. The facts are the same as in paragraph (f)(4)(i)(A) of this section (the facts in Example 1), except that CFC2 does not make a deductible payment to CFC1, and, between E&P measurement dates, CFC2 accrues gross income of 20u from a person that is not related to CFC2, and CFC1 incurs a deductible expense of 20u to a person that is not related to CFC1.

(B) Analysis. Paragraph (f)(1) of this section does not apply because neither the deductible expense of CFC1 nor the income accrual by CFC2 are attributable to a specified payment.

Example 4. Deductible payment between unrelated specified foreign corporations is not a specified payment. (A) Facts. The facts are the same as in paragraph (f)(4)(i)(A) of this section (the facts in Example 1), except that CFC1 owns only 50% of the only class of stock of CFC2, the remainder of which is owned by USI, a United States citizen unrelated to USP, CFC1, and CFC2.

(B) Analysis. The analysis is the same as in paragraph (f)(4)(i)(B) of this section (the analysis in Example 1); thus, the payment is disregarded with the result that CFC1 and CFC2 each have post–1986 earnings and profits of 100u as of the E&P measurement date on December 31, 2017, and a section 965(a) earnings amount of 100u.

Example 5. Deductible payment and income accrued from unrelated persons are not specified payments. (A) Facts. The facts are the same as in paragraph (f)(4)(i)(A) of this section (the facts in Example 1), except that CFC2 does not make a deductible payment to CFC1, and, between E&P measurement dates, CFC2 accrues gross income of 20u from a person that is not related to CFC2, and CFC1 incurs a deductible expense of 20u to a person that is not related to CFC1.

(B) Analysis. Paragraph (f)(1) of this section does not apply because neither the deductible expense of CFC1 nor the income accrual by CFC2 are attributable to a specified payment.
for foreign income taxes in connection with the application of section 965. Paragraph (b) of this section provides rules under section 965(g) for the allowance of a credit or deduction for foreign income taxes paid or accrued. Paragraph (c) of this section provides rules for the allowance of a credit or deduction for foreign income taxes treated as paid or accrued in connection with the application of section 965. Paragraph (d) of this section defines the term applicable percentage.

(b) Rules for foreign income taxes paid or accrued. Neither a deduction (including under section 164) nor a credit under section 901 is allowed for the applicable percentage of any foreign income taxes paid or accrued with respect to any amount for which a section 965(c) deduction is allowed for a section 958(a) U.S. shareholder inclusion year. Neither a deduction (including under section 164) nor a credit under section 901 is allowed for the applicable percentage of any foreign income taxes attributable to a distribution of section 965(a) previously taxed earnings and profits or section 965(b) previously taxed earnings and profits. Accordingly, for example, no deduction or credit is allowed for the applicable percentage of any withholding taxes imposed on a United States shareholder by the jurisdiction of residence of the distributing foreign corporation with respect to a distribution of section 965(a) previously taxed earnings and profits or section 965(b) previously taxed earnings and profits. Similarly, for example, no deduction or credit is allowed for the applicable percentage of foreign income taxes imposed on a United States citizen by the citizen’s jurisdiction of residence upon receipt of a distribution of section 965(a) previously taxed earnings and profits or section 965(b) previously taxed earnings and profits.

(c) Rules for foreign income taxes treated as paid or accrued—(1) Disallowed credit—(i) In general. A credit under section 901 is not allowed for the applicable percentage of any foreign income taxes treated as paid or accrued with respect to any amount for which a section 965(c) deduction is allowed for a section 958(a) U.S. shareholder inclusion year. For purposes of the preceding sentence, taxes treated as paid or accrued include foreign income taxes deemed paid under section 960(a)(1) with respect to a section 965(a) inclusion, foreign income taxes deemed paid under section 960(a)(3) (as in effect on December 21, 2017) or section 960(b) (as applicable to taxable years of controlled foreign corporations beginning after December 31, 2017) with respect to distributions of section 965(a) previously taxed earnings and profits or section 965(b) previously taxed earnings and profits, foreign income taxes allocated to an entity under §1.901–2(f)(4), and a distributive share of foreign income taxes paid or accrued by a partnership.

(ii) Foreign income taxes deemed paid under section 960(a)(3) (as in effect on December 21, 2017). Foreign income taxes deemed paid by a domestic corporation under section 960(a)(3) with respect to a distribution of section 965(a) previously taxed earnings and profits or section 965(b) previously taxed earnings and profits include only the foreign income taxes paid or accrued by an upper-tier foreign corporation with respect to a distribution of section 965(a) previously taxed earnings and profits or section 965(b) previously taxed earnings and profits from a lower-tier foreign corporation. No credit is allowed under section 960(a)(3) or any other section for foreign income taxes that would have been deemed paid under section 960(a)(1) with respect to the portion of section 965(a) earnings amount that is reduced under §1.965–1(b)(2) or §1.965–8(b).

(iii) [Reserved]

(2) Disallowed deduction. No deduction (including under section 164) is allowed for the applicable percentage of any foreign income taxes treated as paid or accrued with respect to any amount for which a section 965(c) deduction is allowed. Such taxes include foreign income taxes allocated to an entity under §1.901–2(f)(4) and a distributive share of foreign income taxes paid or accrued by a partnership.

(i) In general. With respect to foreign income taxes deemed paid by a domestic corporation with respect to its section 965(a) inclusion amount for a section 958(a) U.S. shareholder inclusion year, section 78 applies only to so much of such taxes as bears the same proportion to the amount of such taxes as—

(A) The excess of—

(I) The section 965(a) inclusion amount for a section 958(a) U.S. shareholder inclusion year, over

(II) The amount described in paragraph (d)(1)(i)(B) of this section.

(B) Such section 965(a) inclusion amount.

(ii) Domestic corporation that is a domestic pass-through owner. With respect to foreign income taxes deemed paid by a domestic corporation attributable to such corporation’s domestic pass-through owner share of a section 965(a) inclusion amount of a domestic pass-through entity, section 78 applies only to so much of such taxes as bears the same proportion to the amount of such taxes as the proportion determined under paragraph (c)(3)(i) of this section as applied to the domestic pass-through entity’s section 965(a) inclusion amount for a section 958(a) U.S. shareholder inclusion year.

(d) Applicable percentage—(1) In general. For purposes of this section, except as provided in paragraph (d)(2) and (d)(3) of this section, the term applicable percentage means, with respect to a section 958(a) U.S. shareholder and a section 958(a) U.S. shareholder inclusion year, the amount (expressed as a percentage) equal to the sum of—

(i) 0.771 multiplied by the ratio of—

(A) The section 958(a) U.S. shareholder’s 8 percent rate amount for the section 958(a) U.S. shareholder inclusion year, divided by

(B) The sum of the section 958(a) U.S. shareholder’s 8 percent rate amount for the section 958(a) U.S. shareholder inclusion year plus the section 958(a) U.S. shareholder’s 15.5 percent rate amount for the section 958(a) U.S. shareholder inclusion year; plus

(ii) 0.557 multiplied by the ratio of—

(A) The section 958(a) U.S. shareholder’s 15.5 percent rate amount for the section 958(a) U.S. shareholder inclusion year, divided by

(B) The amount described in paragraph (d)(1)(i)(B) of this section.

(2) No section 965(a) inclusion amount. If a section 958(a) U.S. shareholder does not have an aggregate section 965(a) inclusion amount, the section 958(a) U.S. shareholder’s applicable percentage is 55.7 percent.
(3) Applicable percentage for domestic pass-through owners. In the case of a domestic pass-through owner with respect to a domestic pass-through entity, the domestic pass-through owner’s applicable percentage that is applied to foreign income taxes attributable to the domestic pass-through owner share of the section 965(a) inclusion amount or of distributions of section 965(a) previously taxed earnings and profits or section 965(b) previously taxed earnings and profits is equal to the applicable percentage determined under paragraph (d)(1) or (2) of this section, as applicable, with respect to the domestic pass-through entity.

(4) Applicable percentage with respect to certain distributions of previously taxed earnings and profits. In the case of a distribution of section 965(a) previously taxed earnings and profits or section 965(b) previously taxed earnings and profits (other than with respect to a section 958(a) U.S. shareholder described in paragraph (d)(2) of this section), the applicable percentage that is applied to foreign income taxes attributable to the distribution is the applicable percentage that applied with respect to the section 958(a) U.S. shareholder and the section 958(a) U.S. inclusion year in which, or with which, the inclusion year of the relevant deferred foreign income corporation ends.

For this purpose, the relevant deferred foreign income corporation is the deferred foreign income corporation with respect to which the section 958(a) U.S. shareholder; and

(a) Scope. This section provides rules for the computation of foreign income taxes deemed paid and the allocation and apportionment of deductions. Paragraph (b) of this section provides the general rules for the computation of foreign income taxes deemed paid under sections 902 and 960. Paragraph (c) of this section provides rules for allocation and apportionment of expenses. Paragraph (d) of this section provides rules for foreign income taxes associated with hovering deficits.

(b) Computation of foreign incomes taxes deemed paid—(1) In general. For purposes of determining foreign income taxes deemed paid under section 960(a)(1) with respect to a section 965(a) inclusion attributable to a deferred foreign income corporation that is a member of a qualified group (as defined in section 902(b)(2)), section 902 applies as if the section 965(a) inclusion, translated (if necessary) into the functional currency of the deferred foreign income corporation using the spot rate on December 31, 2017, were a dividend paid by the deferred foreign income corporation.

(2) Dividend or inclusion in excess of post–1986 undistributed earnings. When the denominator of the section 902 fraction is positive but less than the numerator of such fraction, the section 902 fraction is one. When the denominator of the section 902 fraction is zero or less than zero, the section 902 fraction is zero, and no foreign taxes are deemed paid.

(3) Treatment of adjustment under section 965(b)(4)(B). For purposes of section 902(c)(1), the post–1986 undistributed earnings of an E&P deficit foreign corporation are increased under section 965(b)(4)(B) and §1.965–2(d)(2)(i)(A) as of the first day of the foreign corporation’s first taxable year following the E&P deficit foreign corporation’s last taxable year that begins before January 1, 2018.

(4) Section 902 fraction. The term section 902 fraction means, with respect to either a deferred foreign income corporation or an E&P deficit foreign corporation, the fraction that is—

(i) The dividends paid by, or the inclusion under section 951(a)(1) (including a section 965(a) inclusion) with respect to, the foreign corporation, as applicable (the numerator), divided by

(ii) The foreign corporation’s post–1986 undistributed earnings or pre–1987 accumulated profits, as applicable (the denominator).
Paragraph (d) of this section provides rules regarding the section 965(m) election and a special rule for real estate investment trusts. Paragraph (e) of this section provides rules regarding the section 965(n) election. Paragraph (f) of this section provides rules regarding the election to use the alternative method for calculating post–1986 earnings and profits. Paragraph (g) of this section provides definitions that apply for purposes of this section.

(b) Section 965(h) election—(1) In general. Any person with a section 965(h) net tax liability (that is, a section 958(a) U.S. shareholder or a domestic pass-through owner with respect to a domestic pass-through entity that is a section 958(a) U.S. shareholder, but not a domestic pass-through entity itself) may elect under section 965(h) and this paragraph (b) to pay its section 965(h) net tax liability in eight installments. This election may be revoked only by paying the full amount of the remaining unpaid section 965(h) net tax liability.

(i) Amount of installments. Except as provided in paragraph (b)(3) of this section, if a person makes a section 965(h) election, the amounts of the installments are—

(A) Eight percent of the section 965(h) net tax liability in the case of each of the first five installments;

(B) Fifteen percent of the section 965(h) net tax liability in the case of the sixth installment;

(C) Twenty percent of the section 965(h) net tax liability in the case of the seventh installment; and

(D) Twenty-five percent of the section 965(h) net tax liability in the case of the eighth installment.

(ii) Increased installments due to a deficiency or a timely filed or amended return—(A) In general. If a person makes a section 965(h) election, except as provided in paragraph (b)(1)(ii)(C) of this section, any deficiency or additional liability will be prorated to the installments described under paragraph (b)(1)(i) of this section if any of the following occur:

(1) A deficiency is assessed with respect to the person’s section 965(h) net tax liability;

(2) The person files a return by the due date of the return (taking into account extensions, if any) increasing the amount of its section 965(h) net tax liability beyond that taken into account in paying the first installment described under paragraph (b)(1)(i) of this section; or

(3) The person files an amended return that reflects an increase in the amount of its section 965(h) net tax liability.

(B) Timing. If the due date for the payment of an installment to which the deficiency is prorated has passed, the amount prorated to such installment must be paid on notice and demand by the Secretary, or, in the case of an additional liability reported on a return increasing the amount of the section 965(h) net tax liability after payment of the first installment or on an amended return, with the filing of the return. If the due date for the payment of an installment to which the deficiency or additional liability is prorated has not passed, then such amount will be due at the same time as, and as part of, the relevant installment.

(C) Exception for negligence, intentional disregard, or fraud. If a deficiency or additional liability is due to negligence, intentional disregard of rules and regulations, or fraud with intent to evade tax, the proration rule of this paragraph (b)(1)(ii) will not apply, and the deficiency or additional liability (as well as any applicable interest and penalties) must be paid on notice and demand by the Secretary, or, in the case of an additional liability reported on a return increasing the amount of the section 965(h) net tax liability after payment of the first installment or on an amended return, with the filing of the return.

(iii) Due date of installments—(A) In general. If a person makes a section 965(h) election, the first installment payment is due on the due date (without regard to extensions) for the return for the relevant taxable year. For purposes of this paragraph (b), the term relevant taxable year means, in the case in which the person is a section 958(a) U.S. shareholder, the section 958(a) U.S. shareholder inclusion year, or, in the case in which the person is a domestic pass-through owner, the taxable year in which the person has the section 965(a) inclusion to which the section 965(h) net tax liability is attributable. Each succeeding installment payment is due on the due date (without regard to extensions) for the return for the taxable year following the taxable year with respect to which the previous installment payment was made.

(B) Extension for specified individuals. If a person is a specified individual with respect to a taxable year within which an installment payment is due pursuant to paragraph (b)(1)(iii)(A) of this section, then, for purposes of determining the due date of an installment payment under paragraph (b)(1)(iii)(A) of this section, the due date of the return (without regard to extensions) due within the taxable year will be treated as the fifteenth day of the sixth month following the close of the prior taxable year. This paragraph (b)(1)(iii)(B) is applicable regardless of whether the person is a specified individual with respect to the relevant taxable year.

(2) Manner of making election—(i) Eligibility. Any person with a section 965(h) net tax liability may make the section 965(h) election, provided that, with respect to the person, none of the acceleration events described in paragraph (b)(3)(ii) of this section has occurred before the election is made. Notwithstanding the preceding sentence, a person that would be eligible to make the section 965(h) election but for the occurrence of an event described in paragraph (b)(3)(ii) of this section may make the section 965(h) election if the exception described in paragraph (b)(3)(iii)(A) of this section applies.

(ii) Timing. A section 965(h) election must be made no later than the due date (taking into account extensions, if any, or any additional time that would have been granted if the person had made an extension request) for the return for the relevant taxable year. Relief is not available under §301.9100–2 or §301.9100–3 to file a late election.

(iii) Election statement. Except as otherwise provided in publications, forms, instructions, or other guidance, to make a section 965(h) election, a person must attach a statement, signed under penalties of perjury consistent with the rules for signatures applicable to the person’s return, to its return for the relevant taxable year. The statement must include the person’s name, taxpayer identification number, total net tax liability under section 965, section 965(h) net tax liability, section 965(i) net tax liability with respect to
which a section 965(i) election is effective (if applicable), and the anticipated amounts of each installment described under paragraph (b)(1)(i) of this section. The statement must be filed in the manner prescribed in publications, forms, instructions, or other guidance. The attachment of an unsigned copy of the election statement to the timely-filed return for the relevant taxable year satisfies the signature requirement of this paragraph (b)(2)(i) if the person making the election retains the original signed election statement in the manner specified by §1.6001–1(e).

(3) Acceleration of payment—(i) Acceleration. Notwithstanding paragraph (b)(1)(i) of this section, if a person makes a section 965(h) election and an acceleration event described in paragraph (b)(3)(ii) of this section subsequently occurs, then, except as provided in paragraph (b)(3)(iii) of this section, the unpaid portion of the remaining installments will be due on the date of the acceleration event (or in the case of a title 11 or similar case, the day before the petition is filed).

(ii) Acceleration events. The following events are acceleration events for purposes of paragraph (b)(3)(i) of this section with respect to a person that has made a section 965(h) election—

(A) An addition to tax is assessed for the failure to timely pay an installment described in paragraph (b)(1)(i) of this section;

(B) A liquidation, sale, exchange, or other disposition of substantially all of the assets of the person (including in a title 11 or similar case, or, in the case of an individual, by reason of death);

(C) In the case of a person that is not an individual, a cessation of business by the person;

(D) Any event that results in the person no longer being a United States person, including a resident alien (as defined in section 7701(b)(1)(A)) becoming a nonresident alien (as defined in section 7701(b)(1)(B));

(E) In the case of a person that was not a member of any consolidated group, the person becoming a member of a consolidated group;

(F) In the case of a consolidated group, the group ceasing to exist (including by reason of the acquisition of a consolidated group within the meaning of §1.1502–13(j)(5)) or the group otherwise discontinuing in the filing of a consolidated return; or

(G) A determination by the Commissioner described in the second sentence of paragraph (b)(3)(iii)(C)(2) of this section.

(iii) Eligible section 965(h) transferee exception—(A) In general. Paragraph (b)(3)(i) of this section does not apply (such that the unpaid portion of all remaining installments will not be due as of the date of the acceleration event) to a person with respect to which an acceleration event occurs if the requirements described in paragraphs (b)(3)(iii)(A)(1) and (2) of this section are satisfied. A person with respect to which an acceleration event described in this paragraph (b)(3)(iii)(A) occurs is referred to as an eligible section 965(h) transferee.

(1) Requirement to have a covered acceleration event. The acceleration event satisfies the requirements of this paragraph (b)(3)(iii)(A)(1) if it is described in—

(i) Paragraph (b)(3)(ii)(B) of this section, and the acceleration event is a qualifying consolidated group member transaction within the meaning of paragraph (b)(3)(iii)(E) of this section;

(ii) Paragraph (b)(3)(ii)(B) of this section (other than, in the case of an individual, an acceleration event caused by reason of death) in a transaction that is not a qualifying consolidated group member transaction;

(iii) Paragraph (b)(3)(ii)(E) of this section;

(iv) Paragraph (b)(3)(ii)(F) of this section, and the acceleration event results from the acquisition of a consolidated group within the meaning of §1.1502–13(j)(5), and the acquired consolidated group members join a different consolidated group as of the day following the acquisition;

(v) Paragraph (b)(3)(ii)(F) of this section, and the group ceases to exist as a result of the transfer of all of the assets of one or more members of the consolidated group to other members with only one entity remaining (the successor entity); or

(vi) Paragraph (b)(3)(ii)(F) of this section, and the group ceases to exist as a result of the termination of the subchapter S election pursuant to section 1362(d) of a shareholder of the common parent of the consolidated group and, for the shareholder’s taxable year immediately following the termination, the shareholder joins in the filing of a consolidated return as a consolidated group that includes all of the former members of the former consolidated group.

(2) Requirement to enter into a transfer agreement. An eligible section 965(h) transferee and an eligible section 965(h) transferee (as defined in paragraph (b)(3)(iii)(B)(1) of this section) must enter into an agreement with the Commissioner that satisfies the requirements of paragraph (b)(3)(iii)(B) of this section.

(B) Transfer agreement—(1) Eligibility. A transfer agreement that satisfies the requirements of this paragraph (b)(3)(iii)(B) must be entered into by an eligible section 965(h) transferee and an eligible section 965(h) transferee. For this purpose, the term eligible section 965(h) transferee refers to a single United States person that is not a domestic pass-through entity and that—

(i) With respect to an acceleration event described in paragraph (b)(3)(iii)(A)(1) of this section, is a departing member (as defined in paragraph (b)(3)(iii)(E)(1)(i) of this section) or its qualified successor (as defined in paragraph (b)(3)(iii)(E)(2) of this section);

(ii) With respect to an acceleration event described in paragraph (b)(3)(iii)(A)(1)(i) of this section, acquires substantially all of the assets of an eligible section 965(h) transferee;

(iii) With respect to an acceleration event described in paragraph (b)(3)(iii)(A)(1)(ii) of this section, is the agent (within the meaning of §1.1502–77) of the consolidated group that the eligible section 965(h) transferee joins;

(iv) With respect to an acceleration event described in paragraph (b)(3)(iii)(A)(1)(iii) of this section, is the agent (within the meaning of §1.1502–77) of the surviving consolidated group;

(v) With respect to an acceleration event described in paragraph (b)(3)(iii)(A)(1)(iv) of this section, is the successor entity (within the meaning of paragraph (b)(3)(iii)(A)(1)(v) of this section); or

(vi) With respect an acceleration event described in paragraph (b)(3)(iii)(A)(1)(vi) of this section, is the agent (within the meaning of §1.1502–77) of the con-
general. A transfer agreement must be timely filed. Except as provided in paragraph (b)(3)(iii)(B)(2)(ii) of this section, a transfer agreement is considered timely filed only if the transfer agreement is filed within 30 days of the date that the acceleration event occurs. The transfer agreement must be filed in accordance with the rules provided in publications, forms, instructions, or other guidance. In addition, a duplicate copy of the transfer agreement must be attached to the returns of both the eligible section 965(h) transferee and the eligible section 965(h) transferor for the taxable year during which the acceleration event occurs filed by the due date for such returns (taking into account extensions, if any). Relief is not available under §301.9100–2 or §301.9100–3 to file a transfer agreement late.

(ii) Transition rule. If an acceleration event occurs on or before February 5, 2019, the transfer agreement must be filed by March 7, 2019, to be considered timely filed.

(3) Signature requirement. The transfer agreement that is filed within 30 days of the acceleration event or by the due date specified in paragraph (b)(3)(iii)(B)(2)(ii) of this section must be signed under penalties of perjury by a person who is authorized to sign a return on behalf of the eligible section 965(h) transferee and a person who is authorized to sign a return on behalf of the eligible section 965(h) transferee.

(4) Terms of agreement. A transfer agreement under this paragraph (b)(3)(iii)(B) must be entitled “Transfer Agreement Under Section 965(h)(3)” and must contain the following information and representations—

(i) A statement that the document constitutes an agreement by the eligible section 965(h) transferee to assume the liability of the eligible section 965(h) transferor for any unpaid installment payments of the eligible section 965(h) transferor under section 965(h);

(ii) A statement that the eligible section 965(h) transferee (and, if the eligible section 965(h) transferor continues in existence immediately after the acceleration event, the eligible section 965(h) transferor) agrees to comply with all of the conditions and requirements of section 965(h) and paragraph (b) of this section, as well as any other applicable requirements in the section 965 regulations;

(iii) The name, address, and taxpayer identification number of the eligible section 965(h) transferor and the eligible section 965(h) transferee;

(iv) The amount of the eligible section 965(h) transferor’s section 965(h) net tax liability remaining unpaid, as determined by the eligible section 965(h) transferee, which amount is subject to adjustment by the Commissioner;

(v) A copy of the eligible section 965(h) transferor’s most recent Form 965–A or Form 965–B, as applicable, if the eligible section 965(h) transferor has been required to file a Form 965–A or Form 965–B;

(vi) A detailed description of the acceleration event that led to the transfer agreement;

(vii) A representation that the eligible section 965(h) transferee is able to make the remaining payments required under section 965(h) and paragraph (b) of this section with respect to the section 965(h) net tax liability being assumed;

(viii) If the eligible section 965(h) transferor continues to exist immediately after the acceleration event, an acknowledgment that the eligible section 965(h) transferor and any successor to the eligible section 965(h) transferor will remain jointly and severally liable for any unpaid installment payments of the eligible section 965(h) transferee under section 965(h), including, if applicable, under §1.1502–6;

(ix) A statement as to whether the leverage ratio of the eligible section 965(h) transferee and all subsidiary members of its affiliated group immediately after the acceleration event exceeds three to one, which ratio may be modified as provided in publications, forms, instructions, or other guidance;

(x) A certification by the eligible section 965(h) transferee stating that the eligible section 965(h) transferee waives the right to a notice of liability and consents to the immediate assessment of the portion of the section 965(h) net tax liability remaining unpaid; and

(xi) Any additional information, representation, or certification required by the Commissioner in publications, forms, instructions, or other guidance.

(5) Consolidated groups. For purposes of this paragraph (b)(3)(iii)(B), in the case of a consolidated group, the terms “eligible section 965(h) transferor” and “eligible section 965(h) transferee” each refer to a consolidated group that is a party to a covered acceleration event described in paragraph (b)(3)(iii)(A)(1) of this section. In such a case, any transfer agreement under this paragraph (b)(3)(iii)(B) must be entered into by the agent (as defined in §1.1502–77) of the relevant consolidated group.

(6) Leverage ratio. For purposes of paragraph (b)(3)(iii)(B)(4)(ix) of this section, and except as otherwise provided in publications, forms, instructions, or other guidance, the term leverage ratio means the ratio that the total indebtedness of the eligible section 965(h) transferee bears to the sum of its money and all other assets reduced (but not below zero) by such total indebtedness. For this purpose, the amount taken into account with respect to any asset is the adjusted basis thereof for purposes of determining gain, and the amount taken into account with respect to any indebtedness with original issue discount is its issue price plus the portion of the original issue discount previously accrued as determined under the rules of section 1272 (determined without regard to subsection (a)(7) or (b)(4) thereof).

(C) Consent of Commissioner.—(1) In general. Except as otherwise provided in publications, forms, instructions, or other guidance, if an eligible section 965(h) transferor and an eligible section 965(h) transferee file a transfer agreement in accordance with the provisions of paragraph (b)(3)(iii)(B) of this section, the eligible section 965(h) transferor and the eligible section 965(h) transferee will be considered to have entered into an agreement described in paragraph (b)(3)(iii)(A) of this section with the Commissioner for purposes of section 965(h)(3) and paragraph (b)(3)(iii) of this section. If the Commissioner determines that additional information is necessary (for example, additional information regarding the ability of the eligible section 965(h) transferee to fully pay the remaining section 965(h) net
tax liability), the eligible section 965(h) transferee must provide such information upon request.

(2) Material misrepresentations and omissions. If the Commissioner determines that an agreement filed by an eligible section 965(h) transferor and an eligible section 965(h) transferee contains a material misrepresentation or material omission, or if the eligible section 965(h) transferee does not provide the additional information requested under paragraph (b)(3)(ii)(C) of this section within a reasonable timeframe communicated by the Commissioner to the eligible section 965(h) transferee, then the Commissioner may reject the transfer agreement (effective as of the date of the related acceleration event). In the alternative, on the date that the Commissioner determines that the transfer agreement includes a material misrepresentation or material omission, the Commissioner may determine that an acceleration event has occurred with respect to the eligible section 965(h) transferee as of the date of the determination, such that any unpaid installment payments of the eligible section 965(h) transferee that were assumed by the eligible section 965(h) transferee become due on the date of the determination.

(D) Effect of assumption.—(1) In general. If the exception in this paragraph (b)(3)(iii) applies with respect to an eligible section 965(h) transferor and an eligible section 965(h) transferee, the eligible section 965(h) transferee assumes all of the outstanding obligations and responsibilities of the eligible section 965(h) transferee with respect to the section 965(h) net tax liability as though the eligible section 965(h) transferee had included the section 965(a) inclusion in income. Accordingly, the eligible section 965(h) transferee is responsible for making payments and reporting with respect to any unpaid installment payments. In addition, for example, if an acceleration event described in paragraph (b)(3)(ii) of this section occurs with respect to an eligible section 965(h) transferee, any unpaid installment payments of the eligible section 965(h) transferee that were assumed by the eligible section 965(h) transferee will become due on the date of such event, subject to any applicable exception in paragraph (b)(3)(ii) of this section.

(2) Eligible section 965(h) transferor liability. An eligible section 965(h) transferee (or a successor) remains jointly and severally liable for any unpaid installment payments of the eligible section 965(h) transferee that were assumed by the eligible section 965(h) transferee, as well as any penalties, additions to tax, or other additional amounts attributable to such net tax liability.

(E) Qualifying consolidated group member transaction.—(1) Definition of qualifying consolidated group member transaction. For purposes of this paragraph (b)(3), the term qualifying consolidated group member transaction means a transaction in which—

(i) A member of a consolidated group (the departing member) ceases to be a member of the consolidated group (including by reason of the distribution, sale, or exchange of the departing member’s stock);

(ii) The transaction results in the consolidated group (which is treated as a single person for this purpose under §1.965–8(e)(1)) being treated as transferring substantially all of its assets for purposes of paragraph (b)(3)(ii)(B) of this section; and

(iii) The departing member either continues to exist immediately after the transaction or has a qualified successor.

(2) Definition of qualified successor. For purposes of this paragraph (b)(3), the term qualified successor means, with respect to a departing member described in this paragraph (b)(3)(iii)(E), another domestic corporation (or consolidated group) that acquires substantially all of the assets of the departing member (including in a transaction described in section 381(a)(2)).

(3) Departure of multiple members of a consolidated group. Multiple members that deconsolidate from the same consolidated group as a result of a single transaction are treated as a single departing member to the extent that, immediately after the transaction, they become members of the same (second) consolidated group, which would be treated as a single person under §1.965–8(e)(1).

(c) Section 965(i) election.—(1) In general. Each shareholder of an S corporation (including a person listed in §1.1362–6(b)(2) with respect to a trust or estate, but not a domestic pass-through entity itself) that is a United States shareholder of a deferred foreign income corporation may elect under section 965(i) and this paragraph (c) to defer the payment of the shareholder’s section 965(i) net tax liability with respect to the S corporation until the shareholder’s taxable year that includes a triggering event described in paragraph (c)(3) of this section. This election may be revoked only by paying the full amount of the unpaid section 965(i) net tax liability.

(2) Manner of making election.—(i) Eligibility. Each shareholder with a section 965(i) net tax liability with respect to an S corporation may make the section 965(i) election with respect to such S corporation, provided that, with respect to the shareholder, none of the triggering events described in paragraph (c)(3)(ii) of this section have occurred before the election is made. Notwithstanding the preceding sentence, a shareholder that would be eligible to make the section 965(i) election but for the occurrence of an event described in paragraph (c)(3)(ii) of this section may make the section 965(i) election if an exception described in paragraph (c)(3)(iv) of this section applies.

(ii) Timing. A section 965(i) election must be made no later than the due date (taking into account extensions, if any) for the shareholder’s return for each taxable year that includes the last day of the taxable year of the S corporation in which the S corporation has a section 965(a) inclusion to which the shareholder’s section 965(i) net tax liability is attributable. Relief is not available under §301.9100–2 or §301.9100–3 to make a late election.

(iii) Election statement. Except as otherwise provided in publications, forms, instructions, or other guidance, to make a section 965(i) election, a shareholder must attach a statement, signed under penalties of perjury consistent with the rules for signatures applicable to the person’s return, to its return for the taxable year that includes the last day of a taxable year of the S corporation in which the S corporation has a section 965(a) inclusion to which the shareholder’s section 965(i) net tax liability is attributable. The statement must include the shareholder’s name, taxpayer identification number, the name and taxpayer identification number of the S
corporation with respect to which the election is made, the amount described in paragraph (g)(10)(ii)(A) of this section as modified by paragraph (g)(6) of this section for purposes of determining the section 965(i) net tax liability with respect to the S corporation, the amount described in paragraph (g)(10)(i)(B) of this section, and the section 965(i) net tax liability with respect to the S corporation. The statement must be filed in the manner prescribed in publications, forms, instructions, or other guidance. The attachment of an unsigned copy of the election statement to the timely-filed return for the relevant taxable year satisfies the signature requirement of this paragraph (c)(2)(iii) if the shareholder retains the original signed election statement in the manner specified by §1.6001–1(e).

(3) Triggering events—(i) In general. If a shareholder makes a section 965(i) election with respect to an S corporation, the shareholder defers payment of its section 965(i) net tax liability with respect to the S corporation until the shareholder’s taxable year that includes the occurrence of a triggering event described in paragraph (c)(3)(ii) of this section with respect to the section 965(i) net tax liability with respect to the S corporation. If a triggering event described in paragraph (c)(3)(ii) of this section with respect to an S corporation occurs, except as provided in paragraph (c)(3)(iv) of this section, the shareholder’s section 965(i) net tax liability with respect to the S corporation will be assessed as an addition to tax for the shareholder’s taxable year that includes the triggering event.

(ii) Triggering events. The following events are considered triggering events for purposes of paragraph (c)(3)(i) of this section with respect to a shareholder’s section 965(i) net tax liability with respect to an S corporation—

(A) The corporation ceases to be an S corporation (determined as of the first day of the first taxable year that the corporation is not an S corporation);

(B) A liquidation, sale, exchange, or other disposition of substantially all of the assets of the S corporation (including in a title 11 or similar case), a cessation of business by the S corporation, or the S corporation ceasing to exist;

(C) The transfer of any share of stock of the S corporation by the shareholder (including by reason of death or otherwise) that results in a change of ownership for federal income tax purposes; or

(D) A determination by the Commissioner described in the second sentence of paragraph (c)(3)(iv)(C)(2) of this section.

(iii) Partial transfers. If an S corporation shareholder transfers less than all of its shares of stock of the S corporation, the transfer will be a triggering event only with respect to the portion of a shareholder’s section 965(i) net tax liability that is properly allocable to the transferred shares.

(iv) Eligible section 965(i) transferee exception—(A) In general. Paragraph (c)(3)(i) of this section will not apply (such that a shareholder’s section 965(i) net tax liability with respect to an S corporation will not be assessed as an addition to tax for the shareholder’s taxable year that includes the triggering event) if the requirements described in paragraphs (c)(3)(iv)(A)(1) and (2) of this section are satisfied. A shareholder with respect to which a triggering event described in this paragraph (c)(3)(iv)(A) occurs is referred to as an eligible section 965(i) transferor.

(1) Requirement to have a covered triggering event. The triggering event satisfies the requirements of this paragraph (c)(3)(iv)(A) if it is described in paragraph (c)(3)(ii)(C) of this section.

(2) Requirement to enter into a transfer agreement. The shareholder with respect to which a triggering event occurs and an eligible section 965(i) transferee (as defined in paragraph (c)(3)(iv)(B)(I) of this section) must enter into an agreement with the Commissioner that satisfies the requirements of paragraph (c)(3)(iv)(B) of this section.

(B) Transfer agreement—(1) Eligibility. A transfer agreement that satisfies the requirements of this paragraph (c)(3)(iv)(B) may be entered into by an eligible section 965(i) transferor and an eligible section 965(i) transferee. For this purpose, the term eligible section 965(i) transferee refers to a single United States person that becomes a shareholder of the S corporation (including a person listed in §1.1362–6(b)(2) with respect to a trust or estate, but not a domestic pass-through entity itself). In the case of a transfer that consists of multiple partial transfers (as described in paragraph (c)(3)(iii) of this section), a transfer agreement that satisfies the requirements of this paragraph (c)(3)(iv)(B) may be entered into by an eligible section 965(i) transferor and an eligible section 965(i) transferee for each partial transfer.

(ii) Transition rule. If a triggering event occurs on or before February 5, 2019, the transfer agreement must be filed by March 7, 2019, to be considered timely filed.

(iii) Death of eligible section 965(i) transferor. If the triggering event is the death of the eligible section 965(i) transferor, the transfer agreement must be filed by the later of the extended due date for the eligible section 965(i) transferor’s final income tax return or March 7, 2019.

(3) Signature requirement. The transfer agreement that is filed within 30 days of the triggering event or by the due date specified in paragraph (c)(3)(iv)(B)(2)(ii) or (iii) of this section must be signed under penalties of perjury by a person who is authorized to sign a return on behalf of the eligible section 965(i) transferor and a person who is authorized to sign a return on behalf of the eligible section 965(i) transferee.

(4) Terms of agreement. A transfer agreement under this paragraph (c)(3)(iv)(B) must be entitled “Transfer Agreement Under Section 965(i)(2)” and must contain the following information and representations:

(i) A statement that the document constitutes an agreement by the eligible sec-
tion 965(i) transferee to assume the liability of the eligible section 965(i) transferor for the unpaid portion of the section 965(i) net tax liability, or, in the case of a partial transfer, for the unpaid portion of the section 965(i) net tax liability attributable to the transferred stock;

(ii) A statement that the eligible section 965(i) transferee agrees to comply with all of the conditions and requirements of section 965(i) and paragraph (c) of this section, including the annual reporting requirement, as well as any other applicable requirements in the section 965 regulations;

(iii) The name, address, and taxpayer identification number of the eligible section 965(i) transferor and the eligible section 965(i) transferee;

(iv) The amount of the eligible section 965(i) transferor’s unpaid section 965(i) net tax liability or, in the case of a partial transfer, the unpaid portion of the section 965(i) net tax liability attributable to the transferred stock, each as determined by the eligible section 965(i) transferor, which amount is subject to adjustment by the Commissioner;

(v) A copy of the eligible section 965(i) transferor’s most recent Form 965-A, if the eligible section 965(i) transferor has been required to file a Form 965-A;

(vi) A detailed description of the triggering event that led to the transfer agreement, including the name and taxpayer identification number of the S corporation with respect to which the section 965(i) election was effective;

(vii) A representation that the eligible section 965(i) transferee is able to pay the section 965(i) net tax liability being assumed;

(viii) An acknowledgement that the eligible section 965(i) transferor and any successor to the eligible section 965(i) transferor will remain jointly and severally liable for the section 965(i) net tax liability being assumed by the eligible section 965(i) transferee;

(ix) A statement as to whether the leverage ratio of the eligible section 965(i) transferee immediately after the triggering event exceeds three to one, which ratio may be modified as provided in publications, forms, instructions, or other guidance;

(x) Any additional information, representation, or certification required by the Commissioner in publications, forms, instructions, or other guidance.

(5) Special rule in the case of death of eligible section 965(i) transferor. Except in the case of transfers to trusts, if the triggering event is the death of the eligible section 965(i) transferor, and the identity of the beneficiary or beneficiaries (in the case of multiple partial transfers) is determined as of the due date for the transfer agreement described in paragraph (c)(3)(iv)(B)(2)(iii) of this section, then the transfer may be treated as a transfer directly between the eligible 965(i) transferor and the beneficiary or beneficiaries. If, however, the identity of the beneficiary or beneficiaries is not determined as of the due date for the transfer agreement described in paragraph (c)(3)(iv)(B)(2)(iii) of this section, then the transfer must be treated first as a transfer between the eligible section 965(i) transferor and his or her estate at the time of death and second as a transfer between the estate and the beneficiary or beneficiaries when the shares are actually transferred to the beneficiary or beneficiaries. Separate transfer agreements must be filed for each transfer. The transfer from the eligible section 965(i) transferor to his or her estate is a transfer resulting from a triggering event that is the death of the eligible section 965(i) transferor, and the transfer agreement is subject to the timing rules in paragraph (c)(3)(iv)(B)(2)(iii) of this section. The transfer from the estate to the beneficiary or beneficiaries is not a transfer resulting from a triggering event that is the death of the eligible section 965(i) transferor, and the transfer agreement is subject to the timing rules in paragraph (c)(3)(iv)(B)(2)(i) and (ii) of this section.

(6) Leverage ratio. For purposes of paragraph (c)(3)(iv)(B)(4)(ix) of this section, and except as otherwise provided in publications, forms, instructions, or other guidance, the term leverage ratio means the ratio that the total indebtedness of the eligible section 965(i) transferee bears to the sum of its money and all other assets reduced (but not below zero) by such total indebtedness. For this purpose, the amount taken into account with respect to any asset is the adjusted basis thereof for purposes of determining gain, and the amount taken into account with respect to any indebtedness with original issue discount is its issue price plus the portion of the original issue discount previously accrued as determined under the rules of section 1272 (determined without regard to subsection (a)(7) or (b)(4) thereof).

(C) Consent of Commissioner—(1) In general. Except as otherwise provided in publications, forms, instructions, or other guidance, if an eligible section 965(i) transferor and an eligible section 965(i) transferee file a transfer agreement in accordance with the provisions of paragraph (c)(3)(iv)(B) of this section, the eligible section 965(i) transferor and the eligible section 965(i) transferee will be considered to have entered into an agreement with the Commissioner for purposes of section 965(i)(2) and paragraph (c)(3)(iv) of this section. If the Commissioner determines that additional information is necessary (for example, additional information regarding the ability of the eligible section 965(i) transferee to pay the eligible section 965(i) transferor’s unpaid section 965(i) net tax liability), the eligible section 965(i) transferee must provide such information upon request.

(2) Material misrepresentations and omissions. If the Commissioner determines that an agreement filed by an eligible section 965(i) transferor and an eligible section 965(i) transferee contains a material misrepresentation or material omission, or if the eligible section 965(i) transferee does not provide the additional information requested under paragraph (c)(3)(iv)(C)(1) of this section within a reasonable timeframe communicated by the Commissioner to the eligible section 965(i) transferee, then the Commissioner may reject the transfer agreement (effective as of the date of the related triggering event). In the alternative, on the date that the Commissioner determines that the transfer agreement includes a material misrepresentation or material omission, the Commissioner may determine that a triggering event has occurred with respect to the eligible section 965(i) transferee as of the date of the determination, such that the unpaid section 965(i) net tax liability of the eligible section 965(i) transferor that was assumed by the eligible section 965(i) transferee becomes due on the date of the determination.

(D) Effect of assumption—(1) In general. When the exception in this paragraph
In order to obtain the consent of the Commissioner as required by paragraph (c)(3)(v)(D)(1) of this section, the shareholder intending to make the section 965(h) election must file the agreement described in paragraph (c)(3)(v)(D)(4) of this section within 30 days of the occurrence of the triggering event, except as described in paragraph (c)(3)(v)(D)(2)(ii) of this section. The agreement must be filed in accordance with the rules provided in publications, forms, instructions, or other guidance. In addition, a duplicate copy of the agreement must be filed, with the shareholder’s timely-filed return for the taxable year during which the triggering event occurs (taking into account extensions, if any), along with the election statement described in paragraph (b)(2)(iii) of this section. Relief is not available under §301.9100–2 or §301.9100–3 to file an agreement late.

(ii) Transition rule. If a triggering event occurs on or before February 5, 2019, the agreement must be filed by March 7, 2019, in order to be considered timely filed.

(3) Signature requirement. The agreement that is filed within 30 days of the triggering event or by the due date specified in paragraph (c)(3)(v)(D)(2)(ii) of this section must be signed under penalties of perjury by the shareholder.

(4) Terms of agreement. The agreement under this paragraph (c)(3)(v)(D) must be entitled “Consent Agreement Under Section 965(i)(4)(D)” and must contain the following information and representations—

(i) A statement that the shareholder agrees to comply with all of the conditions and requirements of section 965(h) and paragraph (b) of this section, as well as any other applicable requirements in the section 965 regulations;

(ii) The name, address, and taxpayer identification number of the shareholder;

(iii) The amount of the section 965(i) net tax liability under section 965 remaining unpaid with respect to which the section 965(h) election is made pursuant to section 965(i)(4)(D) and paragraph (c)(3)(v)(A) of this section, as determined by the shareholder, which amount is subject to adjustment by the Commissioner; and

(iv) A representation that the shareholder is able to make the payments required under section 965(h) and paragraph (b) of this section with respect to the portion of the total net tax liability under section 965 remaining unpaid described in paragraph (c)(3)(v)(D)(4)(iii) of this section.

(v) A statement as to whether the leverage ratio of the shareholder and all subsidiary members of its affiliated group immediately following the triggering event exceeds three to one; and

(vi) Any additional information, representation, or certification required by the Commissioner in publications, forms, instructions, or other guidance.

(5) Consent of Commissioner—(i) In general. If a shareholder files an agreement in accordance with the provisions of paragraph (c)(3)(v)(D) of this section, the shareholder will be considered to have obtained the consent of the Commissioner for purposes of section 965(i)(4)(D) and paragraph (c)(3)(v)(D)(1) of this section. However, if the Commissioner reviews the agreement and determines that additional information is necessary, the shareholder must provide such information upon request.

(ii) Material misrepresentations and omissions. If the Commissioner determines that an agreement filed by a shareholder in
accordance with the provisions of this paragraph (c)(3)(v)(D) contains a material misrepresentation or material omission, or if the shareholder does not provide the additional information requested under paragraph (c)(3)(v)(D)(5)(i) of this section within a reasonable timeframe communicated by the Commissioner to the shareholder, then the Commissioner may reject the agreement (effective as of the date of the related triggering event).

(6) Leverage ratio. For purposes of paragraph (c)(3)(v)(D)(4)(v) of this section, and except as otherwise provided in publications, forms, instructions, or other guidance, the term leverage ratio means the ratio that the total indebtedness of the shareholder bears to the sum of its money and all other assets reduced (but not below zero) by such total indebtedness. For this purpose, the amount taken into account with respect to any asset is the adjusted basis thereof for purposes of determining gain, and the amount taken into account with respect to any indebtedness with original issue discount is its issue price plus the portion of the original issue discount previously accrued as determined under the rules of section 1272 (determined without regard to subsection (a)(7) or (b)(4) thereof).

(4) Joint and several liability. If any shareholder of an S corporation makes a section 965(i) election, the S corporation is jointly and severally liable for the payment of the shareholder’s section 965(i) net tax liability with respect to the S corporation, as well as any penalties, additions to tax, or other additional amounts attributable to such net tax liability.

(5) Extension of limitation on collection. If an S corporation shareholder makes a section 965(i) election with respect to its section 965(i) net tax liability with respect to an S corporation, any limitation on the time period for the collection of the net tax liability shall not begin before the date of the triggering event with respect to the section 965(i) net tax liability.

(6) Annual reporting requirement—(i) In general. A shareholder that makes a section 965(i) election with respect to its section 965(i) net tax liability with respect to an S corporation is required to report the amount of its deferred net tax liability on its return of tax for the taxable year in which the election is made and on the return of tax for each subsequent taxable year until such net tax liability has been fully assessed.

(ii) Failure to report. If a shareholder fails to report the amount of its deferred net tax liability as required with respect to any taxable year by the due date (taking into account extensions, if any) for the return of tax for that taxable year, five percent of such deferred net tax liability will be assessed as an addition to tax for such taxable year.

(d) Section 965(m) election and special rule for real estate investment trusts—(1) In general. A real estate investment trust may elect under section 965(m) and this paragraph (d) to defer the inclusion in gross income (for purposes of the computation of real estate investment trust taxable income under section 857(b)) of its REIT section 965 amounts and include them in income according to the schedule described in paragraph (d)(2) of this section. This election is revocable only by including in gross income (for purposes of the computation of real estate investment trust taxable income under section 857(b)) the full amount of the REIT section 965 amounts.

(2) Inclusion schedule for section 965(m) election. If a real estate investment trust makes the section 965(m) election, the REIT section 965 amounts will be included in the real estate investment trust’s gross income as follows—

(i) Eight percent of the REIT section 965 amounts in each taxable year in the five-taxable year period beginning with the taxable year the amount would otherwise be included;

(ii) Fifteen percent of the REIT section 965 amounts in the first year following the five year period described in paragraph (d)(2)(i) of this section;

(iii) Twenty percent of the REIT section 965 amounts in the second year following the five year period described in paragraph (d)(2)(i) of this section; and

(iv) Twenty-five percent of the REIT section 965 amounts in the third year following the five year period described in paragraph (d)(2)(i) of this section.

(3) Manner of making election—(i) Eligibility. A real estate investment trust with section 965(a) inclusions may make the section 965(m) election.

(ii) Timing. A section 965(m) election must be made no later than the due date (taking into account extensions, if any) for the return for the first year of the five year period described in paragraph (d)(2)(i) of this section. Relief is not available under §§301.9100–2 or §301.9100–3 to make a late election.

(iii) Election statement. Except as otherwise provided in publications, forms, instructions, or other guidance, to make a section 965(m) election, a real estate investment trust must attach a statement, signed under penalties of perjury consistent with the rules for signatures applicable to the person’s return, to its return for the taxable year in which it would otherwise be required to include the REIT section 965 amounts in gross income. The statement must include the real estate investment trust’s name, taxpayer identification number, REIT section 965 amounts, and the anticipated amounts of each portion of the REIT section 965 amounts described under paragraph (d)(2) of this section, and the statement must be filed in the manner prescribed in publications, forms, instructions, or other guidance. The attachment of an unsigned copy of the election statement to the timely-filed return for the relevant taxable year satisfies the signature requirement of this paragraph (d)(3)(iii) if the real estate investment trust retains the original signed election statement in the manner specified by §1.6001–1.e.

(4) Coordination with section 965(h). A real estate investment trust that makes the section 965(m) election may not also make a section 965(h) election for any year with respect to which a section 965(m) election is in effect.

(5) Acceleration of inclusion. If a real estate investment trust makes a section 965(m) election and subsequently there is a liquidation, sale, exchange, or other disposition of substantially all of the assets of the real estate investment trust (including in a title 11 or similar case), or a cessation of business by the real estate investment trust, any amount not yet included in gross income (for purposes of the computation of real estate investment trust taxable income under section 857(b)) as a result of the section 965(m) election will be so included as of the day before the date of the event. The unpaid portion of any tax liability with respect to such inclusion will
be due on the date of the event (or in the case of a title 11 or similar case, the day before the petition is filed).

(6) Treatment of section 965(a) inclusions of a real estate investment trust. Regardless of whether a real estate investment trust has made a section 965(m) election, and regardless of whether it is a United States shareholder of a deferred foreign income corporation, any section 965(a) inclusions of the real estate investment trust are not taken into account as gross income of the real estate investment trust for purposes of applying paragraphs (2) and (3) of section 856(c) for any taxable year for which the real estate investment trust takes into account a section 965(a) inclusion, including pursuant to paragraph (d)(2) of this section.

(e) Section 965(n) election—(1) In general—(i) General rule. A person may elect to not take into account the amount described in paragraph (e)(1)(ii) of this section in determining its net operating loss under section 172 for the taxable year or in determining the amount of taxable income for such taxable year (computed without regard to the deduction allowable under section 172) that may be reduced by net operating loss carryovers or carrybacks to such taxable year under section 172. The election for each taxable year is irrevocable.

(ii) Applicable amount for section 965(n) election. If a person makes a section 965(n) election, the amount referred to in paragraph (e)(1)(i) of this section is the sum of—

(A) The person’s section 965(a) inclusions for the taxable year reduced by the person’s section 965(c) deductions for the taxable year, and

(B) In the case of a domestic corporation, the taxes deemed paid under section 960(a)(1) for the taxable year with respect to the person’s section 965(a) inclusions that are treated as dividends under section 78.

(iii) Scope of section 965(n) election. If a person makes a section 965(n) election, the election applies to both net operating losses for the taxable year for which the election is made and the net operating loss carryovers or carrybacks to such taxable year, each in their entirety. Any section 965(n) election made by the agent (within the meaning of §1.1502–77) of a consolidated group applies to all net operating losses available to the consolidated group, including all components of the consolidated net operating loss deduction (as defined in §1.1502–21(a)).

(iv) [Reserved]

(2) Manner of making election—(i) Eligibility. A person with a section 965(a) inclusion may make the section 965(n) election.

(ii) Timing. A section 965(n) election must be made no later than the due date (taking into account extensions, if any) for the person’s return for the taxable year to which the election applies. Relief is not available under §301.9100–2 or §301.9100–3 to make a late election.

(iii) Election statement. Except as otherwise provided in publications, forms, instructions, or other guidance, to make a section 965(n) election, a person must attach a statement, signed under penalties of perjury consistent with the rules for signatures applicable to the person’s return, to its return for the taxable year to which the election applies. The statement must include the person’s name, taxpayer identification number, the amounts described in section 965(n)(2)(A) and paragraph (e)(1)(ii)(A) of this section and section 965(n)(2)(B) and paragraph (e)(1)(ii)(B) of this section, and the sum thereof, and the statement must be filed in the manner prescribed in publications, forms, instructions, or other guidance. The attachment of an unsigned copy of the election statement to the timely-filed return for the relevant taxable year satisfies the signature requirement of this paragraph (e)(2)(iii) if the person making the election retains the original signed election statement in the manner specified by §1.6001–1(e).

(f) Election to use alternative method for calculating post–1986 earnings and profits—(1) Effect of election for specified foreign corporations that do not have a 52–53-week taxable year. If an election is made under this paragraph (f) with respect to a specified foreign corporation that does not have a 52–53-week taxable year, the amount of the post–1986 earnings and profits (including a deficit) as of the E&P measurement date on November 2, 2017, is determined under paragraph (f)(3) of this section. The election described in this paragraph (f) is irrevocable. A specified foreign corporation that does not have a 52–53-week taxable year may not use the alternative method of determination in paragraph (f)(3) of this section for purposes of determining its post–1986 earnings and profits on the E&P measurement date on December 31, 2017.

(2) Effect of election for specified foreign corporations that have a 52–53-week taxable year. If an election is made under this paragraph (f) with respect to a specified foreign corporation that has a 52–53-week taxable year, the amount of the post–1986 earnings and profits (including a deficit) as of both E&P measurement dates is determined under paragraph (f)(3) of this section. The election described in this paragraph (f) is irrevocable.

(3) Computation of post–1986 earnings and profits using alternative method. With respect to an E&P measurement date, the post–1986 earnings and profits of a specified foreign corporation for which an election is properly made equals the sum of—

(i) The specified foreign corporation’s post–1986 earnings and profits (including a deficit) determined as of the notional measurement date, if it were an E&P measurement date, plus

(ii) The specified foreign corporation’s annualized earnings and profits amount with respect to the notional measurement date.

(4) Definitions—(i) 52–53-week taxable year. The term 52–53-week taxable year means a taxable year described in §1.441–2(a)(1).

(ii) Annualized earnings and profits amount. The term annualized earnings and profits amount means, with respect to a specified foreign corporation, an E&P measurement date, and a notional measurement date, the amount equal to the product of the number of days between the notional measurement date and the E&P measurement date (not including the former, but including the latter) multiplied by the daily earnings amount of the specified foreign corporation. The annualized earnings and profits amount is expressed as a negative number if the E&P measurement date precedes the notional measurement date.

(iii) Daily earnings amount. The term daily earnings amount means, with respect to a specified foreign corporation and a notional measurement date, the
post–1986 earnings and profits (including a deficit) of the specified foreign corporation determined as of the close of the notional measurement date that were earned (or incurred) during the specified foreign corporation’s taxable year that includes the notional measurement date, divided by the number of days that have elapsed in such taxable year as of the close of the notional measurement date.

(iv) Notional measurement date. The term notional measurement date means—

(A) With respect to an E&P measurement date of a specified foreign corporation with a 52–53-week taxable year, the closest end of a fiscal month to such E&P measurement date, and

(B) With respect to the E&P measurement date on November 2, 2017, of all specified foreign corporations not described in paragraph (f)(4)(iv)(A) of this section, October 31, 2017.

(5) Manner of making election—(i) Eligibility. An election with respect to a specified foreign corporation to use the alternative method of calculating post–1986 earnings and profits as of an E&P measurement date pursuant to this paragraph (f) must be made on behalf of the specified foreign corporation by a controlling domestic shareholder (as defined in §1.964–1(c)(5)) pursuant to the rules of §1.964–1(c)(3), except that the controlling domestic shareholder is not required to file the statement described in §1.964–1(c)(3)(ii).

(ii) Timing. An election under this paragraph (f) must be made no later than the due date (taking into account extensions, if any) for the person’s return for the first taxable year in which the person has a section 965(a) inclusion amount with respect to the specified foreign corporation or in which the person takes into account a specified E&P deficit with respect to the specified corporation for purposes of computing a section 965(a) inclusion amount with respect to another specified foreign corporation. Relief is not available under §301.9100–2 or §301.9100–3 to make a late election.

(iii) Election statement. Except as otherwise provided in publications, forms, instructions, or other guidance, to make an election under this paragraph (f), a person must attach a statement, signed under penalties of perjury consistent with the rules for signatures applicable to the person’s return, to the person’s return for the taxable year described in paragraph (f)(5)(ii) of this section. The statement must include the person’s name, taxpayer identification number, and the name and taxpayer identification number, if any, of each of the specified foreign corporations with respect to which the election is made, and the statement must be filed in the manner prescribed in instructions or other guidance. The attachment of an unsigned copy of the election statement to the timely-filed return for the relevant taxable year satisfies the signature requirement of this paragraph (f)(5)(ii) if the person making the election retains the original signed election statement in the manner specified by §1.6001–1(e).

(6) Examples. The following examples illustrate the application of this paragraph (f).

(i) Example 1. (A) Facts. FS, a foreign corporation, has a calendar year taxable year, and as of October 31, 2017, FS has post–1986 earnings and profits of 10,000u, 3,040u of which were earned during the taxable year that includes October 31, 2017. An election is properly made under paragraph (f)(5) of this section with respect to FS, allowing FS to determine its post–1986 earnings and profits under the alternative method with respect to its E&P measurement date on November 2, 2017.

(B) Analysis. As of the close of October 31, 2017, the notional measurement date with respect to the E&P measurement date on November 2, 2017, 304 days have elapsed in the taxable year of FS that includes October 31, 2017. Therefore, FS’s daily earnings amount is 10u (3,040u divided by 304), and FS’s annualized earnings and profits amount is 20u (10u multiplied by 2 (the number of days between the notional measurement date on October 31, 2017, and the E&P measurement date on November 2, 2017)). Accordingly, FS’s post–1986 earnings and profits as of November 2, 2017, are 10,020u (its post–1986 earnings and profits as of October 31, 2017 (10,000u), plus its annualized earnings and profits amount (20u)).

(ii) Example 2. (A) Facts. The facts are the same as in paragraph (f)(6)(i)(A) of this section (the facts in Example 1), except that a deficit of 3,040u was incurred during the taxable year that includes October 31, 2017.

(B) Analysis. The analysis is the same as in paragraph (f)(6)(i)(B) of this section (the analysis in Example 1), except that FS’s daily earnings amount is (10u) (3,040u divided by 304), and FS’s annualized earnings and profits amount is (20u) (10u) multiplied by 2 (the number of days between the notional measurement date on October 31, 2017, and the E&P measurement date on November 2, 2017)). Accordingly, FS’s post–1986 earnings and profits as of November 2, 2017, are 9,980u (its post–1986 earnings and profits as of October 31, 2017 (10,000u), plus its annualized earnings and profits amount (20u)).

(g) Definitions. This paragraph (g) provides definitions that apply for purposes of this section.

(1) Deferred net tax liability. The term deferred net tax liability means, with respect to any taxable year of a person, the amount of the section 965(i) net tax liability the payment of which has been deferred under section 965(i) and paragraph (c) of this section.

(2) REIT section 965 amounts. The term REIT section 965 amounts means, with respect to a real estate investment trust and a taxable year of the real estate investment trust, the aggregate amount of section 965(a) inclusions and section 965(c) deductions that would (but for section 965(m)(1)(B) and paragraph (d) of this section) be taken into account in determining the real estate investment trust’s income for the taxable year.

(3) Section 965(h) election. The term section 965(h) election means the election described in section 965(h)(1) and paragraph (b)(1) of this section.

(4) Section 965(h) net tax liability. The term section 965(h) net tax liability means, with respect to a person that has made a section 965(h) election, the total net tax liability under section 965 reduced by the aggregate amount of the person’s section 965(i) net tax liabilities, if any, with respect to which section 965(i) elections are effective.

(5) Section 965(i) election. The term section 965(i) election means the election described in section 965(i)(1) and paragraph (c)(1) of this section.

(6) Section 965(i) net tax liability. The term section 965(i) net tax liability means, with respect to an S corporation and a shareholder of the S corporation, in the case in which a section 965(i) election is made, the amount determined pursuant to paragraph (g)(10)(i) of this section by adding before the word “over” in (g)(10)(i)(A) of this section “determined as if the only section 965(a) inclusions included in income by the person are domestic pass-through entity shares of section 965(a) inclusions by the S corporation with respect to deferred foreign income corporations of which the S corporation is a United States shareholder.”
§1.965–8 Affiliated groups (including consolidated groups).

(a) Scope. This section provides rules for applying section 965 and the section 965 regulations to members of an affiliated group (as defined in section 1504(a)), including members of a consolidated group (as defined in §1.1502–1(h)). Paragraph (b) of this section provides guidance regarding the application of section 965(b)(5) to determine the section 965(a) inclusion amounts of a member of an affiliated group. Paragraph (c) of this section provides guidance for designating the source of aggregate unused E&P deficits. Paragraph (d) provides rules regarding earning and profits and stock basis adjustments. Paragraph (e) of this section provides rules that treat members of a consolidated group as a single person for certain purposes. Paragraph (f) of this section provides definitions that apply for purposes of this section. Paragraph (g) of this section provides examples illustrating the application of this section.

(b) Reduction of E&P net surplus shareholder’s pro rata share of the section 965(a) earnings amount of a deferred foreign income corporation by the allocable share of the applicable share of the aggregate unused E&P deficit—(1) In general. This paragraph (b) applies after the application of §1.965–1(b)(2) for purposes of determining the section 965(a) inclusion amount with respect to a deferred foreign income corporation of a section 958(a) U.S. shareholder that is both an E&P net surplus shareholder and a member of an affiliated group in which not all members are members of the same consolidated group. If this paragraph (b) applies, the U.S. dollar amount of the section 958(a) U.S. shareholder’s pro rata share of the section 958(a) earnings amount of the deferred foreign income corporation is further reduced (but not below zero) by the deferred foreign income corporation’s allocable share of the section 958(a) U.S. shareholder’s applicable share of the affiliated group’s aggregate unused E&P deficit.

(2) Consolidated group as part of an affiliated group. If some, but not all, members of an affiliated group are members of a consolidated group, then the consolidated group is treated as a single member of the affiliated group for purposes of §1.965–1(b)(2) and paragraph (b)(1) of this section.

(c) Designation of portion of excess aggregate foreign E&P deficit taken into account—(1) In general. This paragraph (c) provides rules for designating the source of an aggregate unused E&P deficit of an affiliated group that is not also a consolidated group taken into account under section 965(b)(5) and paragraph (b) of this section if the amount described in paragraph (f)(1)(i)(A) of this section with respect to the affiliated group exceeds the amount described in paragraph (f)(1)(i)(B) of this section with respect to the affiliated group. If this paragraph (c)(1) applies, each member of the affiliated group that is an E&P net deficit shareholder must designate by maintaining in its books and records a statement (identical to the statement maintained by all other such members) setting forth the portion of the excess aggregate foreign E&P deficit of the E&P net deficit shareholder taken into account under section 965(b)(5) and paragraph (b) of this section. See §1.965–2(d)(2)(ii)(B) for a rule for designating the portion of a section 958(a) U.S. shareholder’s pro rata share of a specified E&P deficit of an E&P deficit foreign corporation taken into account under section 965(b), §1.965–1(b)(2), and paragraph (b) of this section, as applicable.

(2) Consolidated group as part of an affiliated group. If some, but not all, members of an affiliated group are properly treated as members of a consolidated group, then the consolidated group is treated as a single member of the affiliated group for purposes of applying paragraph (c)(1) of this section.

(d) Adjustments to earning and profits and stock basis.

(1) [Reserved]

(2) Consolidated groups. See §1.1502–33(d)(1) for adjustments to members’ earnings and profits and §1.1502–32(b)(3) for adjustments to members’ basis.
(e) Treatment of a consolidated group as a single section 958(a) U.S. shareholder or a single person—(1) In general.

All members of a consolidated group that are section 958(a) U.S. shareholders of a specified foreign corporation are treated as a single section 958(a) U.S. shareholder for purposes of section 965(b), §1.965–1(b)(2), and §1.965–3. Furthermore, all members of a consolidated group are treated as a single person for purposes of paragraphs (h), (k), and (n) of section 965 and §1.965–7. Thus, for example, any election governed by section 965(h) and §1.965–7(b) must be made by the agent (within the meaning of §1.1502–77) of the group as a single election on behalf of all members of the consolidated group. Similarly, the determination of whether the transfer of assets by one member to a non-member of the consolidated group would constitute an acceleration event under section §1.965–7(b)(3)(ii)(B) takes into account all of the assets of the consolidated group, which for purposes of this determination, includes all of the assets of each consolidated group member. In analyzing issues relating to the transfer of assets of a consolidated group, appropriate adjustments are made to prevent the duplication of assets or asset value.

(2) Limitation. Paragraph (e)(1) of this section does not apply to treat all members of a consolidated group as a single section 958(a) U.S. shareholder or a single person, as applicable, for purposes of determining the amount of any member’s inclusion under section 951 (including a section 965(a) inclusion), the foreign income taxes deemed paid with respect to a section 965(a) inclusion (see sections 960 and 902), or any purpose other than those specifically listed in paragraph (e)(1) of this section or another provision of the section 965 regulations.

(3) Determination of section 965(c) deduction amount. For purposes of determining the section 965(c) deduction amount of any section 958(a) U.S. shareholder that is a member of a consolidated group, the aggregate foreign cash position of the section 958(a) U.S. shareholder is equal to the aggregate section 965(a) inclusion amount of the section 958(a) U.S. shareholder multiplied by the group cash ratio of the consolidated group.

(f) Definitions. This paragraph (f) provides definitions that apply for purposes of applying the section 965 regulations to members of an affiliated group, including members of a consolidated group.

(1) Aggregate unused E&P deficit—(i) General rule. The term aggregate unused E&P deficit means, with respect to an affiliated group, the lesser of—

(A) The sum of the excess aggregate foreign E&P deficit with respect to each E&P net deficit shareholder that is a member of the affiliated group, or

(B) The amount determined under paragraph (f)(3)(ii) of this section.

(ii) Reduction with respect to E&P net deficit shareholders that are not wholly owned by the affiliated group. If the group ownership percentage of an E&P net deficit shareholder is less than 100 percent, the amount of the excess aggregate foreign E&P deficit with respect to the E&P net deficit shareholder that is taken into account under paragraph (f)(1)(i) of this section is the product of the group ownership percentage multiplied by the excess aggregate foreign E&P deficit.

(2) Allocable share. The term allocable share means, with respect to a deferred foreign income corporation and an E&P net surplus shareholder’s applicable share of an aggregate unused E&P deficit of an affiliated group, the product of the E&P net surplus shareholder’s allocable share of the affiliated group’s aggregate unused E&P deficit and the group ownership percentage that is held by other includible corporations and the stock of the United States shareholder that is a member of an affiliated group.

(3) Applicable share. The term applicable share means, with respect to an E&P net surplus shareholder and an aggregate unused E&P deficit of an affiliated group, the amount that bears the same proportion to the affiliated group’s aggregate unused E&P deficit as—

(i) The product of—

(A) The E&P net surplus shareholder’s group ownership percentage, multiplied by

(B) The amount that would (but for section 965(b)(5) and paragraph (b) of this section) constitute the E&P net surplus shareholder’s applicable share of the affiliated group’s aggregate section 965(a) inclusion amount, bears to

(ii) The aggregate amount determined under paragraph (f)(3)(i) of this section with respect to all E&P net surplus shareholders that are members of the group.

(4) Consolidated group aggregate foreign cash position. The term consolidated group aggregate foreign cash position means, with respect to a consolidated group, the aggregate foreign cash position (as defined in §1.965–1(f)(8)(ii)) determined by treating each member of the consolidated group that is a section 958(a) U.S. shareholder as a single section 958(a) U.S. shareholder pursuant to paragraph (e)(1) of this section.

(5) E&P net deficit shareholder. The term E&P net deficit shareholder means a section 958(a) U.S. shareholder that has an excess aggregate foreign E&P deficit.

(6) E&P net surplus shareholder. The term E&P net surplus shareholder means a section 958(a) U.S. shareholder that would (but for section 965(b)(5) and paragraph (b) of this section) have an aggregate section 965(a) inclusion amount greater than zero.

(7) Excess aggregate foreign E&P deficit. The term excess aggregate foreign E&P deficit means, with respect to a section 958(a) U.S. shareholder, the amount, if any, which the amount described in §1.965–1(f)(9)(i) with respect to the section 958(a) U.S. shareholder exceeds the amount described in §1.965–1(f)(9)(ii) with respect to the section 958(a) U.S. shareholder.

(8) Group cash ratio. The term group cash ratio means, with respect to a consolidated group, the ratio of—

(i) The consolidated group aggregate foreign cash position, to

(ii) The sum of the aggregate section 965(a) inclusion amount of all members of the consolidated group.

(9) Group ownership percentage. The term group ownership percentage means, with respect to a section 958(a) U.S. shareholder that is a member of an affiliated group, the percentage of the value of the stock of the United States shareholder which is held by other includible corporations in the affiliated group. Notwithstanding the preceding sentence, the group ownership percentage of the common parent of the affiliated group is 100 percent. Any term used in this paragraph (f)(9) that is also used in section 1504 has the same meaning as when used in such section. Additionally, if the term is used in the context of a rule for which all members of a consolidated group are treated as a single section 958(a) U.S. shareholder under...
paragraph (e)(1) of this section, then the group ownership percentage is determined solely with respect to the value of the stock of the common parent of the consolidated group held by other includible corporations that are not members of the consolidated group.

(g) Examples. The following examples illustrate the application of this section.

(1) Example 1. Application of affiliated group rule. (i) Facts. (A) In general. USP owns all of the stock of USS1, USS2, and USS3. Each of USP, USS1, USS2, and USS3 is a domestic corporation and is a member of an affiliated group of which USP is the common parent (the “USP Group”). The USP Group has not elected to file a consolidated federal income tax return. USS1 owns all of the stock of CFC1 and CFC2. USS2 owns all of the stock of CFC3, and USS3 owns all of the stock of CFC4. Each of CFC1, CFC2, CFC3, and CFC4 is a controlled foreign corporation within the meaning of section 957(a), and, therefore, each is a specified foreign corporation under section 966(e) and §1.965–1(b)(2) (before applying section 965(b) and paragraph (b) of this section). The USP Group, and, therefore, each is a specified foreign corporation under section 966(e) and §1.965–1(b)(2) (before applying section 965(b) and paragraph (b) of this section).

(B) Facts relating to section 965. CFC1 and CFC3 are deferred foreign income corporations with section 965(a) earnings amounts of $600x and $300x, respectively. CFC1 and CFC3 have cash positions of $50x and $50x, respectively, on each of their cash measurement dates. CFC2 and CFC4 are E&P deficit foreign corporations with specified E&P deficits of $400x and $100x, respectively. CFC2 and CFC4 have cash positions of $100x and $50x, respectively, on each of their cash measurement dates. The cash positions all consist solely of cash. CFC1, CFC2, CFC3, and CFC4 all use the U.S. dollar as their functional currency.

(ii) Analysis. (A) Section 965(a) inclusion amounts before application of section 965(b)(5). USS1 is a section 958(a) U.S. shareholder with respect to CFC1 and CFC2; USS2 is a section 958(a) U.S. shareholder with respect to CFC3; and USS3 is a section 958(a) U.S. shareholder with respect to CFC4. USS1’s pro rata share of CFC1’s section 965(a) earnings amount is $600x. Under section 965(b)(3)(A) and §1.965–1(b)(9), USS1’s aggregate foreign E&P deficit is $400x, the lesser of the aggregate of USS1’s pro rata share of the specified E&P deficit of each E&P deficit foreign corporation ($400x) and the amount described in §1.965–1(b)(9)(ii) with respect to USS1 ($600x). Under section 965(b) and §1.965–1(b)(2), in determining its section 965(a) inclusion amount with respect to CFC1, USS1 reduces its pro rata share of the U.S. dollar amount of section 965(a) earnings amount of CFC1 by USS1’s allocable share of USS1’s aggregate foreign E&P deficit. USS1’s allocable share of USS1’s aggregate foreign E&P deficit is $400x, which is the product of USS1’s aggregate foreign E&P deficit ($400x) and 1, which is the ratio determined by dividing USS1’s pro rata share of the section 965(a) earnings amount of CFC1 ($600x), by the product of USS1’s applicable section 965(a) inclusion amount with respect to USS1 ($600x). Accordingly, under section 965(b) and §1.965–1(b)(2) (before applying section 965(b)(5) and paragraph (b) of this section), USS1’s section 965(a) inclusion amount with respect to CFC1 would be $200x (USS1’s pro rata share of the section 965(a) earnings amount of CFC1 of $600x reduced by USS1’s allocable share of USS1’s aggregate foreign E&P deficit of $400x). Under section 965(b) and §1.965–1(b)(2) (before applying section 965(b) and paragraph (b) of this section), USS2’s section 965(a) inclusion amount with respect to CFC3 would be $300x (USS2’s pro rata share of the section 965(a) earnings amount of CFC3).

(B) Application of section 965(b)(5) and paragraph (b) of this section. USS1 is an E&P net surplus shareholder because it would have an aggregate section 965(a) inclusion amount of $200x but for the application of section 965(b)(5) and paragraph (b) of this section. USS2 is also an E&P net surplus shareholder because it would have an aggregate section 965(a) inclusion amount of $300x but for the application of section 965(b)(5) and paragraph (b) of this section. USS3 is an E&P net deficit shareholder because it has an excess aggregate foreign E&P deficit of $100x.

(ii) Determining section 965(a) inclusion amounts under section 965(b)(5). Under section 965(b) and paragraph (b) of this section, for purposes of determining the section 965(a) inclusion amount of a section 958(a) U.S. shareholder with respect to a deferred foreign income corporation, if, after applying §1.965–1(b)(2), the section 958(a) U.S. shareholder is an E&P net surplus shareholder, then the U.S. dollar amount of the section 958(a) U.S. shareholder’s pro rata share of section 965(a) earnings amount of the deferred foreign income corporation is further reduced (but not below zero) by the deferred foreign income corporation’s allocable share of the section 958(a) U.S. shareholder’s allocable share of the affiliated group’s aggregate unused E&P deficit. USS3 is the only E&P net surplus shareholder in the USP Group, and, therefore, the aggregate unused E&P deficit of the USP Group is equal to USS3’s excess aggregate foreign E&P deficit ($100x). The applicable share of the USP Group’s aggregate unused E&P deficit of each of USS1 and USS2, respectively, is an amount that bears the same proportion of determining the section 958(a) inclusion amount of a section 958(a) U.S. shareholder with respect to only one deferred foreign income corporation, if, after applying section 965(b) and paragraph (b) of this section, the section 958(a) U.S. shareholder’s allocable share of the affiliated group’s aggregate unused E&P deficit.

3. Determining section 965(a) inclusion amounts—(1) Single section 958(a) U.S. shareholder treatment. Because each of USS1, USS2, and USS3 is a section 958(a) U.S. shareholder of a specified foreign corporation, and therefore a single section 958(a) U.S. shareholder for purposes of section 965(b) and §1.965–1(b)(2), in determining its section 965(a) inclusion amount, the single section 958(a) U.S. shareholder decreases its pro rata share of the U.S. dollar amount of the section 965(a) earnings amount of CFC1 by USS1’s allocable share of the aggregate foreign E&P deficit of the single section 958(a) U.S. shareholder. CFC1’s allocable share of the aggregate foreign E&P deficit is $333.33x, which is the product of the aggregate foreign E&P deficit of the single section 958(a) U.S. shareholder ($500x $400x + $100x) and 67.5, which is the ratio determined by dividing its pro rata share of the section 965(a) earnings amount of CFC1...
(§600x) by the amount described in §1.965–1(f)(9)(ii) with respect to the single section 958(a) U.S. shareholder ($900x ($600x + $300x)). Therefore, USS1’s section 965(a) inclusion amount with respect to CFC1 is $266.67 (its pro rata share of the section 965(a) earnings amount of CFC1 ($600x) less CFC1’s allocable share of the aggregate foreign E&P deficit of the single section 958(a) U.S. shareholder ($333.33x)). Similarly, under §1.965–1(b)(2), in determining the section 965(a) inclusion amount of USS2, the single section 958(a) U.S. shareholder decreases its pro rata share of the U.S. dollar amount of the section 965(a) earnings amount of CFC3 by CFC3’s allocable share of the aggregate foreign E&P deficit of the single section 958(a) U.S. shareholder, CFC3’s allocable share of the aggregate foreign E&P deficit is $166.67x, which is the product of the aggregate foreign E&P deficit of the single section 958(a) U.S. shareholder ($500x) and .33, which is the ratio determined by dividing its pro rata share of the section 965(a) earnings amount of CFC3 ($300x) by the amount described in §1.965–1(f)(9)(ii) with respect to the single section 958(a) U.S. shareholder ($900x ($600x + $300x)). Therefore, USS2’s section 965(a) inclusion amount with respect to CFC3 is $133.33x (its pro rata share of the section 965(a) earnings amount of CFC3 ($300x) less CFC3’s allocable share of the aggregate foreign E&P deficit of the single section 958(a) U.S. shareholder ($166.67x)).

(B) Consolidated group aggregate foreign cash position. Because USS1 and USS2 are members of a consolidated group, the aggregate foreign cash position of each of USS1 and USS2 is determined under paragraph (e)(3) of this section. Under paragraph (e)(3) of this section, the aggregate foreign cash position of each of USS1 and USS2 is equal to the aggregate section 965(a) inclusion amount of USS1 and USS2, respectively, multiplied by the group cash ratio of the USP Group, as determined pursuant to paragraph (f)(8) of this section. The group cash ratio of the USP Group is .50, which is the ratio of the USP Group’s consolidated group aggregate foreign cash position ($200x ($50x + $100x + $50x)) and the sum of the aggregate section 965(a) inclusion amounts of all members of the USP Group ($400x ($266.67x + $133.33x)). Therefore, under paragraph (e)(3) of this section, the aggregate foreign cash positions of USS1 and USS2 are, respectively, $133.34x ($266.67x x ($200x/$400x)) and $66.67 ($133.33x x ($200x/$400x)).

(C) Section 965(c) deduction amount. The section 965(c) deduction amount of USS1 is $177.14x, which is equal to (i) USS1’s 8 percent rate equivalent percentage (77.1428571%) of its 8 percent rate amount for USS1’s 2017 year ($133.33x ($266.67x - $133.34x)), plus USS1’s 15.5 percent rate equivalent percentage (55.7142857%) of its 15.5 percent rate amount for USS1’s 2017 year ($133.34x). The section 965(c) deduction amount of USS2 is $88.56x, which is equal to (i) USS2’s 8 percent rate equivalent percentage (77.1428571%) of its 8 percent rate amount for USS2’s 2017 year ($66.67x ($133.33x - $66.67x)), plus USS2’s 15.5 percent rate equivalent percentage (55.7142857%) of its 15.5 percent rate amount for USS2’s 2017 year ($66.67x). Because USS3 has no section 965(a) inclusion amount, it has no section 965(c) deduction amount and therefore is not allowed a section 965(c) deduction.

§1.965–9 Applicability dates.

(a) In general. Sections 1.965–1 through 1.965–8 apply beginning the last taxable year of a foreign corporation that begins before January 1, 2018, and with respect to a United States person, beginning the taxable year in which or with which such taxable year of the foreign corporation ends.

(b) Applicability dates for rules disregarding certain transactions. Section 1.965–4 applies regardless of whether, with respect to a foreign corporation, the transaction, effective date of a change in method of accounting, effective date of an entity classification election, or specified payment described in §1.965–4 occurred before the first day of the foreign corporation’s last taxable year that begins before January 1, 2018, or, with respect to a United States person, the transaction, effective date of a change in method of accounting, effective date of an entity classification election, or specified payment described in §1.965–4 occurred before the first day of the taxable year of the United States person in which or with which the taxable year of the foreign corporation ends.

Par. 5. Section 1.986(c)–1 is added to read as follows:

§1.986(c)–1 Coordination with section 965.

(a) Amount of foreign currency gain or loss. Foreign currency gain or loss with respect to distributions of section 965(a) previously taxed earnings and profits (as defined in §1.965–1(f)(39)) is determined based on movements in the exchange rate between December 31, 2017, and the time such distributions are made.

(b) Section 965(a) previously taxed earnings and profits. Any gain or loss recognized under section 986(c) with respect to distributions of section 965(a) previously taxed earnings and profits is reduced in the same proportion as the reduction by a section 965(c) deduction amount (as defined in §1.965–1(f)(42)) of the section 965(a) inclusion amount (as defined in §1.965–1(f)(38)) that gave rise to such section 965(a) previously taxed earnings and profits.

Kirsten Wielobob
Deputy Commissioner for Services and Enforcement.
Approved: December 19, 2018.

David J Kautter
Assistant Secretary of the Treasury (Tax Policy).

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Bulletin No. 2019–09
669
February 25, 2019
T.D. 9847
DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1
Qualified Business Income Deduction
AGENCY: Internal Revenue Service (IRS), Treasury.
ACTION: Final Regulations.
SUMMARY: This document contains final regulations concerning the deduction for qualified business income under section 199A of the Internal Revenue Code (Code). The regulations will affect individuals, partnerships, S corporations, trusts, and estates engaged in domestic trades or businesses. The regulations also contain an anti-avoidance rule under section 643 of the Code to treat multiple trades or businesses. The regulations will affect individual taxpayers who are self-employed with qualified business income from more than one trade or business as well as most partnerships, S corporations, trusts, and estates that have qualified business income. More of the paperwork burden analysis details are explained in the Special Analysis Section J, Anticipated impacts on administrative and compliance costs.

DATES: Effective date: These regulations are effective on February 8, 2019. Sections 1.199A–1 through 1.199A–6 are generally applicable to taxable years ending after February 8, 2019. However, taxpayers may rely on the rules set forth in §§ 1.199A–1 through 1.199A–6, in their entirety, or on the proposed regulations under §§ 1.199A–1 through 1.199A–6 issued on August 16, 2018, in their entirety, for taxable years ending in calendar year 2018.
Applicability date: For dates of applicability, see §§ 1.199A–1(f), 1.199A–2(d), 1.199A–3(d), 1.199A–4(e), 1.199A–5(e), 1.199A–6(e), and 1.643(f)–1(b).

FOR FURTHER INFORMATION CONTACT: Vishal R. Amin or Frank J. Fisher at (202) 317-6850 or Robert D. Alinsky, Margaret Burow, or Wendy L. Kribell at (202) 317-5279.
ADDRESSES: Submit electronic submissions to the Federal eRulemaking Portal at www.regulations.gov (indicate IRS and REG–107892–18) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comment received to its public docket, whether submitted electronically or in hard copy. Send hard copy submissions to CC:PA:LPD:PR (REG–107892–18), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, D.C., 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–107892–18), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C., 20224.
SUPPLEMENTARY INFORMATION:
Paperwork Reduction Act
The collection of information contained in these regulations has been revised and approved by the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507) under control numbers 1545-0123, 1545-0074, and 1545-0092.
Regulations in §§ 1.199A–4 and 1.199A–6 require the collection of information. Section 1.199A–4 requires taxpayers and passthrough entities that choose to aggregate two or more trades or businesses to collect information. Section 1.199A–6 requires passthrough entities to report section 199A information to their owners or beneficiaries. Taxpayers need to report the information to the IRS by attaching the applicable statement to Form 1040 or to the Schedules K–1 for the Form 1041, Form 1065, or Form 1120S, as appropriate, to ensure the correct amount of deduction is reported under section 199A. The collection of information is necessary to ensure tax compliance.
The likely respondents are individuals with qualified business income from more than one trade or business as well as most partnerships, S corporations, trusts, and estates that have qualified business income. More of the paperwork burden analysis details are explained in the Special Analysis Section J, Anticipated impacts on administrative and compliance costs.
Estimated total annual reporting burden: 25 million hours. This estimate primarily reflects two effects of the regulations: a 0.7 million hour increase in reporting burden from compliance with § 1.199A–4 and a 24.2 million hour increase in reporting burden from compliance with § 1.199A–6.
Estimated average annual burden hours per respondent will vary from 30 minutes to 20 hours, depending on individual circumstances, with an estimated average of 2.5 hours.
Estimated number of respondents: 10 million.
Estimated annual frequency of responses: annually.
Estimated monetized burden: Using the IRS’s taxpayer compliance cost estimates, taxpayers who are self-employed with multiple businesses are estimated to have a monetization rate of $39 per hour. Passthroughs that issue K–1s have a monetization rate of $53 per hour. (See “Taxpayer Compliance Costs for Corporations and Partnerships: A New Look,” Contos, et. al. IRS Research Bulletin (2012) p. 5 for a description of the model.)
An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.
Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by section 6103.
Background
This document contains amendments to the Income Tax Regulations (26 CFR part 1) under sections 199A and 643(f) of the Code. On August 16, 2018, the Department of the Treasury (Treasury Department) and the IRS published a notice of proposed rulemaking (REG–107892–18) in the Federal Register (83 FR 40884) containing proposed regulations under sections 199A and 643(f) of the Code (proposed regulations). The Summary of Comments and Explanation of
Revisions summarizes the provisions of sections 199A and 643(f) and the provisions of the proposed regulations, which are explained in greater detail in the preamble to the proposed regulations.

The Treasury Department and the IRS received written and electronic comments responding to the proposed regulations and held a public hearing on the proposed regulations on October 16, 2018. After full consideration of the comments received on the proposed regulations and the testimony heard at the public hearing, this Treasury decision adopts the proposed regulations with modifications in response to such comments and testimony as described in the Summary of Comments and Explanation of Revisions. Concurrently with the publication of these final regulations, the Treasury Department and the IRS are publishing in the Proposed Rule section of this edition of the Federal Register (RIN 1545-BP12) a notice of proposed rulemaking providing additional proposed regulations under section 199A (REG–134652–18).

Summary of Comments and Explanation of Revisions

The Treasury Department and the IRS received approximately 335 comments in response to the notice of proposed rulemaking. All comments were considered and are available at www.regulations.gov or upon request. Most of the comments addressing the proposed regulations are summarized in this Summary of Comments and Explanation of Revisions. However, comments merely summarizing or interpreting the proposed regulations, recommending statutory revisions, or addressing provisions outside the scope of these final regulations are not discussed in this preamble. The Treasury Department and the IRS continue to study comments on issues related to section 199A that are beyond the scope of these final regulations (or the notice of proposed rulemaking on this subject in the Proposed Rules section of this issue of the Federal Register) and may discuss those comments that are beyond the scope of the regulations if future guidance on those issues is published.

As discussed in the preamble to the proposed regulations, the purpose and scope of the proposed regulations and these final regulations are primarily limited to determining the amount of the deduction of up to 20 percent of income from a domestic business operated as a sole proprietorship or through a partnership, S corporation (as defined in section 1361(a)(1)), trust, or estate (section 199A deduction). The purpose and scope of the proposed regulations and these final regulations are also to determine when to treat two or more trusts as a single trust for purposes of subchapter J of chapter 1 of subtitle A of the Code (subchapter J). These final regulations are not intended to address section 643 in general.

Commenters and others requested that the proposed regulations be finalized as quickly as possible to provide guidance to practitioners and taxpayers as they prepare returns and determine the section 199A deduction for the first taxable year in which the deduction is allowed. Commenters also requested that the rules for section 199A be simplified and clarified. Accordingly, these final regulations adopt many of the rules described in the proposed regulations, with revisions in response to the comments received and testimony provided at the public hearing, as described in the remainder of this Summary of Comments and Explanation of Revisions. Additionally, clarifying language and additional examples have been added throughout the final regulations.

Part I of this section provides an overview of the sections of the Code addressed by these final regulations. Part II of this section addresses the operational rules, including definitions, computational rules, special rules, and reporting requirements. Part III of this section addresses the determination of W–2 wages and unadjusted basis immediately after acquisition (UBIA) of qualified property. Part IV of this section addresses the determination of qualified business income (QBI), qualified real estate investment trust (REIT) dividends, and qualified publicly traded partnership (PTP) income. Part V of this section addresses the optional aggregation of trades or businesses. Part VI of this section addresses specified services trades or businesses (SSTBs) and the trade or business of being an employee. Part VII of this section addresses the rules for relevant passthrough entities (RPEs), PTPs, beneficiaries, trusts, and estates. Part VIII of this section addresses the treatment of multiple trusts.

I. Overview

A. Section 199A

As noted in the preamble to the proposed regulations, section 199A was enacted on December 22, 2017, by section 11011 of “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. 115–97 (TCJA), and was amended on March 23, 2018, retroactively to January 1, 2018, by section 101 of Division T of the Consolidated Appropriations Act, 2018, Pub. L. 115–141, (2018 Act). Section 199A applies to taxable years beginning after 2017 and before 2026.

Section 199A provides a deduction of up to 20 percent of income from a domestic business operated as a sole proprietorship or through a partnership, S corporation, trust, or estate. The section 199A deduction may be taken by individuals and by some estates and trusts. A section 199A deduction is not available for wage income or for business income earned through a C corporation (as defined in section 1361(a)(2)). For taxpayers whose taxable income exceeds a statutorily-defined amount (threshold amount), section 199A may limit the taxpayer’s section 199A deduction based on (i) the type of trade or business engaged in by the taxpayer, (ii) the amount of W–2 wages paid with respect to the trade or business (W–2 wages), and/or (iii) the UBIA of qualified property held for use in the trade or business (UBIA of qualified property). These statutory limitations are subject to phase-in rules based upon taxable income above the threshold amount.

Section 199A also allows individuals and some trusts and estates (but not corporations) a deduction of up to 20 percent of their combined qualified REIT dividends and qualified PTP income, including qualified REIT dividends and qualified PTP income earned through pass-through entities. This component of the section 199A deduction is not limited by W–2 wages or UBIA of qualified property.

The section 199A deduction is the lesser of (1) the sum of the combined amounts described in the prior two paragraphs or (2) an amount equal to 20 percent of the excess (if any) of taxable in-
cume of the taxpayer for the taxable year over the net capital gain of the taxpayer for the taxable year.

Additionally, section 199A(g), as amended by the 2018 Act effective as of January 1, 2018, provides that specified agricultural or horticultural cooperatives may claim a special entity-level deduction that is substantially similar to the domestic production activities deduction under former section 199. The Treasury Department and the IRS intend to issue a future notice of proposed rulemaking describing proposed rules for applying section 199A to specified agricultural and horticultural cooperatives and their patrons.

Finally, the statute expressly grants the Secretary authority to prescribe such regulations as are necessary to carry out the purposes of section 199A (section 199A(f)(4)), and provides specific grants of authority with respect to: the treatment of acquisitions, dispositions, and short taxable years (section 199A(b)(5)); certain payments to partners for services rendered in a non-partner capacity (section 199A(c)(4)(C)); the allocation of W–2 wages and UBIA of qualified property (section 199A(f)(1)(A(iii))); restricting the allocation of items and wages under section 199A and such reporting requirements as the Secretary determines appropriate (section 199A(f)(4)(A)); the application of section 199A in the case of tiered entities (section 199A(f)(4)(B)); preventing the manipulation of the depreciation period of qualified property using transactions between related parties (section 199A(h)(1)); and determining the UBIA of qualified property acquired in like-kind exchanges or involuntary conversions (section 199A(h)(2)).

B. Section 643(f)

Part I of subchapter J provides rules related to the taxation of estates, trusts, and beneficiaries. For various subparts of Part I of subchapter J, sections 643(a), 643(b), and 643(c) define the terms distributable net income (DNI), income, and beneficiary, respectively. Sections 643(d) through 643(i) (other than section 643(f)) provide additional rules. Section 643(f) grants the Secretary authority to treat two or more trusts as a single trust for purposes of subchapter J if (1) the trusts have substantially the same grantors and substantially the same primary beneficiaries and (2) a principal purpose of such trusts is the avoidance of the tax imposed by chapter 1 of the Code. Section 643(f) further provides that, for these purposes, spouses are treated as a single person.

II. Operational Rules

A. Definitions

1. Net Capital Gain

Section 199A(a) provides, in relevant part, that the section 199A deduction is limited to the lesser of the taxpayer’s combined QBI or 20 percent of the excess of a taxpayer’s taxable income over the taxpayer’s net capital gain (as defined in section 1(h)) for the taxable year. The proposed regulations do not contain a specific definition of net capital gain. The Treasury Department and the IRS are aware that taxpayers and practitioners have questioned how net capital gain is determined for purposes of section 199A. One commenter suggested that net capital gain, as used to calculate the section 199A deduction, should be defined as excluding qualified dividend income, which is taxed as capital gain.

The final regulations provide a definition of net capital gain for purposes of section 199A. Section 1(h) establishes the maximum capital gains rates imposed on individuals, trusts, and estates that have a net capital gain for the taxable year. Section 1222(11) defines net capital gain as the excess of net long-term capital gain for the taxable year over the net short-term capital loss for such year. Section 1(h)(11) provides that for purposes of section 1(h), net capital gain means net capital gain (determined without regard to section 1(h)(11)) increased by qualified dividend income. Accordingly, § 1.199A–1(b)(3) defines net capital gain for purposes of section 199A as net capital gain within the meaning of section 1222(11) plus any qualified dividend income (as defined in section 1(h)(11)(B)) for the taxable year.

The Treasury Department and the IRS note that under section 1(h)(2), net capital gain is reduced by the amount that the taxpayer takes into account as investment income under section 163(d)(4)(B)(iii). This reduction does not change the definition of net capital gain for purposes of section 1(h). Instead, it reduces the amount of gains that can be taxed at the maximum capital gains rates as a tradeoff for allowing a taxpayer to elect to deduct more investment interest under section 163(d). Consequently, capital gains and qualified dividends treated as investment income are net capital gain for purposes of determining the section 199A deduction.

2. Relevant Passthrough Entity

The proposed regulations define an RPE as a partnership (other than a PTP) or an S corporation that is owned, directly or indirectly, by at least one individual, estate, or trust. A trust or estate is treated as an RPE to the extent it passes through QBI, W–2 wages, UBIA of qualified property, qualified REIT dividends, or qualified PTP income. In response to a comment, the final regulations provide that other passthrough entities, including common trust funds as described in § 1.6032–T and religious or apostolic organizations described in section 501(d), are also treated as RPEs if the entity files a Form 1065, U.S. Return of Partnership Income, and is owned, directly or indirectly, by at least one individual, estate, or trust. The Treasury Department and the IRS decline to adopt the recommendation of another commenter to treat regulated investment companies (RICs) as RPEs because RICs are C corporations, not pass-through entities.

3. Trade or Business

a. In General

The calculation of QBI and therefore, the benefits of section 199A, are limited to taxpayers with income from a trade or business. Section 199A and its legislative history, however, do not define the phrase “trade or business.” The proposed regulations define trade or business by reference to section 162. Section 162(a) permits a deduction for all the ordinary and necessary expenses paid or incurred in carrying on a trade or business. Multiple commenters agreed that section 162 is the most appropriate standard for what constitutes a
trade or business for purposes of section 199A, but noted that there are significant uncertainties in the meaning of trade or business under section 162. However, because many taxpayers who will now benefit from the section 199A deduction are already familiar with the trade or business standard under section 162, using the section 162 standard appears to be the most practical for taxpayers and the IRS. Therefore, after considering all relevant comments, the final regulations retain and slightly reword the proposed regulation’s definition of trade or business. Specifically, for purposes of section 199A and the regulations thereunder, § 1.199A–1(b)(14) defines trade or business as a trade or business under section 162 (section 162 trade or business) other than the trade or business of performing services as an employee.

The Treasury Department and the IRS received a number of comments requesting additional guidance with respect to determining whether an activity rises to the level of a section 162 trade or business, and therefore, will be considered to be a trade or business for purposes of determining the section 199A deduction. Commenters suggested guidance in the form of a regulatory definition, a bright-line test, a factor-based test, or a safe harbor. Whether an activity rises to the level of a section 162 trade or business, however, is inherently a factual question and specific guidance under section 162 is beyond the scope of these regulations. Accordingly, the Treasury Department and the IRS have concluded that the factual setting of various trades or businesses varies so widely that a single rule or list of factors would be difficult to provide in a timely and manageable manner and would be difficult for taxpayers to apply.

In Higgins v. Commissioner, 312 U.S. 212 (1941), the Supreme Court noted that determining whether a trade or business exists is a factual determination. Specifically, the Court stated that the determination of “whether the activities of a taxpayer are ‘carrying on a business’ requires an examination of the facts in each case.” 312 U.S. at 217. Because there is no statutory or regulatory definition of a section 162 trade or business, courts have established elements to determine the existence of a trade or business. The courts have developed two definitional requirements.

One, in relation to profit motive, is said to require the taxpayer to enter into and carry on the activity with a good faith intention to make a profit or with the belief that a profit can be made from the activity. The second is in relation to the scope of the activities and is said to require considerable, regular, and continuous activity. See generally Commissioner v. Groetzinger, 480 U.S. 23 (1987). In the seminal case of Groetzinger, the Supreme Court stated, “[w]e do not overrule or cut back on the Court’s holding in Higgins when we conclude that if one’s gambling activity is pursued full time, in good faith, and with regularity, to the production of income for a livelihood, and is not a mere hobby, it is a trade or business within the statutes with which we are here concerned.” Id. at 35.

A few commenters suggested adopting the definitions or rules regarding a trade or business found in other provisions of the Code, including sections 469 and 1411. Section 469(c)(6) and § 1.469–4(b)(1) broadly define trade or business activities other than rental activities to include any activity performed: (i) in connection with a trade or business within the meaning of section 162, (ii) with respect to which expenses are allowable as a deduction under section 121, (iii) conducted in anticipation of the commencement of a trade or business, or (iv) that involves research and experimentation expenditures (within the meaning of section 174). Section 1.469–4(b)(2) defines a rental activity as an activity that constitutes a rental activity within the meaning of § 1.469–1T(e)(3). Passive activities for purposes of section 469 are defined as any activity that involves the conduct of a trade or business in which the taxpayer does not materially participate and includes all rental activity.

The definition of trade or business for section 469 purposes is significantly broader than the definition for purposes of section 162 as it is intended to capture a larger universe of activities, including passive activities. Section 469 was enacted to limit the deduction of certain passive losses and therefore, serves a very different purpose than the allowance of a deduction under section 199A. Further, section 199A does not require that a taxpayer materially participate in a trade or business in order to qualify for the section 199A deduction. Consequently, the Treasury Department and the IRS decline to adopt the recommendation to define trade or business for purposes of section 199A by reference to section 469. The Treasury Department and the IRS also decline to define trade or business by reference to section 1411 as § 1.1411–1(d)(12) defines trade or business by reference to section 162 in a manner similar to § 1.199A–1(b)(14).

Commenters also suggested that the section 199A regulations incorporate the real estate professional provisions in section 469(c)(7) in a manner similar to the cross references in section 163(j) and § 1.1411–4(g)(7). Under section 469, a real estate professional may treat rental real estate activities described in section 469(c)(7)(C) as nonpassive if the taxpayer materially participates in such activities. Section 1.469–5T(a) provides seven tests to establish material participation, but as noted above, these tests only determine whether an individual materially participates in a rental real estate activity. They cannot be used to determine whether the activity itself is a trade or business. Unlike section 469, whether a taxpayer is entitled to a section 199A deduction is not determined based on the taxpayer’s level of participation in a trade or business, nor does it require that an individual materially participate in the trade or business. Instead, section 199A is dependent on whether the individual has QBI from a trade or business. Consequently, the Treasury Department and the IRS decline to adopt these comments because the § 1.469–5T material participation tests are not a proxy to establish regular, continuous, and considerable activity that rises to the level of a trade or business for purposes of section 199A.

b. Rental Real Estate Activities as a Trade or Business.

A majority of the comments received on the meaning of a trade or business focus on the treatment of rental real estate activities. Commenters noted inconsistency in the case law in determining whether a taxpayer renting real estate is engaged in a trade or business. Some commenters suggested including safe harbors, tests, or a variety of factors, which if satisfied, would qualify a rental real estate
activity as a trade or business. A number of commenters suggested that all rental real estate activity should qualify as a trade or business. Further, one commenter suggested that rental income from real property held for the production of rents within the meaning of section 62(a)(4) should be considered a trade or business for purposes of section 199A. Another commenter suggested that final regulations provide that an individual whose taxable income does not exceed the threshold amount will be considered to be conducting a trade or business with respect to any real estate rental of which the individual owns at least ten percent and in which the individual actively participates within the meaning of section 469(i).

In determining whether a rental real estate activity is a section 162 trade or business, relevant factors might include, but are not limited to (i) the type of rented property (commercial real property versus residential property), (ii) the number of properties rented, (iii) the owner’s or the owner’s agents day-to-day involvement, (iv) the types and significance of any ancillary services provided under the lease, and (v) the terms of the lease (for example, a net lease versus a traditional lease and a short-term lease versus a long-term lease).

Providing bright line rules on whether a rental real estate activity is a section 162 trade or business for purposes of section 199A is beyond the scope of these regulations. Additionally, the Treasury Department and the IRS decline to adopt a position deeming all rental real estate activity to be a trade or business for purposes of section 199A. However, the Treasury Department and IRS recognize the difficulties taxpayers and practitioners may have in determining whether a taxpayer’s rental real estate activity is sufficiently regular, continuous, and considerable for the activity to constitute a section 162 trade or business. Accordingly, Notice 2019–07, 2019–9 IRB 740, released concurrently with these final regulations, provides notice of a proposed revenue procedure detailing a proposed safe harbor under which a rental real estate enterprise may be treated as a trade or business solely for purposes of section 199A.

Under the proposed safe harbor, a rental real estate enterprise may be treated as a trade or business for purposes of section 199A if at least 250 hours of services are performed each taxable year with respect to the enterprise. This includes services performed by owners, employees, and independent contractors and time spent on maintenance, repairs, collection of rent, payment of expenses, provision of services to tenants, and efforts to rent the property. Hours spent by any person with respect to the owner’s capacity as an investor, such as arranging financing, procuring property, reviewing financial statements or reports on operations, planning, managing, or constructing long-term capital improvements, and traveling to and from the real estate are not considered to be hours of service with respect to the enterprise. The proposed safe harbor also would require that separate books and records and separate bank accounts be maintained for the rental real estate enterprise. Property leased under a triple net lease or used by the taxpayer (including an owner or beneficiary of an RPE) as a residence for any part of the year under section 280A would not be eligible under the proposed safe harbor. A rental real estate enterprise that satisfies the proposed safe harbor may be treated as a trade or business solely for purposes of section 199A and such satisfaction does not necessarily determine whether the rental real estate activity is a section 162 trade or business. Likewise, failure to meet the proposed safe harbor would not necessarily preclude rental real estate activities from being a section 162 trade or business.

Examples 1 and 2 of proposed § 1.199A–1(d)(4) describe a taxpayer who owns several parcels of land that the taxpayer manages and leases to airports for parking lots. The Treasury Department and the IRS are aware that some practitioners and taxpayers questioned whether the use of the lease of unimproved land in these examples was intended to imply that the lease of unimproved land is a trade or business for purposes of section 199A. Proposed § 1.199A–1(d)(4) provides that for purposes of the examples all businesses described in the examples are trades or business for purposes of section 199A. Example 1 was intended to provide a simple illustration of how the calculation would work if a taxpayer lacked sufficient W–2 wages or UBIA of qualified property to claim the deduction. Example 2 built on the fact pattern by adding UBIA of qualified property to the facts. The examples in the proposed regulations were not intended to imply that the lease of the land is, or is not, a trade or business for purposes of section 199A beyond the assumption in the examples. In order to avoid any confusion, the final regulations remove the references to land in both examples.

c. Special Rule for Renting Property to a Related Person.

In one instance, the proposed regulations and the final regulations extend the definition of trade or business for purposes of section 199A beyond section 162. Solely for purposes of section 199A, the rental or licensing of tangible or intangible property to a related trade or business is treated as a trade or business if the rental or licensing activity and the other trade or business are commonly controlled under proposed § 1.199A–4(b)(1)(i). This rule also allows taxpayers to aggregate their trades or businesses with the leasing or licensing of the associated rental or intangible property if all of the requirements of proposed § 1.199A–4 are met.

One commenter asked for clarification regarding whether this rule applies to situations in which the rental or licensing is to a commonly controlled C corporation. Another commenter suggested that the rule in the proposed regulations could allow passive leasing and licensing-type activities to benefit from section 199A even if the counterparty is not an individual or an RPE. The commenter recommended that the exception be limited to scenarios in which the related party is an individual or an RPE and that the term related party be defined with reference to existing attribution rules under sections 267, 707, or 414. The final regulations clarify these rules by adopting these recommendations and limiting this special rule to situations in which the related party is an individual or an RPE. Further, as discussed in part V.B. of this Summary of Comments and Explanation of Revisions, the final regulations provide that the related party rules under sections 267(b) or 707(b) will be used to determine relatedness for purposes of § 1.199A–4 and this special rule.
d. Multiple Trades or Businesses Within an Entity

Several commenters suggested that there should be safe harbors or factors to determine how to delineate separate section 162 trades or businesses within an entity and when an entity’s combined activities should be considered a single section 162 trade or business. Some of the factors suggested include whether the activities: have separate books and records, facilities, locations, employees, and bank accounts; operate separate types of businesses or activities; are held out as separate to the public; and are housed in separate legal entities. One commenter suggested adopting the separate trade or business rules provided in regulations under sections 446 and 469.

The Treasury Department and the IRS decline to adopt these recommendations because specific guidance under section 162 is beyond the scope of these final regulations and, as described in part IIA.3.a. of this Summary of Comments and Explanation of Revisions, guidance under section 469 is inapplicable. Further, § 1.199A–1(d) does not provide guidance on when trades or businesses will be considered separate and distinct. Instead, it provides that a taxpayer can use different methods of accounting for separate and distinct trades or businesses and specifies two circumstances in which trades or businesses will not be considered separate and distinct. Section 1.199A–1(d)(2) provides that no trade or business will be considered separate and distinct unless a complete and separable set of books and records is kept for that trade or business. Further, trades or businesses will not be considered separate and distinct if, by reason of maintaining different methods of accounting, there is a creation or shifting of profits and losses between the businesses of the taxpayer so that income of the taxpayer is not clearly reflected.

e. Taxpayer Consistency.

In cases in which other Code provisions use a trade or business standard that is the same or substantially similar to the section 162 standard adopted in these final regulations, taxpayers should report such items consistently. For example, if taxpayers who own tenancy in common interests in rental property treat such joint interests as a trade or business for purposes of section 199A but do not treat the joint interests as a separate entity for purposes of § 301.7701–1(a)(2), the IRS will consider the facts and circumstances surrounding the differing treatment. Similarly, taxpayers should consider the appropriateness of treating a rental activity as a trade or business for purposes of section 199A where the taxpayer does not comply with the information return filing requirements under section 6041.

b. Computational Rules

Section 1.199A–1(d)(2)(iii)(A) of the proposed regulations provides that if an individual’s QBI from at least one trade or business is less than zero, the individual must offset the QBI attributable to each trade or business that produced net positive QBI with the QBI from each trade or business that produced net negative QBI in proportion to the relative amounts of net QBI in the trades or businesses with positive QBI. This rule is applied prior to the application of the W–2 wage and UBIA of qualified property limitations. One commenter supported this rule, noting that it leads to fair and administrable results for both the government and taxpayers. Another commenter argued that the rule requiring losses to be allocated to a trade or business with positive QBI should be eliminated. The commenter noted that aggregation is optional and netting provisions force a mathematical aggregation where one is not desired or necessary. The commenter also stated that taxpayers are prevented from claiming an excessive deduction by the taxable income, W–2 wage, and UBIA of qualified property limitations. A third commenter suggested that if the netting rule is retained, a taxpayer should be able to elect to include an unprofitable business with any group of businesses when determining the amount of their W–2 wages and UBIA of qualified property regardless of whether the aggregation factors are met.

The Treasury Department and the IRS decline to adopt these recommendations. The aggregation rules provided in § 1.199A–4 are optional and are intended to assist taxpayers in applying the W–2 wage and UBIA of qualified property limitations in situations in which a unified business is conducted across multiple entities. In contrast, the netting rule is derived from section 199A(b) of the Code, which provides in relevant part that the term “combined qualified business income amount” includes the sum of 20 percent of the taxpayer’s QBI with respect to each qualified trade or business of the taxpayer. Further, the conference report accompanying the TCJA describes the Senate amendment as providing that “[i]f the net amount of qualified business income from all qualified trades or businesses during the taxable year is a loss, it is carried forward as a loss from a qualified trade or business in the next taxable year.” H.R. Rep. No. 115–466, at 214 (2017) (Conference Report). The Conference Report also includes an example, “For example, an individual has two business activities that give rise to a
net business loss of 3 and 4, respectively, in year one, giving rise to a carryover business loss of 2 in year two. If in year two the two business activities each give rise to net business income of 2, a carryover business loss of 3 is carried to year three (that is, \(<7>- (2 + 2) = <3>\).”

Id. at 211. This example indicates that QBI is netted in determining combined QBI.

Another commenter asked, in the case of a taxpayer with taxable income within the phase-in range, whether QBI from an SSTB is reduced by the applicable percentage before or after QBI from all of the taxpayer’s trades or businesses is netted. The commenter recommended that negative QBI be netted with positive QBI before the reduction amount is applied to the QBI from the SSTB.

The Treasury Department and the IRS agree that clarification is needed regarding the reduction of QBI from an SSTB when a taxpayer has multiple trades or businesses. Section 199A(d)(3)(A)(ii) provides that only the applicable percentage of qualified items of income, gain, deduction, or loss, and the W–2 wages and the unadjusted basis immediately after acquisition of qualified property, of the taxpayer allocable to such specified service trade or business shall be taken into account in computing the qualified business income, W–2 wages, and the unadjusted basis immediately after acquisition of qualified property of the taxpayer for the taxable year for purposes of applying this section. The Treasury Department and the IRS believe this language applies for all purposes in computing the section 199A deduction. Accordingly, the final regulations provide that for taxpayers with taxable income within the phase-in range, QBI from an SSTB must be reduced by the applicable percentage before the application of the netting and carryover rules described in § 1.199A–1(d)(2)(iii)(A). The final regulations clarify that the SSTB limitations also apply to qualified income received by an individual from a PTP.

C. Other Comments

1. Disregarded Entities

The proposed regulations do not address the treatment of disregarded entities for purposes of section 199A. A few commenters questioned whether trades or businesses conducted by disregarded entities would be treated as if conducted directly by the owner of the entity. Section 1.199A–1(e)(2) of the final regulations provides that an entity with a single owner that is treated as disregarded as an entity separate from its owner under any provision of the Code is disregarded for purposes of section 199A and §§ 1.199A–1 through 1.199A–6. Accordingly, trades or businesses conducted by a disregarded entity will be treated as conducted directly by the owner of the entity for purposes of section 199A.

2. Deductions Limited by Taxable Income

One commenter requested clarification that other deductions limited by taxable income, such as the 65-percent-of-taxable-income limit imposed on the deduction for oil and gas percentage depletion under section 613A, are to be computed without regard to any section 199A deduction. The Treasury Department and the IRS decline to adopt this comment as the specific question is answered by section 613A(d)(1)(B), as amended by the TCJA, which provides that taxable income for purposes of the limitation under section 613A(d)(1) is computed without regard to any deduction allowable under 199A. The Treasury Department and the IRS believe that limitations on other deductions provided for under the Code are more properly addressed by guidance under those Code sections.

3. Treatment of Section 199A Deduction for Purposes of Section 162(a)

Another commenter suggested that the final regulations provide that the section 199A deduction is treated as a deduction for purposes of section 199A only and not as a deduction that is paid or incurred for purposes of section 162(a) or for any other purposes of the Code. The Treasury Department and the IRS decline to adopt this recommendation. In making this suggestion, the Treasury Department and the IRS assume the commenter is concerned with how section 199A interacts with the many Code sections that reference a “trade or business.” How section 199A interacts with other Code sections must be determined with respect to the particular Code section at issue. Accordingly, the Treasury Department and the IRS decline to adopt this general suggestion.

4. Section 6662(a) Penalty for Underpayment of Tax

Section 6662(a) provides a penalty for an underpayment of tax required to be shown on a return. Under section 6662(b), the penalty applies to the portion of any underpayment that is attributable to a substantial underpayment of income tax. Section 6662(d)(1) defines substantial understatement of tax, which is generally an understatement that exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000. Section 6662(d)(1)(C) provides a special rule in the case of any taxpayer who claims the section 199A deduction for the taxable year, which requires that section 6662(d)(1)(A) is applied by substituting “5 percent” for “10 percent.” Section 1.199A–1(e)(6) cross-references this rule. One commenter asked for guidance on how the section 6662 accuracy penalty would be applied if an activity was determined by the IRS not to be a trade or business for purposes of section 199A. The Treasury Department and the IRS decline to adopt this suggestion as guidance regarding the application of section 6662 is beyond the scope of these regulations.

III. Determination of W–2 Wages and Unadjusted Basis Immediately After Acquisition of Qualified Property

A. W–2 Wages

One commenter asked for clarification regarding whether W–2 wages include elective deferrals to self-employed Simplified Employee Pensions (SEP), simple retirement accounts (SIMPLE), and other qualified plans. Revenue Procedure 2019–11, 2019–9 IRB 742, issued concurrently with these final regulations, provides additional guidance on the definition of W–2 wages, including amounts treated as elective deferrals. A few commenters asked for confirmation that W–2 wages include S corporation owner/employee W–2 wages for purposes of the W–2 wage limitation (assuming the wages are included on the Form W–2 filed within 60 days of the due date). The definition of W–2 wages includes amounts paid to
officers of an S corporation and common-law employees of an individual or RPE. Amounts paid as W–2 wages to an S corporation shareholder cannot be included in the recipient’s QBI. However, these amounts are included as W–2 wages for purposes of the W–2 wage limitation to the extent that the requirements of § 1.199A–2 are otherwise satisfied.

Another commenter suggested that, for purposes of the W–2 wage limitation, taxpayers should be able to include wages paid during the 12 months prior to the sale, disposition, or other transactions involving a business segment that generates LIFO and depreciation recapture. The Treasury Department and the IRS decline to adopt this comment. Section 199A(b)(4) provides that the term W–2 wages means, with respect to any person for any taxable year of such person, the amounts described in paragraphs (3) and (8) of section 6051(a) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year. Therefore, regardless of recapture, wages paid prior to a calendar year cannot be included in determining W–2 wages for such calendar year under the language of the statute.

B. UBIA

1. Qualified Property Held by an RPE

The proposed regulations provide that in the case of qualified property held by an RPE, each partner’s or shareholder’s share of the total UBIA of qualified property is an amount that bears the same proportion to the total UBIA of qualified property as the partner’s or shareholder’s share of tax depreciation bears to the RPE’s total tax depreciation with respect to the property for the year. In the case of a partnership with qualified property that does not produce tax depreciation during the year, each partner’s share of the UBIA of qualified property would be based on how gain would be allocated to the partners pursuant to sections 704(b) and 704(c) if the qualified property were sold in a hypothetical transaction for cash equal to the fair market value of the qualified property. Several commenters suggested that only section 704(b) should be used for this purpose, arguing that the use of section 704(c) allocation methods would be unduly burdensome and could lead to unintended results. One commenter recommended that partners should share UBIA of qualified property in the same manner that they share the economic depreciation of the property. Another commenter suggested allocating UBIA based on a ratio of each partner’s allocation of depreciation and the partnership’s total depreciation of qualified property for the year. One commenter requested clarification regarding how UBIA is allocated when a partner or shareholder has depreciation expense as an ordinary deduction and as a rental real estate deduction and they are allocated differently.

The Treasury Department and the IRS agree with the commenters that relying on section 704(c) to allocate UBIA could lead to unintended shifts in the allocation of UBIA. Therefore, the final regulations provide that each partner’s share of the UBIA of qualified property is determined in accordance with how depreciation would be allocated for section 704(b) book purposes under § 1.704–1(b)(2)(iv)(g) on the last day of the taxable year. To the extent a partner has depreciation expense as an ordinary deduction and as a rental real estate deduction, the allocation of UBIA should match the allocation of the expenses. The Treasury Department and the IRS request comments on whether a new regime is necessary in the case of a partnership with qualified property that does not produce tax depreciation during the taxable year. In the case of qualified property held by an S corporation, each shareholder’s share of UBIA of qualified property is a share of the unadjusted basis proportionate to the ratio of shares in the S corporation held by the shareholder on the last day of the taxable year over the total issued and outstanding shares of the S corporation.

2. Property Contributed to a Partnership or S Corporation in a Nonrecognition Transfer

The proposed regulations provide that the UBIA of qualified property means the basis on the placed in service date of the property. Therefore, the UBIA of qualified property contributed to a partnership in a section 721 transaction generally equals the partnership’s tax basis under section 723 rather than the contributing partner’s original UBIA of the property. Similarly, the UBIA of qualified property contributed to an S corporation in a section 351 transaction is determined by reference to section 362. Multiple commenters expressed concern that this treatment could result in a step-down in the UBIA of qualified property used in a trade or business at the time of the contribution due only to the change in entity structure. These commenters suggested that the UBIA of qualified property contributed to a partnership under section 721 or to an S corporation under section 351 should be determined as of the date it was first placed in service by the contributing partner or shareholder. Another commenter suggested that final regulations should generally provide for carryover of UBIA of qualified property in non-recognition transactions, but provide an anti-abuse rule for cases in which a transaction was engaged in with a principal purpose of increasing the section 199A deduction.

The Treasury Department and the IRS agree that qualified property contributed to a partnership or S corporation in a non-recognition transaction should generally retain its UBIA on the date it was first placed in service by the contributing partner or shareholder. Accordingly, § 1.199A–2(c)(3)(iv) provides that, solely for the purposes of section 199A, if qualified property is acquired in a transaction described in section 168(i)(7)(B), the transferee’s UBIA in the qualified property is the same as the transferor’s UBIA in the property, decreased by the amount of money received by the transferor in the transaction or increased by the amount of money paid by the transferee to acquire the property in the transaction.

The rules set forth in these regulations are limited solely to the determination of UBIA of qualified property for purposes of section 199A and are not applicable to the determination of gain, loss, basis, or depreciation with respect to transactions described in section 168(i)(7).

3. Property Received in a Section 1031 Like-Kind Exchange or Section 1033 Involuntary Conversion

Section 1.199A–2(c)(3) of the proposed regulations explains that UBIA of qualified property means the basis of qual-
ized property on the placed in service date of the property as determined under applicable sections of chapter 1 of subtitle A of the Code, which includes sections 1012 (Basis of property—cost), 1031 (Exchange of real property held for productive use or investment), and 1033 (Involuntary conversions). Section 1.199A–2(c)(3) of the proposed regulations also explains that UBIA of qualified property is determined without regard to any adjustments for depreciation described in section 1016(a)(2) or (3). Example 2 to proposed § 1.199A–2(c)(4) illustrates that the UBIA of qualified property received in a section 1031 like-kind exchange is the adjusted basis of the relinquished property transferred in the exchange as determined under section 1031(d), which reflects the adjustment in basis for depreciation deductions previously taken under section 168.

Several commenters argued that the proposed regulations discourage like-kind exchanges by providing an incentive to retain property in order to maintain greater UBIA of qualified property. These commenters argue that the UBIA of replacement qualified property should be the taxpayer’s UBIA of the relinquished property on the placed in service date by the taxpayer, increased by any additional capital invested by the taxpayer to acquire the replacement property, rather than the adjusted basis of the replacement property at the time of the exchange as determined under section 1031(d). This would be consistent with the step-in-the-shoes rule for determining the depreciable period. Another commenter suggested that if the rule is retained, the provision should be revised to treat the placed in service date as the date of the exchange.

Section 1.1002–1(c) of the Income Tax Regulations generally describes nonrecognition sections, including section 1031, as “exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal than substantial,” so that recognition and income inclusion at that time of the exchange are not appropriate. The underlying assumption of these exceptions to the recognition requirement is that the new property is substantially a continuation of the old investment still unliquidated; and in the case of reorganization, that the new enterprise, the new corporate structure, and the new property are substantially a continuation of the old still unliquidated investment. Id.

Application of section 1031(d) in determining UBIA for the replacement property would require, among other possible adjustments, a downward adjustment for depreciation deductions. This approach is contrary to the rule in § 1.199A–2(c)(3) of the proposed regulations that UBIA of qualified property is determined without regard to any adjustments for depreciation described in section 1016(a)(2) or (3).

Accordingly, the final regulations provide that the UBIA of qualified like-kind property that a taxpayer receives in a section 1031 like-kind exchange is the UBIA of the relinquished property. However, if a taxpayer either receives money or property not of a like kind to the relinquished property (other property) or provides money or other property as part of the exchange, the taxpayer’s UBIA in the replacement property is adjusted. The taxpayer’s UBIA in the replacement property is adjusted downward by the excess of any money or the fair market value of other property received by the taxpayer in the exchange over the taxpayer’s appreciation in the relinquished property (excess boot). Appreciation for this purpose is the excess of the relinquished property’s fair market value on the date of the exchange over the fair market value of the relinquished property on the date of acquisition by the taxpayer. This reduction for excess boot in the taxpayer’s UBIA in the replacement property reflects a partial liquidation of the taxpayer’s investment in qualified property.

If the taxpayer adds money or other property to acquire replacement property, the taxpayer’s UBIA in the replacement property is adjusted upward by the amount of money paid or the fair market value of the other property transferred to reflect additional taxpayer investment.

If the taxpayer receives other property in the exchange that is qualified property, the taxpayer’s UBIA in the qualified other property will equal the fair market value of the other property. Consequently, a taxpayer who receives qualified other property in the exchange is treated, for UBIA purposes, as if the taxpayer receives cash in the exchange and uses that cash to purchase the qualified property.

The rules are similar for qualified property acquired pursuant to an involuntary conversion under section 1033, except that appreciation for this purpose is the difference between the fair market value of the converted property on the date of the conversion over the fair market value of the converted property on the date of acquisition by the taxpayer. In addition, other property is property not similar or related in service or use to the converted property.

The rules set forth in these final regulations are limited solely to the determination of UBIA of qualified property for purposes of section 199A and are not applicable to the determination of gain, loss, basis, or depreciation with respect to transactions governed by sections 1031 or 1033.

In determining the depreciable period of replacement property acquired in a like-kind exchange or in an involuntary conversion, the proposed regulations apply § 1.168(i)–6 which, in turn, follows the rules in section 1031(d) or 1033(b), as applicable. Because the final regulations do not determine the UBIA of replacement property under section 1031(d) or 1033(b), the final regulations correspondingly remove the indirect references to those rules for determining the depreciable period of replacement property. To be consistent with the rules regarding the UBIA of replacement property that is of like kind to the relinquished property or that is similar or related in service or use to the involuntarily converted property, the final regulations provide that (i) for the portion of the individual’s or RPE’s UBIA in the replacement property that does not exceed the individual’s or RPE’s UBIA in the relinquished property or involuntarily converted property, the date such portion in the replacement property was first placed in service by the individual or RPE is the date on which the relinquished property or involuntarily converted property was first placed in service by the individual or RPE, and (ii) for the portion of the individual’s or RPE’s UBIA in the replacement property that exceeds the individual’s or RPE’s UBIA in the relinquished property or involuntarily converted property, such portion in the replacement property is treated as sepa-
rate qualified property that the individual or RPE first placed in service on the date on which the replacement property was first placed in service by the individual or RPE. This rule is not a change from the proposed regulations, but is consistent with the step-in-the-shoes rationale for determining the depreciable period for certain non-recognition transactions described in section 168(i)(7)(B).

In addition, the final regulations provide that when qualified property that is not of like kind to the relinquished property or qualified property that is not similar or related in service or use to involuntarily converted property is received in a section 1031 or 1033 transaction, such qualified property is treated as separate qualified property that the individual or RPE first placed in service on the date on which such qualified property was first placed in service by the individual or RPE. This rule is consistent with the rules regarding the UBIA of such qualified property.

The rules set forth in these final regulations are limited solely to the determination of the depreciable period for purposes of section 199A and are not applicable to the determination of the placed in service date for depreciation or tax credit purposes.

4. Sections 734(b) and 743(b) Special Basis Adjustments

The proposed regulations provide that basis adjustments under sections 734(b) and 743(b) are not treated as qualified property. The preamble to the proposed regulations describes concerns about inappropriate duplication of the UBIA of qualified property in circumstances such as when the fair market value of property has not increased and its depreciable period has not ended. Several commenters agreed that special basis adjustments could result in the duplication of UBIA of qualified property to the extent that the fair market value of the qualified property does not exceed UBIA. However, many of these commenters suggested that basis adjustments under section 734(b) and 743(b) should be treated as qualified property to the extent that the fair market value of the qualified property to which the adjustments relate exceeds the UBIA of such property immediately before the special basis adjustment. Other commenters recommended that both section 734(b) and section 743(b) adjustments should generate new UBIA. Commenters suggested a variety of methods for adjusting UBIA to account for the special basis adjustments. These included incorporating existing principles of sections 734(b), 743(b), 754, and 755 by determining the UBIA of separate qualified property by reference to the difference between the transferee partner’s outside basis and its share of UBIA; treating the entire amount of the section 743(b) adjustment as separate qualified property with a new depreciation period, with adjustments to the partner’s share of the partnership’s UBIA to avoid duplicating UBIA; and creating an entirely new regime mirroring the principles of sections 734(b), 743(b), 754, and 755.

The Treasury Department and the IRS agree that section 743(b) basis adjustments should be treated as qualified property to extent the section 743(b) basis adjustment reflects an increase in the fair market value of the underlying qualified property. Accordingly, the final regulations define an “excess section 743(b) basis adjustment” as an amount that is determined with respect to each item of qualified property and is equal to an amount that would represent the partner’s section 743(b) basis adjustment with respect to the property, as determined under §1.743–1(b) and §1.755–1, but calculated as if the adjusted basis of all of the partnership’s property was equal to the UBIA of such property. The absolute value of the excess section 743(b) basis adjustment cannot exceed the absolute value of the total section 743(b) basis adjustment with respect to qualified property. The excess section 743(b) basis adjustment is treated as a separate item of qualified property placed in service when the transfer of the partnership interest occurs. This rule is limited solely to the determination of the depreciable period for purposes of section 199A and is not applicable to the determination of the placed in service date for depreciation or tax credit purposes. The recovery period for such property is determined under §1.743–1(j)(4)(i)(B) with respect to positive basis adjustments and §1.743–1(j)(4)(ii)(B) with respect to negative basis adjustments.

The Treasury Department and the IRS do not believe that a section 734(b) adjustment is an acquisition of qualified property for purposes of determining UBIA. Section 734(b)(1) provides that, in the case of a distribution of property to a partner with respect to which a section 754 election is in effect (or when there is a substantial basis reduction under section 734(d)), the partnership will increase the adjusted basis of partnership property by the sum of (A) the amount of any gain recognized to the distributee partner under section 731(a)(1), and (B) in the case of distributed property to which section 732(a)(2) or (b) applies, the excess of the adjusted basis of the distributed property to the partnership immediately before the distribution (as adjusted by section 732(d)) over the basis of the distributed property to the distributee, as determined under section 732. The Treasury Department and the IRS do not believe that the adjustment to basis is an acquisition for purposes of section 199A.

Commenters also noted that the failure to adjust UBIA for reduction of basis under section 734 could result in a duplication of UBIA if property is distributed in liquidation of a partner’s interest in a partnership and the partner takes that property with the partner’s outside basis under section 732(b) without the partnership adjusting the UBIA in the partnership’s remaining assets. The Treasury Department and the IRS agree that such a duplication is inappropriate, but do not agree with commenters that such a distribution results in an increase in UBIA. These regulations provide that the partnership’s UBIA in the qualified property carries over to a partner that receives a distribution of the qualified property.

The Treasury Department and the IRS continue to study this issue and request additional comments on the interaction of the special basis adjustments under sections 734(b) and 743(b) with section 199A and whether a new regime for calculating adjustments with respect to UBIA is necessary.
Section 199A(b)(6)(A)(i) and proposed § 1.199A–2(c) provide that qualified property must be held by, and available for use in, the qualified trade or business at the close of the taxable year. One commenter suggested the final regulations contain a rule for determining the UBIA of qualified property in a short year on acquisition or disposition of a trade or business, similar to the guidance provided in § 1.199A–2(b)(2)(v) for purposes of calculating W–2 wages. The commenter suggested that one approach for UBIA could be a pro rata calculation based on the number of days the qualified property is held during the year. The Treasury Department and the IRS decline to adopt this suggestion because the statute looks to qualified property held at the close of the taxable year.

Another commenter asked for additional guidance on this rule with respect to qualified property held by an RPE. The commenter questioned whether the applicable taxable year is that of the taxpayer or the RPE. The commenter also asked how the rule would be applied if a taxpayer transferred his or her interest in an RPE. The Treasury Department and the IRS believe that the UBIA of qualified property is measured at the trade or business level. Accordingly, in the case of qualified property held by an RPE, the applicable taxable year is that of the RPE. A taxpayer who transfers an interest in an RPE prior to the close of the RPE’s taxable year is not entitled to a share of UBIA from the RPE.

In the context of S corporations, one commenter noted that section 1377(a) provides that income for the taxable year is allocated among shareholders on a pro rata basis by assigning a pro rata share of each corporate item to each day of the taxable year. The commenter suggested that all shareholders who were owners during the taxable year should be given access to the UBIA of qualified property held by an S corporation at the close of the S corporation’s taxable year. The Treasury Department and the IRS decline to adopt this comment because section 199A does not have a rule comparable to the rule in section 1377(a).

The proposed regulations provide that property is not qualified property if the property is acquired within 60 days of the end of the taxable year and disposed of within 120 days without having been used in a trade or business for at least 45 days prior to disposition, unless the taxpayer demonstrates that the principal purpose of the acquisition and disposition was a purpose other than increasing the section 199A deduction. The Treasury Department and the IRS received no comments with respect to this rule. The final regulations retain the rule but clarify that the 120 day period begins with the acquisition of the property.

6. Qualified Property Acquired from a Decedent

The preamble to the proposed regulations provides that for property acquired from a decedent and immediately placed in service, the UBIA generally will be its fair market value at the time of the decedent’s death under section 1014. One commenter recommended that the regulations should clearly state this rule in the regulatory text. The commenter recommended that the regulations should further clarify that the date of the decedent’s death should commence a new depreciable period for the property. The Treasury Department and the IRS adopt these comments. The final regulations provide that for qualified property acquired from a decedent and immediately placed in service, the UBIA of the property will generally be its fair market value at the date of the decedent’s death under section 1014. Further, the regulations provide that a new depreciable period for the property commences as of the date of the decedent’s death.

IV. Qualified Business Income, Qualified REIT Dividends, and Qualified PTP Income

A. Qualified Business Income

1. Items Spanning Multiple Tax Years

Section 1.199A–3(b)(1)(iii) provides that section 481 adjustments (whether positive or negative) are taken into account for purposes of computing QBI to the extent that the requirements of this section and section 199A are otherwise satisfied, but only if the adjustment arises in taxable years ending after December 31, 2017. One commenter suggested that income from installment sales and deferred cancellation of indebtedness income under section 108(i) arising in taxable years ending before January 1, 2018, should not be taken into account for purposes of computing QBI. The commenter also recommended that items deferred under Revenue Procedure 2004–34, 2004–1 C.B. 911 (advanced payments not included in revenue) prior to January 1, 2018, should be included in QBI. The Treasury Department and the IRS continue to study this issue and request additional comments on when items arising in taxable years prior to January 1, 2018, should be taken into account for purposes of computing QBI.

2. Previously Disallowed Losses

The proposed regulations provide that previously disallowed losses or deductions (including under sections 465, 469, 704(d), and 1366(d)) allowed in the taxable year are taken into account for purposes of computing QBI so long as the losses were incurred in a taxable year beginning after January 1, 2018. Because previously disallowed losses incurred for taxable years beginning before January 1, 2018, cannot be taken into account for purposes of computing QBI, several commenters recommended that final regulations provide an ordering rule for the use of such losses. Commenters recommended both “last-in, first-out” (LIFO) and “first-in, first-out” (FIFO) approaches, with a slight preference for the FIFO approach as consistent with former section 199. The Treasury Department and the IRS agree that taxpayers with previously disallowed losses for taxable years beginning both before and after January 1, 2018, require an ordering rule to determine which portion of a previously disallowed loss can be taken into account for purposes of section 199A. Consistent with regulations under former section 199, these regulations provide that any losses disallowed, suspended, or limited under the provisions of sections 465, 469, 704(d), and 1366(d), or any other similar provisions,
shall be used, for purposes of section 199A and these regulations, in order from the oldest to the most recent on a FIFO basis.

One commenter suggested that a special rule should be provided to identify the section 469 trade or business losses that are used to offset income if the taxpayer’s section 469 groupings differ from the taxpayer’s section 199A aggregations. The commenter recommended that any section 469 loss carryforward that is later used should be allocated across the taxpayer’s section 199A aggregations based on income with respect to such aggregations in the year the loss was generated. The Treasury Department and the IRS decline to adopt this comment. Concurrently with the publication of these proposed regulations, the Treasury Department and the IRS are publishing proposed regulations under section 199A (REG–134652–18) that treat previously suspended losses as losses from a separate trade or business for purposes of section 199A.

3. Net Operating Losses and the Interaction of Section 199A with Section 461(l)

The preamble to the proposed regulations requested comments on the interaction of sections 199A and 461(l). Commenters requested guidance in many areas including: ordering rules for the use of suspended active business losses; methods for tracing losses to a taxpayer’s various trades or businesses; whether a loss retains its character; whether a deduction under section 199A is a loss for calculating the loss limitation; and how the section 199A loss carryover rules interact with a loss limited under section 461(l). The Treasury Department and the IRS understand that taxpayers will need guidance as to the interaction of section 199A and section 461(l). However, these issues are beyond the scope of these regulations and will be considered in future guidance under section 461(l).

Section 199A(c)(1) provides that QBI includes the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer. Commenters requested additional guidance on whether certain items constitute qualified items under this provision. Several commenters suggested that deductions for self-employment tax, self-employed health insurance, and certain other retirement plan contribution deductions should not reduce QBI. One commenter reasoned that qualified retirement plan contributions should not reduce QBI because they should not be treated as being associated with a trade or business, consistent with the treatment when calculating net operating losses under section 172(d)(4)(D). The commenter also suggested that while self-employed health insurance is treated as associated with a trade or business, such expense should likewise not reduce QBI for purposes of simplification in administering the rule. Another commenter suggested that QBI should not be reduced by these expenses because they are personal adjustments. One commenter also requested guidance on whether unreimbursed partnership expenses of computing QBI in the subsequent taxable year in which it is deducted.

4. Recapture of Overall Foreign Losses

One commentator requested that Treasury and the IRS provide that U.S.-source taxable income arising upon recapture of an overall foreign loss described in section 904(f) be treated as QBI in the recapture year to the extent the overall foreign loss limited the section 199A deduction in a prior tax year. This comment was not adopted. Section 199A(c)(3)(A)(i) limits QBI to items that are effectively connected to a U.S. trade or business in the tax year concerned and the recapture rules in section 904(f) apply only for purposes of subchapter N, Part III, Subpart A of the Code. In addition, it would not be appropriate to expand the scope of QBI for recaptured foreign losses when no similar relief is available if non-qualifying domestic losses are subsequently offset by non-qualifying domestic income.

5. Treatment of Other Deductions

Section 199A(c)(1) provides that QBI includes the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer. Commenters requested additional guidance on whether certain items constitute qualified items under this provision. Several commenters suggested that deductions for self-employment tax, self-employed health insurance, and certain other retirement plan contribution deductions should not reduce QBI. One commenter reasoned that qualified retirement plan contributions should not reduce QBI because they should not be treated as being associated with a trade or business, consistent with the treatment when calculating net operating losses under section 172(d)(4)(D). The commenter also suggested that while self-employed health insurance is treated as associated with a trade or business, such expense should likewise not reduce QBI for purposes of simplification in administering the rule. Another commenter suggested that QBI should not be reduced by these expenses because they are personal adjustments. One commenter also requested guidance on whether unreimbursed partnership expenses of computing QBI in the subsequent taxable year in which it is deducted.

6. Guaranteed Payments for the Use of Capital

A few commenters suggested that the rule in the proposed regulations which excludes guaranteed payments for the use of capital under section 707(c) should be removed. Commenters argued that while section 199A(c)(4) excludes guaranteed payments paid to a partner for services rendered with respect to a trade or business under section 707(a), the statutory language does not likewise exclude guaranteed payments for the use of capital under section 707(c). The commenters ar-
guessed that Congress drew a line between payments for services and payments for the use of capital when it drafted section 199A(c) and that even though payments for the use of capital are determined without regard to the partnership’s income, that does not mean that they are not attributable to a trade or business. Several commenters stated that contrary to the reasoning in the preamble to the proposed regulations, there is risk involved when making guaranteed payments for the use of capital because the payments do rely to some degree on the partnership’s success. Commenters noted that guaranteed payments for the use of capital are generally accepted as part of the partner’s distributive share from the partnership and taxed as such, and should be included in calculating QBI. Similarly, another commenter generally requested additional guidance for how to determine when a payment to a partner is considered for the use of capital and excluded from the calculation of QBI. Another commenter suggested that if guaranteed payments for the use of capital under section 707(c) are excluded from the calculation of QBI, a partnership’s expense related to guaranteed payments for the use of capital also should be excluded from the calculation of QBI. One commenter suggested that to the extent a guaranteed payment for the use of capital is considered akin to interest income on indebtedness, it is generally appropriate to exclude the payment from QBI but noted the significant uncertainty in determining whether an arrangement is a guaranteed payment for the use of capital, a gross income allocation, or something else. The commenter also noted that guaranteed payments for the use of capital are not necessarily akin to interest income.

The Treasury Department and the IRS decline to adopt the comments suggesting that guaranteed payments for the use of capital are generally attributable to a trade or business. Although section 199A is silent with respect to guaranteed payments for the use of capital, section 199A does limit the deduction under section 199A to income from qualified trades or businesses. The Treasury Department and the IRS believe that guaranteed payments for the use of capital are not attributable to the trade or business of the partnership because they are determined without regard to the partnership’s income. Consequently, such payments should not generally be considered part of the recipient’s QBI. Rather, for purposes of section 199A, guaranteed payments for the use of capital should be treated in a manner similar to interest income. Interest income other than interest income which is properly allocated to trade or business is specifically excluded from qualified items of income, gain, deduction or loss under section 199A(c)(3)(B)(iii). One commenter noted that if guaranteed payments are treated like interest income for purposes of section 199A, and if such payments are properly allocated to a qualified trade or business of the recipient, they should constitute QBI to that recipient in respect of such qualified trade or business. Although, this is an unlikely fact pattern to occur, the Treasury Department and the IRS agree with this comment and the final regulations adopt this comment. Further, guidance under sections 707(a) and 707(c) is beyond the scope of these regulations.

7. Section 707(a) Payments for Services

The proposed regulations provide that any payment described in section 707(a) received by a partner for services rendered with respect to a trade or business, regardless of whether the partner is an individual or an RPE, is excluded from QBI. A number of commenters suggested that payments to partners in exchange for services provided to the partnership under section 707(a) should not be excluded from QBI and others suggested a narrowing of the rule for certain circumstances. Some commenters suggested that the payments should be QBI when the arrangement is structured as it would be with a third-party. Many commenters argued that section 707(a) payments should be QBI when the partner who is providing services has its own business separate from that of the partnership. On a related note, one commenter suggested payments for services should be QBI when the services provided are a different business from that of the partnership. Other commenters further suggested that payments should be QBI when the partner is not primarily providing services solely to one partnership. One commenter suggested that the rule excluding section 707(a) payments from QBI should be narrowed to apply only in the context of SSTBs or if the payments would be considered wages by the partner, but that generally payments from the partner’s qualified trade or business should be QBI. One commenter suggested that the regulations excluding section 707(a) payments from QBI be applied only to individuals and RPEs that are either (i) not otherwise engaged in a trade or business of providing similar services to other consumers or (ii) whose ownership interests in the partnership exceed a de minimis amount. Another commenter suggested that the exclusion of section 707(a) payments be replaced with a narrowly tailored anti-abuse rule that would exclude from QBI section 707(a) payments (i) paid to a partner owning more than 50 percent of the capital or profits interests in the partnership and (ii) designed with a primary purpose of causing income that would not otherwise have qualified as QBI to be treated as QBI.

The Treasury Department and the IRS decline to adopt these recommendations. As stated in the preamble to the proposed regulations, payments under section 707(a) for services are similar to guaranteed payments, reasonable compensation, and wages, none of which are includable in QBI. Thus, treating section 707(a) payments received by a partner for services rendered to a partnership as QBI would be inconsistent with the statute. Further, as noted by one commenter, it is difficult to distinguish between payments under section 707(a) and payments under section 707(a). Therefore, creating such a distinction would be difficult for both taxpayers and the IRS to administer.

Section 1.199A–3(b)(2) of the proposed regulations addresses items that are not taken into account as qualified items of income, gain, deduction, or loss, and includes all of the items listed in both section 199A(c)(3) (exceptions from qualified items of income, gain, deduction, and loss) and section 199A(c)(4) (treatment of reasonable compensation and guaranteed payments). As suggested by one commenter, the final regulations clarify that amounts received by an S corporation shareholder as reasonable compensation or by a partner as a payment for services under sections 707(a) or 707(c) are not taken into account as qualified items of
income, gain, deduction, or loss, and thus are excluded from QBI.

8. Interaction of Sections 875(l) and 199A

Section 199A(c)(3)(A)(i) provides that for purposes of determining QBI, the term qualified items of income, gain, deduction, and loss means items of income, gain, deduction and loss to the extent such items are effectively connected with the conduct of a trade or business within the United States (within the meaning of section 864(c), determined by substituting “qualified trade or business” (within the meaning of section 199A) for “nonresident alien individual or a foreign corporation” or for “a foreign corporation” each place it appears). The preamble to the proposed regulations provides that certain items of income, gain, deduction, and loss are treated as effectively connected income but are not with respect to a domestic trade or business (such as items attributable to the election to treat certain U.S. real property sales as effectively connected pursuant to section 871(d)), and are thus not QBI because they are not items attributable to a qualified trade or business for purposes of section 199A. One commenter agreed with this interpretation but requested additional guidance on the interaction between sections 875(l) and 199A, specifically whether the determination of whether an activity is a trade or business is made at the entity level for purposes of section 199A. The commenter also recommended that regulations distinguish between (1) items of income, gain, loss, or deduction that are incurred in a trade or business applying the principles of section 162 and (2) items of income, gain, deduction, or loss that are not incurred in such a trade or business.

For purposes of section 199A, the determination of whether an activity is a trade or business is made at the entity level. If an RPE is engaged in a trade or business, items of income, gain, loss, or deduction from such trade or business retain their character as they pass from the entity to the taxpayer – even if the taxpayer is not personally engaged in the trade or business of the entity. Conversely, if an RPE is not engaged in a trade or business, income, gain, loss, or deduction allocated to a taxpayer from such entity will not qualify for the section 199A deduction even if the taxpayer is not personally engaged in a trade or business. As described in part II.A.3 of this Summary of Comments and Explanation of Revisions, a trade or business for purposes of section 199A is generally defined by reference to the standards for a section 162 trade or business. A rental real estate enterprise that meets the safe harbor described in Notice 2017–07, released concurrently with these final regulations, may also treated as trades or businesses for purposes of section 199A. Additionally, the rental or licensing of property if the property is rented or licensed to a trade or business conducted by the individual or an RPE which is commonly controlled under §1.199A–4(b)(1)(i) is also treated as a trade or business for purposes of section 199A. In addition to these requirements, the items must be effectively connected to a trade or business within the United States as described in section 864(c).

One commenter requested guidance coordinating section 199A with section 751(a) and the rules for dispositions of certain interests by foreign persons in section 864(c)(8). The proposed regulations provide that, with respect to a partnership, if section 751(a) or (b) applies, then gain or loss attributable to assets of the partnership giving rise to ordinary income under section 751(a) or (b) is considered attributable to the trades or businesses conducted by the partnership, and is taken into account for purposes of computing QBI. The commenter questioned whether income treated as ordinary income under section 751 for purposes of section 864(c)(8) should be QBI. The treatment of ordinary income under section 751 for purposes of section 864(c)(8) is generally a function of section 864(c)(8). On December 27, 2018, the Federal Register published a notice of proposed rulemaking (REG–113604–18) at 83 FR 66647 under section 864(c)(8) (proposed section 864(c)(8) regulations). The proposed section 864(c)(8) regulations provide rules for determining the amount of gain or loss treated as effectively connected with the conduct of a trade or business within the United States (“effectively connected gain” or “effectively connected loss”) described in section 864(c)(8), including rules coordinating section 864(c)(8) with sections 741 and 751 (relating to the character of gain or loss realized in connection with the sale or exchange of an interest in a partnership). Because the proposed section 864(c)(8) regulations apply the deemed sale construct of section 751(a) to determine whether gain or loss on the sale of a partnership interest is subject to tax under section 864(c)(8), the issue raised in this comment does not arise, and thus this comment is not adopted. The Treasury Department and the IRS request further comments on the interaction of section 199A and the proposed regulations under section 864(c)(8) after the publication of those proposed regulations.

9. Reasonable Compensation

Several commenters were concerned that an overlap of the QBI, W–2 wage limitation, and reasonable compensation rules for S corporations would cause disparities between taxpayers operating businesses in different entity structures. These commenters stated that the rules might have the unintended consequence of encouraging taxpayers to select or avoid certain business entities. For example, one commenter noted that the reasonable compensation requirement for S corporations favors S corporations for purposes of the W–2 wage limitation when calculating the section 199A deduction, compared to sole proprietorships and partnerships which may not pay any wages. That commenter suggested the final regulations include an election for partners or sole proprietors to treat an amount of reasonable compensation paid as wages for purposes of the W–2 wage limitation. Other commenters similarly noted the entity choice issue, but from the perspective that S corporations can be less advantageous. The commenters argued that QBI is reduced for S corporation shareholders because reasonable compensation is not included in QBI and noted there could be further impacts depending on whether the taxpayer is above or below the income thresholds. These commenters suggested that the final regulations should strive for equity between taxpayers operating businesses in different entity structures. Finally, one commenter suggested the need for additional
guidance regarding whether and how reasonable compensation paid to an S corporation shareholder is considered wages for purposes of the W–2 wage limitation.

One commenter maintained that to avoid incentivizing minimization of compensation and Federal Insurance Contributions Act tax, the final regulations should provide that deductions with respect to reasonable compensation should not reduce QBI. The commenter stated that reasonable compensation must be added back in calculating QBI.

The Treasury Department and the IRS decline to adopt these suggestions. Section 199A(c)(4) clearly excludes reasonable compensation paid to a taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business from QBI. These amounts are attributable to a trade or business and are thus qualified items of deduction as described in section 199A(c)(3) to the extent they are effectively connected with the conduct of a trade or business within the United States and included or allowed in determining taxable income for the taxable year. In addition, reasonable compensation paid to a shareholder-employee is included as W–2 wages for purposes of the W–2 wage limitation to the extent that the requirements of § 1.199A–2 are otherwise satisfied. Further, guaranteed payments and payments to independent contractors are not W–2 wages and therefore, cannot be counted for purposes of the W–2 wage limitation.

A few commenters were concerned about whether tax return preparers would have the responsibility to closely examine whether compensation paid to a shareholder of an S corporation is reasonable before calculating the section 199A deduction, and whether tax return preparers could be subject to penalties. One commenter suggested a small business safe harbor approach where certain cash method S corporations that treat at least 70 percent of dividend distributions to shareholder-employees as wages are deemed to satisfy the reasonable compensation requirement of Rev. Rul. 74–44, 1974–1 C.B. 287. Providing additional guidance with respect to what constitutes reasonable compensation for a shareholder-employee of an S corporation or the application or non-application of assessable penalties applicable to tax return preparers is beyond the scope of these final regulations.

10. Items Treated as Capital Gain or Loss

The proposed regulations provide that any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss, including any item treated as one of such items, such as gains or losses under section 1231, that are treated as capital gains or losses, are not taken into account as a qualified item of income, gain, deduction, or loss in computing QBI.

Several commenters suggested that many technical complications arise from the exclusion of section 1231 gain from QBI. Specifically, commenters noted that whether a taxpayer has long-term capital gain or loss under section 1231 is determined at the taxpayer level and not at the level of the various trades or businesses for which QBI is being determined. For example, if a taxpayer has two businesses, the taxpayer may have section 1231 gains in one trade or business and section 1231 losses in the other trade or business. One commenter suggested that both section 1231 gains and losses be included in the calculation of QBI regardless of whether they result in a capital or ordinary amount when combined at the taxpayer level. The commenter asserts that this approach would not affect the overall limitation that restricts a taxpayer’s deduction to 20 percent of the excess of taxable income over net capital gain.

The Treasury Department and the IRS acknowledge the added challenges in applying section 1231 in the context of calculating QBI under section 199A. Generally, under section 1231, a taxpayer nets all of its section 1231 gains and losses from multiple trades or businesses before determining their ultimate character. In other words, the section 1231 determination is not made until the taxpayer combines its section 1231 gain or loss from all sources. This does not change in the context of section 199A. Thus, the section 1231 rules remain the same in the context of section 199A. For purposes of calculating QBI, taxpayers should continue to net their section 1231 gains and losses from their multiple trades or businesses to determine whether they have excess gain (which characterizes all of the gain or loss as capital and so all are excluded from QBI) or excess loss (which characterizes all of the gain or loss as ordinary and so all are included in QBI). As would be the case outside the section 199A context, the character tracks back to the trade or business that disposed of the asset.

Another potential complication noted by commenters is the section 1231(c) recapture rule. Under the rule, a taxpayer that has a section 1231 capital gain in the current year must look back to any section 1231 ordinary loss taken in the previous five years and convert a portion of the current year section 1231 capital gain to ordinary gain, based on the previous losses taken. One commenter asked for further guidance on how to allocate ordinary gains and losses that may result from the section 1231 calculation to multiple trades or businesses. While the Treasury Department and the IRS recognize the complexity in applying the section 1231(c) recapture rules and allocating gain to multiple trades or businesses, providing additional guidance with respect to section 1231(c) is beyond the scope of these regulations. For purposes of determining whether ordinary income is included in QBI, taxpayers should apply the section 1231(c) recapture rules in the same manner as they would otherwise. Notice 97–59, 1997–2 C.B. 309, provides guidance on netting capital gains and losses and how that netting incorporates the section 1231(c) recapture rule.

Given the specific reference to section 1231 gain in the proposed regulations, other commenters requested guidance with respect to whether gain or loss under other provisions of the Code would be included in QBI. One commenter asked for clarification about whether real estate gain, which is taxed at a preferential rate, is included in QBI. Additionally, other commenters requested clarification regarding whether items treated as ordinary income, such as gain under sections 475, 1245, and 1250, are included in QBI.

To avoid any unintended inferences, the final regulations remove the specific reference to section 1231 and provide that any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss, including any item treated as one of such items under any other provision of the Code, is not taken into account as a qualified item of income, gain, deduction, or loss. To the
reasonable approach to allocating items that are not clearly attributable to a single trade or business could be the cost allocation methods used in § 1.199–4(b)(2). The commenter suggested that the reasonableness standard could be applied to determine the allocation of items of QBI among multiple trades or businesses. The commenter also suggested a safe harbor allocation method allowing a taxpayer to bypass direct tracing if the amount of other items of QBI that must be allocated is below a pre-determined threshold, such as a percentage of total QBI or a specified dollar amount.

The Treasury Department and the IRS decline to adopt this comment as the rules under § 1.199–4 were intended solely for the allocation of expenses. By contrast, the rule described in § 1.199A–3(b)(5) requires the allocation of all qualified items of income, gain, loss, and deduction across multiple trades or businesses. Whether direct tracing or allocations based on gross income are reasonable methods depends on the facts and circumstances of each trade or business. Different reasonable methods may be appropriate for different items. Accordingly, the final regulations retain the rule in the proposed regulations. However, once a method is chosen for an item, it must be applied consistently with respect to that item. The Treasury Department and the IRS continue to study this issue and request additional comments, including comments with respect to potential safe harbors.

Another commenter requested guidance on when or how a method can be changed from year to year if, for example, it is no longer reasonable or no longer clearly reflects income. The Treasury Department and the IRS decline to adopt this comment as it is beyond the scope of these regulations. If a method is no longer reasonable or no longer clearly reflects income, the method cannot continue to be used. The individual or RPE must choose a new method that is reasonable under the facts and circumstances and apply it consistently going forward.

B. Qualified REIT Dividends

1. Regulated Investment Companies

A number of commenters requested guidance that would allow a shareholder in a RIC to take a section 199A deduction with respect to certain distributions or deemed distributions from the RIC attributable to qualified REIT dividends received by the RIC. One of these commenters also suggested that RICs should be able to pass through qualified PTP income. As noted in part II.A.2. of this Summary of Comments and Explanation of Revisions, the final regulations do not treat a RIC as an RPE, because a RIC is a C corporation, not a passthrough entity. However, concurrently with the publication of these final regulations, the Treasury Department and the IRS are publishing elsewhere in this issue of the Federal Register proposed regulations under section 199A (REG–134652–18, RIN 1545–BP12) that address the payment by RICs of dividends that certain shareholders may include as qualified REIT dividends under section 199A(b)(1)(B). The pass through by RICs of qualified PTP income would raise several novel issues and the commenter suggesting that RICs be allowed to pass through such income did not address how these issues should be resolved. Accordingly, the proposed regulations do not provide for the pass through of qualified PTP income by RICs, but request comments on the issues that would be presented if RICs were allowed to pass through qualified PTP income.

2. Meaning of Qualified REIT Dividend

The proposed regulations provide that a REIT dividend is not a qualified REIT dividend if the stock with respect to which it is received is held for fewer than 45 days, taking into account the principles of sections 246(c)(3) and (4). One commenter interpreted the rule as requiring the REIT stock to have been held at least 45 days prior to the dividend, and asked that the definition of qualified REIT dividend not be conditioned on a 45-day holding period. The commenter suggested that the reporting entity might not have sufficient information to determine whether the holding period was met and thus whether a particular dividend was in fact a qualified REIT dividend. The commenter also argued that the proposed rule was not part of the statutory text and could create significant administrative burdens, including in situations where there is no abuse and potentially subject a REIT or broker to information reporting penalties. The
commenter suggested two alternatives. First, the section 199A deduction could be disallowed to the extent it offsets short-term capital gains. Second, the holding period could be eliminated as part of the definition of qualified REIT dividend and the Treasury Department and the IRS could be given authority to disallow the deduction in the event that the taxpayer held the stock for the period specified in section 246(c)(1)(A).

The Treasury Department and the IRS have determined that a holding period for REIT stock with respect to which a qualified REIT dividend is received is appropriate in order to prevent abuse. The holding period in the proposed regulations requires holding the stock no fewer than any 45 days, not necessarily the 45 days prior to the REIT dividend. To provide additional certainty regarding the holding period requirements, these final regulations define the requisite holding period for the REIT stock as the period described in section 246(c)(1)(A). Generally, use of a holding period to prevent abuse is consistent with established principles under the Code, and the application of these principles and the duration of the holding period should be familiar to affected entities. Furthermore, the Treasury Department and the IRS intend to provide guidance to REITs and brokers on how to report qualified REIT dividends in instances in which it is impractical to determine whether the shareholder has met the requisite holding period. This guidance is expected to be similar to guidance instructing a person required to make a return under section 6042 to report a dividend as a qualified dividend on a Form 1099-DIV if such person determines that the recipient of the dividend has satisfied the holding period test in section 1(h)(11)(B)(iii) or it is impractical for such person to make such determination. See Notice 2003–79, 2003–2 C.B. 1206; Notice 2004–71, 2004–2 C.B. 793 and Notice 2006–3, 2006–1 C.B. 306. The Treasury Department and the IRS also intend to inform REIT shareholders that they may receive Forms 1099-DIV reporting qualified REIT dividends that are not actually qualified REIT dividends because the shareholders have not met the holding period requirement.

V. Aggregation

A. Overview

As described in part II of this Summary of Comments and Explanation of Revisions, the final regulations incorporate the principles of section 162 for determining whether a trade or business exists for purposes of section 199A. A taxpayer can have more than one section 162 trade or business. See § 1.1446–1(d)(1). Multiple trades or businesses can also be conducted within one entity. A trade or business, however, cannot generally be conducted across multiple entities for tax purposes.

The preamble to the proposed regulations acknowledges that it is not uncommon for what may be thought of as single trades or businesses to be operated across multiple entities, for various legal, economic, or other non-tax reasons. It is because trades or businesses may be structured this way that the proposed regulations permit aggregation.

The proposed regulations provide a set of rules under which an individual can aggregate multiple trades or businesses for purposes of applying the W–2 wage and UBIA of qualified property limitations described in § 1.199A–1(d)(2)(iv). Based on comments received, the final regulations retain these rules with modifications as described in the remainder of this part V. The Treasury Department and the IRS received comments in support of the aggregation rules generally, though some commenters suggested that the grouping rules described in the regulations under section 469 be used to determine when a taxpayer may aggregate. The Treasury Department and the IRS decline to adopt this suggestion. For reasons stated in the proposed regulations (that is, the differences in the definition of trade or business, section 469’s reliance on a taxpayer’s level of involvement in the trade or business, and the use of separate rules for specified service trades or businesses), the Treasury Department and the IRS do not consider the grouping rules under section 469 an appropriate method for determining whether a taxpayer can aggregate trades or businesses for purposes of applying section 199A. Another commenter suggested looking to the controlled group rules under section 414 rather than creating a new framework for aggregation. The Treasury Department and the IRS decline to adopt the controlled group rules under section 414 as those rules are too specific to be applied as a general aggregation rule under section 199A.

The preamble to the proposed regulations requested comments on whether the aggregation method described in § 1.199A–4 would be an appropriate grouping method for purposes of sections 469 and 1411, in addition to section 199A. One commenter suggested that the section 199A aggregation method would not be an appropriate method for sections 469 and 1411 because the primary focus of grouping under those sections is based on the taxpayer’s level of participation. Another commenter, noting that the standard for aggregation under the proposed regulations is narrower than the section 469 grouping requirements, recommended that taxpayers be permitted to adopt their section 199A aggregation for purposes of section 469. The commenter stated that this would provide taxpayers with an option to mitigate the administrative burden of multiple grouping rules. The Treasury Department and the IRS continue to study this issue and request additional comments.

B. General Rules

The proposed regulations provide rules that allow a taxpayer to aggregate trades or businesses based on a 50-percent ownership test, which must be maintained for a majority of the taxable year. The final regulations clarify that majority of the taxable year must include the last day of the taxable year. One commenter requested guidance on whether each individual included in making the ownership determination must own an interest in each trade or business to be aggregated. Another commenter suggested that to avoid abuse in situations where actual overlapping ownership is low, anyone who owns less than 10 percent of the value of an enterprise could be excluded from the group of owners whose ownership is considered in testing. The commenter suggested clarification or modification of the overlapping ownership requirement including by requiring a minimum ownership threshold of the trades or businesses, or that the 50 percent test use each owner’s lowest interest in the REIT. The ownership rule in
the proposed regulations do not require that every person involved in the ownership determination own an interest in every trade or business. The rule is satisfied so long as one person or group of persons holds a 50 percent or more ownership interest in each trade or business. The Treasury Department and the IRS decline to require a minimum ownership threshold for purposes of the ownership test as the abuse potential is outweighed by the administrative complexity such a rule would create. The Treasury Department and the IRS note that trades or businesses to be aggregated must meet all of the requirements of §1.199A–4, not just the ownership requirement.

Other commenters suggested that aggregation should be allowed for trades or businesses that do not meet the common ownership test if the general partner or managing member is the same for each entity. The Treasury Department and the IRS decline to adopt this recommendation. The aggregation rules are intended to allow aggregation of what is commonly thought of as a single trade or business where the business is spread across multiple entities. Common ownership is an essential element of a single trade or business.

Several commenters noted that the family attribution rules under section 199A do not include grandparents, siblings, or adopted children. One commenter requested clarification that the family attribution rules would not cause an aggregated trade or business to cease to qualify for aggregation when children and grandchildren reached adulthood. A few commenters requested guidance on the manner in which beneficial interests in trusts are considered for purposes of the common ownership rule. Other commenters suggested that the attribution rules in sections 267 and 707 should be used in place of the family attribution rule. Another commenter suggested that final regulations provide a specific attribution rule that treats owners of entities as owning a pro rata share of any business owned by the entity for purposes of the 50 percent ownership test. Another commenter recommended defining “directly or indirectly” as used in the proposed regulations by reference to a specific ownership rule. The final regulations address these recommendations by requiring that the same person or group of persons, directly or by attribution through sections 267(b) or 707(b), own 50 percent or more of each trade or business. A corporation may constitute part of this group.

In addition, the proposed regulations require that all items attributable to aggregated trades or businesses be reported on returns for the same taxable year. Several commenters recommended that this requirement be removed, arguing that trades or businesses that meet the ownership and factor tests could have different taxable years. The Treasury Department and the IRS decline to adopt this recommendation because the aggregation rules are intended for use in applying the W–2 wage and UBIA of qualified property limitations. As described in §1.199A–2(b), W–2 wages are determined based on a calendar year. Allowing trades or businesses with different taxable years to aggregate would require special rules for apportioning W–2 wages for purposes of applying the W–2 wage limitation. Accordingly, the final regulations retain the requirement that all of the items attributable to each trade or business to be aggregated are reported on returns at the trade or business level with the same taxable year, not taking into account short taxable years. One commenter asked for clarification regarding whether the majority of the taxable year requirement refers to the taxable year of the taxpayer claiming the deduction or of the RPE reporting the items. The aggregation rules are applied at the trade or business level. Accordingly, the majority of the taxable year requirement refers to the individual or RPE that conducts the trade or business to be aggregated.

The proposed regulations also provide that an SSTB cannot be aggregated. One commenter requested guidance on whether SSTBs with de minimis gross receipts are permitted to aggregate. A trade or business with gross receipts from a specified service activity below the de minimis thresholds described in §1.199A–5(c)(1) is not treated as an SSTB and therefore may be aggregated under the rules described in §1.199A–4. Another commenter suggested that the prohibition on aggregation for SSTBs is unnecessary because a taxpayer must combine W–2 wages and UBIA of qualified property for the aggregated trade or business prior to applying the W–2 wages and UBIA limitations. The commenter recommended that at a minimum, the prohibition be removed for taxpayers within the phase-in range and that taxpayers should be permitted to aggregate SSTBs with other SSTBs for reporting purposes. The Treasury Department and the IRS decline to adopt the recommendation to allow SSTBs to aggregate as doing so would increase administrative burden and complexity without providing significant benefit. Aggregation is intended to assist taxpayers in applying the W–2 wage and UBIA of qualified property limitations. A taxpayer with taxable income below the threshold amount does not need to apply the W–2 wage and UBIA of qualified property limitations and therefore will not benefit from aggregation. Further, the Treasury Department and the IRS decline to adopt the recommendation that the prohibition on aggregation of SSTBs be removed for taxpayers with taxable income within the phase-in range as taxpayers may have taxable income within the phase-in range for some taxable years and taxable income that exceeds the phase-in range in other taxable years.

To determine whether trades or businesses may be aggregated, the proposed regulations provide that multiple trades or businesses must, among other requirements, satisfy two of three listed factors, which demonstrate that the businesses are part of a larger, integrated trade or business. These factors include: (1) the businesses provide products and services that are the same (for example, a restaurant and a food truck) or customarily provided together (for example, a gas station and a car wash); (2) the businesses share facilities or share significant centralized business elements (for example, common personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources); or (3) the businesses are operated in coordination with, or reliance on, other businesses in the aggregated group (for example, supply chain interdependencies). Some commenters expressed support for the factors in the proposed regulations while others suggested modifications to the test. One commenter questioned whether, to meet the first factor, trades or businesses must provide both products and services that...
are the same. Another commenter noted that it is unclear how to apply the first factor with respect to real estate as real estate is neither a product nor a service. In response to these comments, the final regulations describe the first factor as products, property, or services that are the same or customarily offered together. Additionally, the final regulations add examples clarifying when a real estate trade or business satisfies the aggregation rules. Other commenters requested additional guidance on whether certain fact patterns regarding specific trades or businesses would satisfy a particular factor. The Treasury Department and the IRS decline to address specific fact patterns or trades or businesses because this test is based on all the facts and circumstances. Therefore, specific rules would be impractical and imprecise. Similarly, the Treasury Department and the IRS decline to define “significant” in terms of centralized business elements in the second factor because the answer is dependent on the facts and circumstances of each combination of trades and businesses.

Another commenter suggested that operational interdependence could be determined more precisely by using tests such as the twelve factor test outlined in §1.469–4T(g)(3). The commenter noted that such a test would be less likely to inappropriately preclude a section 199A deduction. Other commenters suggested that taxpayers be permitted to aggregate when two of the four factors are met. The Treasury Department and the IRS have carefully considered alternatives, including the factors outlined in §1.469–4T(g)(3). Aggregation of multiple trades or businesses is not provided for in the statutory text, but was added to the regulations to enhance administrability for taxpayers and the IRS in situations when what is thought of as a single trade or business is operated across multiple entities for various legal, economic, or other non-tax reasons. Aggregation is optional and the inability to aggregate does not preclude a taxpayer with QBI from multiple trades or businesses from claiming a section 199A deduction on the separate trades or businesses to the extent otherwise allowed by section 199A and these regulations. The Treasury Department and the IRS believe that reducing the required number of factors would allow the aggregation of trades or businesses that are not owned and operated as integrated businesses. Conversely, adding new factors would increase complexity and burden for both taxpayers and the IRS. Accordingly, the final regulations retain the factors provided in the proposed regulations, modified to take real estate into account.

C. Aggregation by RPEs

Multiple commenters recommended that RPEs be permitted to aggregate at the entity level. One commenter suggested that allowing aggregation at the entity level would reduce reporting requirements if the owners of taxpayers or beneficiaries of the entity were required to follow the entity’s aggregation. The commenter also suggested that entity aggregation would help non-majority owners by allowing them to benefit from aggregation without requiring the entity to provide ownership information. Another commenter suggested that reporting would be simplified if aggregation was allowed at the entity level when it is known that the owners want to aggregate. A third commenter suggested that aggregation should be allowed where each owner provides consent, including through provisions in the operating agreements. Another commenter suggested that if entity level aggregation is not allowed generally, an exception should be made for disregarded and wholly-owned entities.

The Treasury Department and the IRS agree that aggregation should be allowed at the entity level. Accordingly, the final regulations provide that an RPE to aggregate trades or businesses it operates directly or through lower-tier RPEs. The resulting aggregation must be reported by the RPE and by all owners of the RPE. An individual or upper-tier RPE may not separate the aggregated trade or business of a lower-tier RPE, but instead must maintain the lower-tier RPE’s aggregation. An individual or upper-tier RPE may aggregate additional trades or businesses with the lower-tier RPE’s aggregation if the rules of §1.199A–4 are otherwise satisfied. Each RPE in a tiered structure is subject to the disclosure and reporting requirements in §1.199A–4(c)(1). Further, as discussed in part II.C.1 of this Summary of Comments and Explanations of Revisions, §1.199A–1(e)(2) of the final regulations provides that an entity with a single owner that is treated as disregarded as an entity separate from its owner under any other provision of the Code is disregarded for purposes of section 199A and §§1.199A–1 through 1.199A–6.

D. Reporting and Disclosure

The proposed regulations require consistent reporting of aggregated trades or businesses. Each individual who chooses to aggregate must attach a statement to their return annually identifying each trade or business to be aggregated. A few commenters requested clarification of these rules in situations in which a taxpayer did not aggregate or failed to report an aggregation. Several commenters suggested that taxpayers be required to file only one disclosure in the first year the taxpayer chooses to aggregate and that any subsequent aggregation information be reported on the same form used to report a taxpayer’s section 199A deduction. Further, these commenters suggested that taxpayers be allowed to remedy a failure to provide the required information by filing an amended return or upon examination, provided that the taxpayer can establish reasonable cause for the failure. One commenter recommended that any required aggregation information be reported on a form for the section 199A deduction instead of as a separate statement. Additionally, commenters requested guidance as to whether a taxpayer is required to aggregate in its first year and if the failure to aggregate precludes aggregation in a later year. Finally, one commenter requested guidance regarding when a taxpayer could re-aggregate. The commenter suggested that options could include during an open season; after a change in circumstances; under a formal process similar to a change in accounting method; or based on a list of circumstances that would allow for automatic permission to re-aggregate.

Based on these comments, the final regulations provide that a taxpayer’s failure to aggregate trades or businesses will not be considered to be an aggregation under this rule; that is, later aggregation is not precluded. The final regulations do not generally allow for an initial aggregation to be made on an amended return as this would allow aggregation decisions to be
made with the benefit of hindsight. A taxpayer who fails or chooses not to aggregate in Year 1 can still choose to aggregate in Year 2 or other future year (but cannot amend returns to choose to aggregate for Year 1). A taxpayer who chooses to aggregate must continue to aggregate each taxable year unless there is a material change in circumstances that would cause a change to the aggregation. However, the Treasury Department and the IRS acknowledge that many individuals and RPEs may be unaware of the aggregation rules when filing returns for the 2018 taxable year. Therefore, the IRS will allow initial aggregations to be made on amended returns for the 2018 taxable year. The final regulations retain the annual disclosure requirement and, in order to provide flexibility as forms and instructions change, allow the Commissioner to require disclosure of information on aggregated trades or businesses as provided in a variety of formats including forms, instructions, or published guidance. The final regulations contain similar reporting and disclosure rules for RPEs.

The preamble to the proposed regulations requested comments on whether reporting requirements should be imposed on RPEs requiring majority owners to provide information about all of the other RPEs in which they hold a majority interest. One commenter stated that the extra time and cost of imposing additional reporting requirements on aggregated trades or businesses would not be worth the potential benefit a non-majority owner may gain by having such information. Another commenter suggested that the need for such a rule would be reduced if the final regulations allowed aggregation by RPEs. The Treasury Department and the IRS agree with these comments. Accordingly, the final regulations do not adopt a rule requiring the disclosure of such information to non-majority owners.

The proposed regulations permit the Commissioner to disaggregate trades or businesses if a taxpayer fails to attach the required annual disclosure. The preamble to the proposed regulations requested comments on an administrable standard under which trades or businesses will be disaggregated. One commenter suggested that a disaggregation rule is unnecessary because the Commissioner can always assert that an aggregation that was inappropriate should be disregarded. The commenter suggested that the Treasury Department and the IRS consider a rule allowing the Commissioner to aggregate trades or businesses in which the taxpayer engages in a transaction or series of transactions to divide trades or businesses in a manner that allows the taxpayer to use the aggregation rules to artificially increase the taxpayer’s section 199A deduction.

The Treasury Department and the IRS decline to adopt both of these suggestions. Although the Treasury Department and the IRS agree with the commenter that the Commissioner can always assert that an inappropriate aggregation should be disregarded, the reporting requirements, including the disaggregation rule, are necessary for the Commissioner to administer section 199A in accordance with the statutory intent. The final regulations clarify that the disaggregation is not permanent by providing that trades or businesses that are disaggregated by the Commissioner may not be re-aggregated for the three subsequent taxable years, similar to the typical period during which a tax return may be audited. The Treasury Department and the IRS also decline to adopt the commenter’s suggestion that the final regulations include an additional anti-abuse rule that would allow the Commissioner to aggregate trades or business in cases in which a division of the taxpayer’s trades or businesses is used in conjunction with the aggregation rules with a principal purpose of increasing the taxpayer’s section 199A deduction. As explained in part II.D. of this Summary of Comments and Explanation of Revisions, taxpayers and entities can have more than one trade or business. The suggested anti-abuse rule is overly broad and would create unnecessary complexity for both taxpayers and the IRS.

E. Examples

The proposed regulations provide several examples of the aggregation rules. One commenter noted that proposed § 1.199A–4(b)(1)(i) refers to the capital or profits of a partnership while the examples refer to the capital and profits of a partnership. The language in the examples was intended to demonstrate that the taxpayers were sharing proportionately in all items. For clarification, the final regulations retain the reference to capital or profits in § 1.199A–4(b)(1)(i) and update the examples to remove the references to capital and profits.

VI. Specified Service Trades or Businesses and the Trade or Business of Being an Employee

A. Definition of Specified Service Trade or Business

1. In General

The proposed regulations provide definitional guidance on the meaning of a trade or business involving the performance of services in each of the fields listed in section 199A(d)(2). Multiple commenters requested guidance on whether specific trades or businesses would constitute SSTBs. In many cases, the determination of whether a specific trade or business is an SSTB depends on whether the facts and circumstances demonstrate that the trade or business is in one of the listed fields. Although the Treasury Department and the IRS understand the desire for certainty, because the determination of whether a particular trade or business is an SSTB is factually dependent, this analysis is beyond the scope of these regulations.

Several commenters argued that the meaning of performance of services in the various fields should be limited to the definitions provided in § 1.448–1T(e)(4). A few commenters noted that any expansion beyond these definitions is contrary to legislative intent as expressed in “Tax Cuts and Jobs Act,” Statement of Managers to the Conference Report to Accompany H.R. 1, H.R. Rept. 115–466 (Dec. 15, 2017), p. 216–222. These commenters argue that the Statement of Managers notes that the committee adopted the Senate Amendment and described the section 448 regulations as an indicator of the meaning of services in the health, performing arts, and consulting fields referenced in section 1202(e)(3)(A) as incorporated by section 199A. The Treasury Department and the IRS decline to adopt these comments. While the Statement of Managers does reference § 1.448–1T(e)(4), nothing in the language of the report limits the definitions for purposes of section 199A to those provided in
§ 1.448–1T(e)(4). Section 199A does not reference section 448; instead, section 199A incorporates section 1202(e)(3)(A) with modifications. The Treasury Department and the IRS believe it is appropriate to look to the definitions provided for in the regulations under section 448 because guidance under section 1202 is limited. However, as stated in the preamble to the proposed regulations, the existing guidance under section 448 is not a substitute for guidance under section 199A.

The intent of section 448 and the intent of section 199A are different. Section 448 prohibits certain taxpayers from computing taxable income under the cash receipts and disbursements method of accounting. Qualified personal services corporations are excluded from this prohibition. Section 448(d)(2) defines the term qualified personal service corporation to include certain employee-owned corporations, substantially all of the activities of which involve the performance of services in the fields of health, law, engineering architecture, accounting, actuarial sciences, performing arts, or consulting. By contrast, section 199A provides a deduction based on QBI from a qualified trade or business. For taxpayers with taxable income above the phase-in range, an SSTB is not a qualified trade or business. Section 199A, through reference to section 1202, defines an SSTB as a trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners. The trade or business of the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)) is also defined as an SSTB for purposes of section 199A. Further, section 199A looks to the trade or business of performing services involving one or more of the listed fields, and not the performance of services themselves in determining whether a trade or business is an SSTB. The designation of a trade or business as an SSTB applies to owners of the trade or business, regardless of whether the owner is passive or participated in any specified service activity. Accordingly, it is both necessary and consistent with the statute and the legislative history to expand the definitions of the fields of services listed in section 199A(d)(1) and (2) and § 1.199A–5 beyond those provided in § 1.448–1T(e)(4).

One commenter suggested that in order to provide certainty and further economic growth, the final regulations should include a franchising example to clarify that a franchisor will not be considered to be an SSTB based solely on the selling of a franchise in a listed field of service. The Treasury Department and the IRS adopt this comment and have included a franchising example in the final regulations.

Finally, the final regulations add two rules of general application. First, the final regulations specify that the rules for determining whether a business is an SSTB within the meaning of section 199A(d)(2) apply solely for purposes of section 199A and therefore, may not be taken into account for purposes of applying any other provision of law, except to the extent that another provision expressly refers to section 199A(d). Second, the final regulations include a hedging rule that is applicable to any trade or business conducted by an individual or an RPE. The hedging rule provides that income, deduction, gain, or loss from a hedging transaction entered into in the normal course of a trade or business is included as income, deduction, gain, or loss from that trade or business. A hedging transaction for these purposes is defined in § 1.1221–2(b) and the timing rules of § 1.446–4 are also applicable.

The remainder of this part VI.A. responds to those comments advocating that a specific category of trade or business should be excluded from one of the listed fields in section 199A(d)(2) or from the SSTB provisions entirely.

2. Health

Multiple commenters submitted comments requesting additional guidance on the meaning of performance of services in the field of health. Several commenters recommended that the definition of the performance of services in the field of health should differentiate between institutional health care providers (such as skilled nursing homes), which bill on a fee-for-service or per diem-basis, versus health care providers who provide and bill for professional services (such as a physician’s practice). Another commenter suggested a distinction between these types of providers based on whether the trade or business had made the capital investment necessary to function as a custodial institution. One commenter recommended the definition be restricted to health care providers who derive a majority of their revenue from billing patients and third party payers for professional services, thereby excluding health care providers who derive a majority of their revenue from billing for institutional services (skilled nursing facilities, hospitals, ambulatory surgery centers, home health care agencies, outpatient radiology centers, and hospice agencies).

Commenters noted the many services that skilled nursing facilities and assisted living facilities provide are unrelated to health care, including housing, meals, laundry facilities, security, and socialization activities. In some cases, skilled nursing and similar facilities may make available independent contractors who provide services related to health care available to patients, without the facility receiving any payment or revenue with respect to such services. Another commenter suggested that skilled nursing facilities, assisted living, and similar facilities should be excluded from the definition of services in the field of health unless 95 percent or more of the time spent by employees of the facility are directly related to providing medical care.

The Treasury Department and the IRS agree that skilled nursing, assisted living, and similar facilities provide multi-faceted services to their residents. Whether such a facility and its owners are in the trade or business of performing services in the field of health requires a facts and circumstances inquiry that is beyond the scope of these final regulations. The final regulations provide an additional example of one such facility offering services that the Treasury Department and the IRS do not believe rises to the level of the performance of services in the field of health.

Several commenters asked for clarification regarding when two separate activities would generally be viewed separately, particularly in the context of health care facilities such as emergency centers,
urgent care centers, and surgical centers that provide improved real estate and equipment but do not directly provide treatment or diagnostic care to service recipients. One commenter noted that there is precedent under section 469 for distinguishing between the provision of direct treatment and diagnostic care versus the business of providing services or facilities ancillary to direct care, even if the physicians own an interest in the entity owning the facilities. The commenter suggested that the final regulations provide examples or other clarification regarding when these and similar facilities will be treated as performing services in the field of health, particularly if one of the owners of a facility also performs medical services in the facility. The final regulations provide an additional example of an outpatient surgical center demonstrating a fact pattern that the Treasury Department and the IRS do not believe is a trade or business providing services in the field of health.

Several commenters requested clarification regarding whether a retail pharmacy selling pharmaceuticals or medical devices is engaged in a health service trade or business. One commenter suggested that final regulations include an example of when a pharmacist would be considered in the health profession. The commenter agreed that a pharmacist working as an independent contractor at various pharmacies, a pharmacist providing inoculations directly to the patient, and a consulting pharmacist working as an independent contractor would all be examples of a pharmacist engaged in an SSTB. Another commenter stated that the inclusion of pharmacists in the definition might be overbroad, suggesting that a pharmacist who was also a pharmacy owner generating revenue from selling pharmaceuticals or medical devices would not be engaged in an SSTB while a pharmacist operating as a consultant and paid as an independent contractor would be engaged in an SSTB. A third commenter suggested that a pharmacist working as an independent contractor for several pharmacies would not be performing services in the field of health unless the pharmacists provide medical services, such as inoculations, directly to a patient.

The Treasury Department and the IRS agree that the sale of pharmaceuticals and medical devices by a retail pharmacy is not by itself a trade or business performing services in the field of health. As the commenters note, however, some services provided by a retail pharmacy through a pharmacist are the performance of services in the field of health. The final regulations provide an additional example of a pharmacist performing services in the field of health.

Another commenter argued that gene therapy and similar injectable products such as stem cell therapy and RNA-based therapies manufactured or produced from the patient’s body itself should be treated in the same manner as pharmaceuticals. The commenter argued that their manufacture and production should not be treated as an SSTB, regardless of whether they take place in a hospital or in a separate production facility. The Treasury Department and the IRS decline to adopt this recommendation as this is a question of facts and circumstances.

Another commenter argued that veterinary medicine should not be considered an SSTB. The commenter stated that delivery of veterinary care is different than delivery of human health care because veterinary patients are property and the nature of the animal may dictate the level of veterinary care provided by the owner. Most veterinary practices have other streams of income such as retail, laboratory and diagnostic services, boarding and grooming services, and pharmacies, and the commenter expressed concern that it would be difficult for veterinarians to segregate those other streams of income. The commenter noted that animal boarding and grooming would ordinarily generate income eligible for the deduction and that should not change when services are provided by a veterinarian. The commenter also noted that Federal health legislation does not apply to veterinarians unless the legislation specifically refers to veterinarians, veterinary medicine, or animal health. Finally, the commenter noted that § 1.448–1T(e)(4)(ii) does not reference veterinarians, suggesting that this is an indication that Congress did not intend for veterinary medicine to be treated as a business in the field of health.

Issued nearly three decades ago, Rev. Rul. 91–30, 1991–1 C.B. 61, described a corporation in which employees spend all of their time in the performance of veterinary services, including diagnostic and recuperative services as well as activities, such as the boarding and grooming of animals, that are incident to the performance of these services. The ruling also describes the definition of the performance of services in the field of health contained in § 1.448–1T(e)(4)(ii) and holds that a corporation whose employees perform veterinary services is a qualified personal service corporation within the meaning of sections 448(d)(2) and 11(b)(2) and a personal service corporation within the meaning of section 441(i). Accordingly, the Treasury Department and the IRS believe that it is appropriate to continue the long-standing treatment of veterinary services as the performance of services in the field of health for purposes of section 199A and these final regulations.

Another commenter noted that there is a dividing line between physical therapists and other health-related occupations. For example, reimbursement rates from third-party payers are higher for doctors, nurses, and dentists. The commenter also noted that Congress initially attempted to exclude physical therapists from participating in Medicare and Medicaid incentive programs and health service student loan forgiveness programs. The Treasury Department and the IRS decline to adopt this comment as multiple health services are reimbursed differently, but are still within the field of health.

One commenter suggested that services are not performed in the field of health unless services are performed directly to a patient. As an example, the commenter argued that a physician who reads x-rays for another physician but does not work directly with the patient would not be performing a service in the field of health. Another commenter stated that defining services in the field of health by proximity to patients could lead to arbitrary results, pointing out that a radiologist who acts as an expert consultant to a physician engages in the same exercise of medical skills and judgment as a physician who sees patients. The commenter suggested that technicians who operate medical equipment or test samples, but are not required to exercise medical judgment should not be considered as performing services in the field of health. The Treasury Department and the IRS agree with
the second commenter that proximity to patients is not a necessary component of providing services in the field of health. Accordingly, the final regulations remove the requirement that medical services be provided directly to the patient. The final regulations do not adopt the suggestion that technicians who operate medical equipment or test samples are not considered to be performing services in the field of health as this is a question of fact. However, the final regulations do include an additional example related to laboratory services.

3. Accounting

One commenter suggested that real estate settlement agents should be excluded from the definition of those who perform services in the field of accounting. The commenter recommended that final regulations define the performance of services in the field of accounting as the performance of core accounting services such as bookkeeping (including data entry), write-up work, review services, and attest functions, as well as tax preparation and similar functions. As an alternative, the commenter recommended that settlement agents be added as not constituting the practice of accounting. A second commenter stated that the definition of accounting should be narrowed to the ordinary meaning of accounting. This comment noted that the field of accounting should include bookkeeping and financial statement preparation, but not tax return advice and preparation. A third commenter noted that the proposed regulations treat bookkeeping services, which do not require professional training or license, as an accounting service. The commenter argued that if the intent of section 199A is to create parity between C corporations and passthrough entities, the regulations should narrowly define SSTBs, as was done for reputation and skill, and not expand the definitions beyond what was expressly contemplated by Congress.

The Treasury Department and the IRS decline to adopt these comments. As noted in the preamble to the proposed regulations, the provision of services in the field of accounting is not limited to services requiring state licensure. It is based on a common understanding of accounting, which includes tax return and bookkeeping services. Whether a real estate settlement agent is engaged in the performance of services in the field of accounting depends on the facts and circumstances including the specific services offered and performed by the trade or business.

4. Actuarial Science

The proposed regulations provide that the performance of services in the field of actuarial science means the provision of services by individuals such as actuaries and similar professionals performing services in their capacity as such. One commenter stated that the definition creates uncertainty for businesses that employ actuaries but do not separately bill for the services (such as insurance businesses). The commenter recommended providing a rule similar to the rule for consulting services related to the manufacture and sale of goods for actuarial science. The Treasury Department and the IRS decline to adopt this comment as section 199A looks to the trade or business of performing services rather than the performance of services themselves. As stated in the preamble to the proposed regulations, the field of actuarial science does not include the provision of services by analysts, economists, mathematicians, and statisticians not engaged in analyzing or assessing the financial cost of risk or uncertainty of events. The mere employment of an actuary does not itself cause a trade or business to be treated as performing services in the field of actuarial science. Whether a trade or business is providing actuarial services is a question of fact and circumstance.

5. Performing Arts

Multiple commenters stated that the definition of performance of services in the field of performing arts should be limited to the definition in § 1.448–1T(e)(4)(iii). One commenter argued that the position in the proposed regulations includes individuals who participate in the creation of the performing arts is not supported by the legislative history, namely the Statement of Managers that references the section 448 regulations. As described in part VII.A.1. of this Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS decline to limit the definition of the performance of services in the field of performing arts to the definition in § 1.448–1T(e)(4)(iii). Another commenter suggested that writers should fall outside the definition of the performance of services in the field of performing arts because writing does not require a skill unique to the creation of performing arts. Further, writers create a wide variety of works not intended to be performed before an audience. The Treasury Department and the IRS also decline to adopt this comment. To the extent that a writer is paid for written material, such as a song or screenplay, that is integral to the creation of the performing arts, the writer is performing services in the field of performing arts.

6. Consulting

One commenter suggested that proposed § 1.199A–5(b)(3), Example 3, should be modified to clarify that C, a taxpayer in the business of providing services that assist unrelated entities in making their personnel structures more efficient, does not provide any temporary workers, and C’s compensation and fees are not affected by whether C’s clients use temporary workers. The commenter argued that such a change would prevent the example from being interpreted as treating any recommendation for a business to use temporary workers as consulting services. The commenter also suggested that the final regulations include an additional example similar to Example 7 of § 1.448–1T(e)(4)(iv)(B) related to staffing firms. The commenter recommended that the example provide that a business that assists other businesses in meeting their personnel needs by referring job applicants to them does not engage in the performance of services in the field of consulting when the compensation for the business referring job applicants is based on whether the applicants accept employment positions with the businesses searching for employees. The final regulations adopt these suggestions.

Another commenter suggested that final regulations clarify whether services provided by engineers and architects could be considered to be an SSTB if their services meet the definition of consulting.
services. The Treasury Department and the IRS adopt this comment. Section 1.199A–5(b)(2)(vii) of the final regulations provides that services within the fields of architecture and engineering are not treated as consulting services for purposes of section 199A.

One commenter suggested that the definition of consulting should be narrowed to stand-alone advice and counsel with no link to production, manufacturing, sales, or licensing of products. The Treasury Department and the IRS decline to adopt this suggestion as it would be difficult to administer and subject to manipulation. Another commenter suggested that the phrase “provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems” is overly broad as it could apply to almost any service-based business that assists clients in achieving goals and solving problems. The commenter stated that applying the ancillary rule would be difficult where a taxpayer is required to separately bill for embedded consulting services under state or local sales tax laws. The commenter suggested that the consulting field should be limited to taxpayers that fall under a consulting-related business activity code under the North American Industry Classification Systems (NAICS). The Treasury Department and the IRS agree with the commenter that many service-based businesses could be construed as providing professional advice and counsel to clients to assist the client in achieving goals and solving problems; however, the Treasury Department and the IRS decline to adopt the recommendation to limit the consulting field based on NAICS codes. Section 1.199A–5(b)(2)(vii) excludes the performance of services other than providing advice and counsel from the field of consulting. At issue is whether advice and counsel is provided in the context of the provision of goods or services (that are not otherwise SSTBs). This is a question of facts and circumstances. Consulting services that are separately billed are generally not considered to be provided in the context of the provisions of goods or services.

7. Athletics

A few commenters suggested that the definition of a trade or business involving the performance of services in the field of athletics should not include the trade or business of owning a professional sports team. One commenter stated that the definition should be limited to entities that are either owned or controlled by, or whose primary beneficiaries are, professional athletes or that involve the performance of services by those athletes; in other words, the definition should apply solely to athletes’ personal services companies.

Another commenter recommended that § 1.199A–5(b)(3) Example 2 be revised to reflect that neither sports clubs nor club owners perform services described in section 1202(e)(3)(A). The commenter stated that a professional sports club and its owners do not perform services in the field of athletics. Instead, a sports club sells tickets, licenses, sponsorships, and other intellectual property, creates digital content, engages in community activities, manages a stadium, and produces an entertainment product. The commenter argued that Congress intended through the SSTB rules to prevent W–2 wage income from being converted to QBI and that only the trade or business of an athlete involves W–2 wage income from athletic performance. The commenter continued, stating that professional sports clubs are not described in section 1202(e)(3)(A) or provided in section 448(d)(2)(A).

The Treasury Department and the IRS decline to adopt this comment. As described in part VII.A.1. of this Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS do not believe that definitional guidance should be limited to that provided in § 1.448–1T(e)(4)(i) (by analogy to performing arts for athletics). While sports club and team owners are not performing athletic services directly, that is not a requirement of section 199A, which looks to whether there is income attributable to a trade or business involving the performance of services in a specified activity, not who performed the services. A professional sports club may operate more than one trade or business. For example, a team may operate its concession services as a separate trade or business. The Treasury Department and the IRS agree that such concession services generally would not be a trade or business of performing services in the field of athletics. Nonetheless, a professional sports club’s operation of an athletic team is a trade or business of performing services in the field of athletics. Income from that trade or business, including income from ticket sales and broadcast rights, is income from a trade or business of performing services in the field of athletics. The performance of services in the field of athletics does not include the provision of services by persons who broadcast or otherwise disseminate video or audio of athletic events to the public.

8. Financial Services

Several commenters suggested that final regulations clarify that financing, including taking deposits, making loans, and entering into financing contracts, is not a financial service. One commenter requested an explicit rule clarifying that non-bank mortgage bankers are not SSTBs and that customary activities of mortgage bankers including mortgage loan origination, sales of mortgage loans, mortgage loan servicing, and sale of mortgage servicing rights are not financial services. The preamble to the proposed regulations provides that the provision of financial services does not include taking deposits or making loans. The final regulations clarify that the provision of financial services does not include taking deposits or making loans.

One commenter stated that the determination that banking is not a financial service appears to be wrong and inconsistent with statutory construction since any common definition of financial services includes banking services. As stated in the preamble to the proposed regulations, banking is listed in section 1202(e)(3)(B) but not section 1202(e)(3)(A). As a matter of statutory construction, the Treasury Department and the IRS believe that banking must therefore be excluded from the definition of financial services for purposes of section 199A. Another commenter suggested that insurance should be categorically excluded from the meaning of financial services because insurance is described...
in section 1202(e)(3)(B). The Treasury Department and the IRS agree that by operation of section 1202(e)(3)(B), insurance cannot be considered a financial service for purposes of section 199A. The commenter also suggested that a rule similar to the ancillary services rule for consulting should be extended to cover financial services. Another commenter argued that insurance agents and others who provide investment advice are not in the field of financial services, unless the agent receives a fee for the advice, rather than a commission on the sale. The Treasury Department and the IRS decline to categorically exclude services provided by insurance agents from the definition of financial services as financial services such as managing wealth, advising clients with respect to finances, and the provision of advisory and other similar services that can be provided by insurance agents. However, the Treasury Department and the IRS note that the provision of these services to the extent that they are ancillary to the commission-based sale of an insurance policy will generally not be considered the provision of financial services for purposes of section 199A.

9. Brokerage Services

Another commenter suggested that final regulations clarify that life insurance products are not securities for purposes of section 199A or that life insurance brokers engaged in their capacity as such are not brokers in securities for purposes of section 199A. Other commenters requested the final regulations clarify that the business of financing or making loans, including the services provided by mortgage banking companies, does not fall within the definition of brokerage services. The Treasury Department and the IRS address this comment in the final regulations by explicitly stating that although the performance of services in the field of financial services does not include taking deposits or making loans, it does include arranging lending transactions between a lender and borrower. The final regulations define securities by reference to section 475(c)(2).

10. Investing and Investment Management

One commenter recommended that the performance of services that consist of investing and investment management be limited to investment management and investment advisory businesses whose income is principally attributable to the performance of personal services involving the provision of investment advice or the regular and contemporaneous management of investors’ assets by individual employees or owners of the business. The commenter recommended that the definition exclude large, diversified asset managers that invest significant capital in and derive significant income from the research, development, and sale of investment products. The commenter suggested that rather than making business-by-business determinations, the final regulations should look to rules such as the regulations under now repealed section 1348 looked to earned income including fees received by taxpayers engaged in a professional occupation. Section 199A is focused on a trade or business, not a profession of an individual. Accordingly, the determination of whether a trade or business in an SSTB must be made on a business-by-business basis.

Another commenter suggested that final regulations clarify that investing and investment management does not include the sale of life insurance products and that life insurance products are not investments for purposes of section 199A. The Treasury Department and the IRS decline to define investment for purposes of section 199A but note that commission-based sales of insurance policies generally will not be considered the performance of services in the field of investing and investing management for purposes of section 199A.

Another commenter recommended that final regulations clarify that directly managing real property includes management through agents and affiliates acting as agents for the property manager. The SSTB limitations apply to direct and indirect owners of a trade or business that is an SSTB, regardless of whether the owner is passive or participated in any specified service activity. Accordingly, direct and indirect management of real property includes management through agents, employees, and independent contractors.

11. Dealing

a. Mortgage Banking, Credit Sales, and Non-Bank Lending

Several commenters suggested that the provisions regarding dealing in securities should exclude mortgage banking and other lending activities in which lending is the primary business focus. Several of these commenters noted that the plain language meaning of “purchasing securities” does not include making loans. One commenter suggested that the reference to the definition of negligible sales should be clarified to explain that negligible sales as
defined in § 1.475(c)–1(c)(2) and (4) does not apply if the loan is in connection with mortgage servicing contracts as excluded in section 451(b)(1)(B). Another commenter suggested that portfolio lenders should also be able to use the negligible sales exemption and all sales of loans outside the ordinary course of business should be excluded from consideration in applying the negligible sales test. A third commenter suggested that the regulation clarify that the negligible sales exception is simply an exception to the general definition of dealing in securities. Another commenter suggested that application of dealing in securities should be limited to taxpayers engaged in broker-dealer activities for which registration under Federal law would be required. Another commenter suggested that the creation of a loan should not be construed as a purchase and a taxpayer should be considered a dealer in securities only if they both purchase and sell securities. As an alternative, this commenter suggested that negligible sales could be defined in terms of the number of customers that the lender sells loans to each year. For this purpose, the Government National Mortgage Association (GNMA) would be considered to be the customer for purposes of sales of GNMA mortgage pools through the issuance of mortgage backed securities. Another commenter suggested that sales of retail installment contracts or loans for purposes of liquidity, portfolio diversification, and similar purposes should be considered to be outside of recurring business activity and thus not dealing in securities. In response to these comments, the final regulations provide that for purposes of section 199A and the definition of performing services that consist of dealing in securities, the performance of services to originate a loan is not treated as the purchase of a security from the borrower in determining whether the lender is performing services consisting of dealing in securities. The comment regarding the definition of a dealer in securities, however, is not accepted, as the definition of a securities dealer has never involved the performance of services that consist of dealing in securities. Another commenter suggested that the meaning of sales to customers should be clarified in the context of a mortgage finance business. This commenter requested that the regulations clarify that a mortgage loan originator which transfers mortgages to an agency or broker/dealer for cash or mortgage-backed securities does not engage in a sale by the originator to a customer for purposes of section 199A.

In response to these comments, the final regulations provide that the performance of services to originate a loan is not treated as the purchase of a security from the borrower in determining whether the lender is performing services consisting of dealing in securities. The comment regarding the definition of a dealer in securities, however, is not accepted, as the definition of a securities dealer has never involved the performance of services that consist of dealing in securities. The commenter also suggested that the definition of dealing in securities should be clarified in the context of a mortgage finance business. This commenter requested that the regulations clarify that a mortgage loan originator which transfers mortgages to an agency or broker/dealer for cash or mortgage-backed securities does not engage in a sale by the originator to a customer for purposes of section 199A.

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In response to these comments, the final regulations provide that the performance of services to originate a loan is not treated as the purchase of a security from the borrower in determining whether the lender is performing services consisting of dealing in securities. The comment regarding the definition of a dealer in securities, however, is not accepted, as the definition of a securities dealer has never involved the performance of services that consist of dealing in securities. The commenter also suggested that the definition of dealing in securities should be clarified in the context of a mortgage finance business. This commenter requested that the regulations clarify that a mortgage loan originator which transfers mortgages to an agency or broker/dealer for cash or mortgage-backed securities does not engage in a sale by the originator to a customer for purposes of section 199A.

b. Banking

Many commenters recommended that traditional banking activities be excluded entirely from the definition of an SSTB, including the performance of services that consist of dealing in securities. The commenters argued that Congress intended banks that elect under section 1362(a) to be S corporations (subchapter S banks) to have the same relative reduction in taxes as C corporation banks after enactment of the TCJA. Many commenters noted that subchapter S bank activities are already strictly limited by the Bank Holding Company Act and this effectively serves as a guardrail against abuse of the section 199A deduction. As an alternative, commenters suggested that the definition of SSTB should be more narrowly drawn to exclude bank services such as trust or fiduciary services, securities brokerage, and the origination and sale of mortgages and loans. Commenters also expressed concern that the de minimis rule is insufficient to protect banks. These commenters suggested revisions including raising the de minimis threshold to 25 percent regardless of the amount of gross receipts and using net income rather than gross receipts for the measure.

The Treasury Department and the IRS decline to accept these comments. Although the final regulations continue to exclude taking deposits or making loans from the definition of an SSTB involving the performance of financial services, and exclude the origination of loans from the definition of dealing in securities for purposes of section 199A, the Treasury Department and the IRS do not believe that there is a broad exemption from the listed SSTBs with respect to all services that may be legally permitted to be performed by banks. Therefore, to the extent a bank operates a single trade or business that involves the performance of services listed as SSTBs outside of the de minimis exception, such as investing and investment management, the bank’s single trade or business will be treated as an SSTB. However, as noted previously, an RPE, including a subchapter S bank, may operate more than one trade or business. Thus, a subchapter S bank could segregate specified service activities from an existing trade or business and operate such specified service activities as an SSTB separate from its remaining trade or business, either within the same legal entity or in a separate entity.

c. Commodities

Several commenters suggested that the final regulations provide that a trade or business is not engaged in the performance of services of investing, trading, or dealing in commodities if it regularly takes physical possession of the underlying commodity in the ordinary course of
its trade or business. These commenters also argued that a business that takes physical possession of the commodity should not be treated as an SSTB if it hedges its risk with respect to the commodity as part of the ordinary course of its trade or business. The commenters state that dealing in commodities for purposes of section 199A should be understood to mean an activity similar to dealing in securities and should be limited to the dealing in financial instruments referenced to commodities, such as commodities futures or options that are traded on regulated exchanges. One commenter argued that if the regulations were to apply to physical commodities it would result in different tax treatment depending on whether the commodity is actively traded and that Congress intended the definition of commodities to apply only to commodities derivatives. Another commenter suggested that manufacturing activities as defined under the now repealed section 199 should be expressly excluded from the definition of both trading in commodities and dealing in commodities.

The Treasury Department and the IRS agree with commenters that the definition of dealing in commodities for purposes of section 199A should be limited to a trade or business that is dealing in financial instruments or otherwise does not engage in substantial activities with respect to physical commodities. To distinguish a trade or business that performs substantial activities with physical commodities from a trade or business that engages in a commodities trade or business by dealing or trading in financial instruments that are commodities (within the meaning of section 475(e)(2)), or a trade or business that otherwise does not perform substantial activities with commodities, the final regulations adopt rules similar to the rules that apply to qualified active sales of commodities in § 1.954–2(f)(2)(iii). Those rules generally require a person to be engaged in the active conduct of a commodities business as a producer, processor, merchant, or handler of commodities and to perform certain activities with respect to those commodities.

Accordingly, for purposes of section 199A, gains and losses from the sale of commodities in the active conduct of a commodities business as a producer, processor, merchant, or handler of commodities will be qualified active sales and gains and losses from qualified active sales are not taken into account in determining whether a person is engaged in the trade or business of dealing in commodities. Similarly, income, deduction, gain, or loss from a hedging transaction (as defined in § 1.1221–2(b)) entered into in the normal course of a commodities business conducted by a producer, processor, merchant, or handler of commodities will be treated as gains and losses from qualified active sales that are part of that trade or business. Qualified active sales generally require a taxpayer to hold commodities as inventory or similar property and to satisfy specified conditions regarding substantial and significant activities described in the final regulations. A sale by a trade or business of commodities held for investment or speculation is not a qualified active sale.

13. Reputation/Skill

Many commenters expressed support for the position in the proposed regulations that reputation or skill was intended to describe a narrow set of trades or businesses not otherwise covered by the other listed SSTBs, often writing that a more broad interpretation would be inherently complex and unworkable. Other commenters disagreed with the definition in the proposed regulations, expressing concern that the narrowness of the definition is contrary to the language of the statute and Congressional intent.

The Treasury Department and the IRS remain concerned that a broad interpretation of the reputation and skill clause would result in substantial uncertainty for both taxpayers and the IRS. As stated in the preamble to the proposed regulations, it would be inconsistent with the text, structure, and purpose of section 199A to potentially exclude income from all service businesses from qualifying for the section 199A deduction for taxpayers with taxable income above the threshold amount. If Congressional intent was to exclude all service businesses, Congress clearly could have drafted such a rule. Accordingly, the final regulations retain the proposed rule limiting the meaning of the reputation or skill clause to fact patterns in which an individual or RPE is engaged in the trade or business of receiving income from endorsements, the licensing of an individual’s likeness or features, and appearance fees.

One commenter requested additional clarification regarding whether advertising income received for on air advertising spots in which a program host reads a script describing the positive qualities of a product or service, and may also choose to describe his or her own positive experiences with the product, is endorsement income as described in § 1.199A–5(b)(2)(xiv)(A). The commenter argued that such income should not be considered endorsement income because it is not received in connection with a separate trade or business of making endorsements. The Treasury Department and the IRS decline to adopt this suggestion as § 1.199A–5(b)(2)(xiv)(A) looks to whether the individual or RPE is receiving income from the endorsement of products or services, not whether the income is received in connection with a separate trade or business of making endorsements. Whether a taxpayer endorses a product or services is dependent on the facts and circumstances.

B. De Minimis Rule

The proposed regulations provide that for a trade or business with gross receipts of $25 million or less for the taxable year, a trade or business is not an SSTB if less than 10 percent of the gross receipts of the trade or business are attributable to a specified service field. The percentage is reduced to 5 percent in the case of trades or businesses with gross receipts in excess of $25 million. Several commenters requested clarification regarding whether the entire trade or business is designated an SSTB if the threshold is exceeded. Some of these commenters suggested that the rule be modified so that the deduction could be claimed on the portion of the trade or business activity that was not an SSTB. A few suggested that an allocation similar to that in now repealed section 199 could be used. One commenter suggested using the cost accounting principles of section 861 with a safe harbor allowing a simplified method for entities with average annual gross receipts less than $25 million. Another commenter stated that
treating the entire trade or business as an SSTB is a trap for the unwary because well-advised taxpayers could avoid application of the rule by rearranging their activities into separate entities. One commenter suggested that the de minimis rule allow for minor year-to-year changes in gross receipts for businesses that are close to the de minimis thresholds. The commenter also suggested that the thresholds be increased and recommended an incremental approach in which the deduction is calculated based on the portion of the business that is not engaged in an SSTB. Another commenter suggested that if the rule is retained, it should be imposed only at a greater than 50 percent threshold since only at that point would SSTB gross receipts predominate over non-SSTB gross receipts. The commenter also noted that a higher threshold would be easier to track. Several commenters also suggested that the de minimis threshold be raised. One commenter suggested that the de minimis threshold be raised to 20 percent for all qualified businesses, regardless of gross receipts. The commenter argued that a 20 percent threshold is supported by Congress’s decision to use section 1202(e) for its definition of an SSTB, noting that section 1202(e)(1)(A) uses an at least 80 percent (by value) rule for determining whether a qualified trade or business satisfies the section’s active business requirement. Other commenters recommended that the ten percent threshold should apply for purposes of the de minimis threshold regardless of the amount of gross receipts of the trade or business. Public comments lacked consensus regarding the 5-percent de minimis threshold. After considering all of the comments, the Treasury Department and the IRS chose to retain the 5-percent threshold in the final regulations as it is a de minimis threshold that is generally consistent with prior regulations under the Code in similar circumstances and therefore, such a standard should be familiar to affected entities.

Another commenter suggested that final regulations clarify whether revenue generated from the sale of medical products or devices should be excluded from the overall QBI for trades or businesses that provide services in the field of health. The commenter noted that physicians who provide their patients with medical services should be able to use the deduction with respect to income from such devices and expressed concern that the de minimis thresholds could limit the ability of some practitioners to use the deduction. Another commenter suggested that a business with SSTB gross receipts in excess of the de minimis should not be entirely disqualified, but that the facts and circumstances should be analyzed to determine the true nature of the trade or business. The commenter also suggested that a safe harbor should be provided in which a business can make an election to deem the SSTB activity as a separate trade or business solely for the purposes of section 199A. Finally, one commenter suggested that final regulations include an example of what result occurs if a taxpayer’s SSTB revenue is not de minimis.

The Treasury Department and the IRS decline to adopt most of the recommendations in these comments. As stated in the preamble to the proposed regulations, the statutory language of section 199A does not provide a certain quantum of activity before an SSTB is found. Rather, section 199A looks to whether the trade or business involves the performance of services in the list of SSTBs. The use of the word “involving” suggests that any amount of specified service activity causes a trade or business to be an SSTB. Consequently, the Treasury Department and the IRS believe that it would be inappropriate to adopt a pro rata rule. However, requiring all taxpayers to evaluate and quantify any amount of specified service activity would be unduly burdensome and complex for both taxpayers and the IRS. Accordingly, the proposed rule provides a de minimis threshold under which a trade or business will not be considered an SSTB merely because it provides a small amount of services in a specified service activity. Trades or business with gross income from a specified service activity in excess of the de minimis threshold are considered to be SSTBs. The final regulations retain the proposed rule but add an additional example demonstrating the result in which a trade or business has income from a specified service activity in excess of the de minimis threshold.

As discussed in part II of this Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS acknowledge that an RPE can have more than one trade or business for purposes of section 162 and thus for section 199A. However, each trade or business is required under section 199A to be separately tested to determine whether that trade or business is an SSTB. Similarly, the de minimis threshold is applied to each trade or business of an RPE separately, not in the aggregate to all the trades or businesses of the RPE. Thus, to the extent that an individual or RPE has more than one trade or business, the presence of specified service activity in one of those trades or business will not cause the individual’s or RPE’s other trades or businesses to be considered SSTBs except to the extent that the rules in § 1.199A–5(c)(2) (services or property provided to an SSTB) apply.

C. Services or Property Provided to an SSTB.

The proposed regulations provide special rules for service or property provided to an SSTB by a trade or business with common ownership. A trade or business that provides more than 80 percent of its property or services to an SSTB is treated as an SSTB if there is 50 percent or more common ownership of the trades or businesses. In cases in which a trade or business provides less than 80 percent of its property or services to a commonly owned SSTB, the portion of the trade or business providing property to the commonly owned SSTB is treated as part of the SSTB with respect to the related parties.

One commenter suggested that the provision is warranted because of abuse potential but is overbroad and prevents legitimate transactions. The commenter recommended that the rule be modified into a presumption that a taxpayer could rebut with evidence demonstrating that the property or services provided to the SSTB by the related RPE are (1) comparable to those available from competing organizations and (2) that prices charged by the RPE and paid by the SSTB are
comparable to those charged in the market. The commenter also suggested that the IRS could examine the totality of facts and circumstances, including historic conduct between the SSTB and RPE. Another commenter suggested that the final rule add an exception to the rule for taxpayers that can demonstrate they have a substantial purpose (apart from Federal income tax effects) for structuring their trade or business in a particular manner. For example, title to a skilled nursing facility could be held by one pass-through entity that is operated by a related pass-through entity in order to satisfy Department of Housing and Urban Development lending requirements. The Treasury Department and the IRS decline to adopt these recommendations. Creating a presumption or substantial purpose test would lead to greater complexity and administrative burden for both taxpayers and the IRS.

A few commenters requested clarification regarding whether the rule applies when the property or services are provided to a commonly-owned C corporation. One commenter also asked for clarification on the meaning of 50 percent or more common ownership, examples of how ownership is determined, and whether the definition is different than the 50 percent or more common ownership test used in the aggregation rules. One commenter suggested that the rule should apply only to those owners who make up the 50 percent ownership test. Another commenter suggested that the rule should not apply to real estate rentals to a commonly-owned SSTB. Another commenter suggested that structures that existed before December 22, 2017, be grandfathered so that the rule would not apply. In response to comments, the final regulations clarify that the rule applies only to those who make up the 50 percent test. As discussed in section V.B. of this Summary of Comments and Explanation of Revisions, the final regulations provide that sections 267(b) and 707(b) apply in determining common ownership for purposes of the aggregation rules. The Treasury Department and the IRS decline to exempt real estate rentals or to structures that existed before December 22, 2017, as the rule is intended to address goods and services that are provided to an SSTB regardless of the type of good or service provided or the date on which the structure was put into place.

One commenter stated that the rule is overbroad and not based on statutory authority and unfairly punishes related party transactions. Other commenters suggested that the rule automatically treating a trade or business that provides more than 80 percent of its goods or services to a commonly owned SSTB as an SSTB is unnecessary, as there are no abuse concerns regarding the portions of goods or services provided to a third party. The Treasury Department and the IRS agree with this comment and have removed the 80 percent rule in the final regulations. Accordingly, the final regulations provide that if a trade or business provides property or services to an SSTB and there is 50 percent or more common ownership of the trade or business, the portion of the trade or business providing property or services to the 50 percent or more commonly-owned SSTB will be treated as a separate SSTB with respect to related parties.

D. Incidental to a Specified Service Trade or Business

The proposed regulations provide that if a trade or business (that would not otherwise be treated as an SSTB) has both 50 percent or more common ownership with an SSTB and shared expenses with an SSTB, then the trade or business is treated as incidental to and, therefore, part of the SSTB, if the gross receipts of the trade or business represent no more than five percent of the total combined gross receipts of the trade or business and the SSTB in a taxable year. One commenter recommended that this rule be removed because it is unnecessary and causes administrative difficulties for taxpayers who must determine whether a trade or business is incidental in order to apply the rule. If the rule is retained, the commenter recommended that final regulations define gross receipts and shared expenses, make adjustments to avoid double counting the same gross receipts, clarify what businesses are taken into account for purposes of the rule, and treat a trade or business to which the anti-abuse rule applies as a separate SSTB rather than as part of the SSTB. Another commenter suggested that the final regulations add an exception for start-ups such as a three to five year grace period and also clarify the ownership standard, how the rule would apply if the trades or business have different tax years, and how shared expenses would be determined. In accordance with the comments, the rule is removed from the final regulations.

E. Trade or Business of Performing Services as an Employee

Multiple commenters expressed support for the rule in the proposed regulations that provides that an individual who was previously treated as an employee and is subsequently treated as other than an employee while performing substantially the same services to the same person, or a related person, will be presumed to be in the trade or business of performing services as an employee for purposes of section 199A. The commenters noted that the presumption furthers the public policy goal of preventing worker misclassification, preserves agency resources, and prevents a decline in Federal and state tax revenues. The commenters also state that regulations should not incentivize workers to accept misclassification by their employer in order to obtain a tax benefit.

Other commenters recommended that the presumption be removed arguing that the common law test under current law is sufficient for determining whether a former employee is properly classified as an employee and that the presumption would impede the objective of ensuring similar treatment of similarly situated taxpayers because two similarly situated taxpayers who provide services to the same company would be treated differently if one was a former employee of the company and the other was not. The commenter also notes that the presumption would create uncertainty for taxpayers and would cause former employees to not claim the deduction in order to avoid a dispute with the IRS.

Another commenter expressed concern that the presumption as written in the proposed regulations could create a dual standard for worker classification under the Code, in which a worker could be classified as an independent contractor for employment tax purposes, and an employee for purposes of claiming section 199A.
deduction. This could result in an independent contractor being held liable for self-employment taxes and unable to claim the section 199A deduction on income that would otherwise qualify as QBI. The commenter suggested that if the presumption is retained, it should include an exemption for certain independent contractors based on factors including income, source of income, industry practice, and timeframe.

A different commenter suggested that the presumption should provide that an independent contractor is operating as such and that it is up to the relevant Federal agencies to determine whether the business misclassified the individual. The commenter also noted that the IRS is barred from issuing regulations with respect to the employment status of any individual for employment tax purposes under Section 530(b) of the Revenue Act of 1978 (Pub. L. 95-600), as amended by section 9(d)(2) of Pub. L. 96-167, section 1(a) of Pub. L. 96-541, and section 269(c) of Pub. L. 97-248, and that the presumption could result in an individual otherwise subject to self-employment tax to not get the benefit of the section 199A deduction. Another commenter argued that an employee who changes his status from employee to independent contractor so he may deduct business expenses on Schedule C and claim a section 199A deduction is exercising his right to structure his business transactions to minimize his tax liability.

Another commenter questioned how the rule would be applied, asking for clarification on whether the rule is intended to prohibit employers from firing employees and rehiring them as independent contractors; whether it applies to former employees regardless of current relationship; and how far the IRS would look back at prior employees. Another commenter suggested that a new example be added to the final regulations demonstrating that the presumption is inapplicable when the facts demonstrate that a service recipient and a service provider have materially modified their relationship such that its proper classification is that of a service recipient and a partner.

The Treasury Department and the IRS agree with commenters that all of an RPE’s items related to section 199A should not be presumed to be zero because of a failure to report one item. For example, an RPE may have sufficient W–2 wages and send out that information, but decline to provide information for UBIA of qualified property because it is not necessary or is an insignificant amount. Accordingly, the final regulations retain the reporting requirement but revise the presumption to provide that if an RPE fails to separately identify or report one item of QBI, W–2 wages, and UBIA of qualified property, the owner’s share of each unreported item of positive QBI, W–2 wages, or UBIA of qualified property attributable to trades or businesses engaged in by that RPE will be presumed to be zero. A few commenters suggested that the final regulations clarify that if an RPE fails to separately identify or report each owner’s allocable share of QBI, W–2 wages, or UBIA of qualified property, then only the unidentified or unreported amount is presumed to be zero. Another commenter suggested that a return be considered substantially complete even if an RPE chooses not to report QBI, W–2 wages, and UBIA of qualified property, while other commenters suggested that taxpayers could rebut the presumption. One commenter requested that the final regulations clarify that if an RPE fails to report QBI, W–2 wages, UBIA of qualified property, and SSTB information, the information can still be reported on an amended or late filed return if filed while the period of limitations is still open. Another commenter suggested that to incentivize accurate and timely reporting, taxpayers should be given reasonable opportunities to correct errors and not be subject to penalties for such errors.

The Treasury Department and the IRS agree with commenters that all of an RPE’s items related to section 199A should not be presumed to be zero because of a failure to report one item. For example, an RPE may have sufficient W–2 wages and send out that information, but decline to provide information for UBIA of qualified property because it is not necessary or is an insignificant amount. Accordingly, the final regulations retain the reporting requirement but revise the presumption to provide that if an RPE fails to separately identify or report one item of QBI, W–2 wages, or UBIA of qualified property, the owner’s share of each unreported item of positive QBI, W–2 wages, or UBIA of qualified property attributable to trades or businesses engaged in by that RPE will be presumed to be zero. The final regulations also provide that such information can be reported on an amended or late filed return for any open tax year. Guidance on the application of penalties is beyond the scope of these regulations.

The preamble to the proposed regulations requested comments regarding whether it is administrable to provide a special rule that if none of the owners of the RPE have taxable income above the
threshold amount, the RPE does not need to determine and report W–2 wages, UBIA of qualified property, or whether the trade or business is an SSTB. One commenter recommended that a special rule be provided that an RPE need not determine or report W–2 wages, UBIA of qualified property or whether the trade or business is an SSTB if none of the owners of the RPE have taxable income above the threshold amount. The commenter suggested that the final regulations provide an exception to the reporting requirements if (1) an RPE does not have gross receipts that constitute QBI; (2) none of the owners of the RPE are non-corporate taxpayers; or (3) none of the RPE owners have taxable income above the threshold amount. The commenter suggested that an RPE could establish the taxable income of its owners through the review and maintenance of its owners’ tax returns or written statements signed under the penalty of perjury. Another commenter suggested that an RPE should not be subject to the reporting requirements unless the RPE is aware of a non-corporate owner. Another commenter suggested that the RPE only needs to report W–2 wages when it is clear that the amount will result in an amount greater than 20 percent of QBI. Another commenter requested guidance on how to qualify for the special rule and what information the RPE would be required to report to its owners and retain in connection with the rule. One commenter, however, cautioned against a special rule because of the lack of knowledge the RPE has about the owners. The commenter also suggested that a certification process by the owners would create an administrative burden. The commenter requested guidance on who would be responsible for corrections and penalties due to failure to disclose the information on the Schedule K–1 when the determination affects the owner’s QBI deduction. One commenter suggested that RPEs should not have to report QBI, W–2 wages, and UBIA of qualified property with respect to trades or businesses not effectively connected with the United States.

The Treasury Department and the IRS remain concerned that RPEs do not have sufficient information to determine an ultimate owner’s taxable income or whether the ultimate owner will require W–2 wage or UBIA of qualified property information for the RPE’s trades or businesses in order to determine the owner’s section 199A deduction. Conversely, the RPE itself, not its ultimate owners, is in the best position to determine the RPE’s section 199A items. Accordingly, the final regulations do not contain a special reporting rule for RPEs based on whether the RPE’s owners have taxable income below the threshold amounts. Similarly, the Treasury Department and the IRS decline to create a reporting exception based on whether an RPE has non-corporate owners. Finally, a trade or businesses that is not effectively connected with the United States produces no QBI, W–2 wages, or UBIA of qualified property and thus has no reporting requirement under § 1.199A–6.

3. ESBTs

One commenter supported the proposed regulation’s position on ESBT’s eligibility for the deduction. Another commenter stated that based on § 1.641(c)–1(a) and its reference to an ESBT being two separate trusts for purposes of chapter I of subtitle A of the Code (except regarding administrative purposes), the S portion and non-S portion should each have its own threshold. The Treasury Department and the IRS disagree with this comment. Although an ESBT has separate portions, it is one trust. Therefore, in order to provide clarity, the final regulations state that the S and non-S portions of an ESBT are treated as a single trust for purposes of determining the threshold amount.

4. Inclusion of Trust Distributions in Taxable Income

Multiple commenters suggested that distributions should not be counted twice in determining whether the threshold amount is met or exceeded, saying this is counter to the statute and beyond the regulatory authority of the Treasury Department and the IRS. Further, sections 651 and 661 are fundamental principles of fiduciary income taxation and the possible duplication of the threshold is better addressed in anti-abuse provisions. Another commenter suggested that double counted income should be ignored, arguing that double counting is punitive because it fails to take into account the economic consequences of distributions and is inconsistent with the longstanding fundamental principles of subchapter J. Another commenter recommended that the distribution deduction should be given effect in computing thresholds, consistent with section 1411 and fiduciary obligations.
The Treasury Department and IRS agree with the commenters that distributions should reduce taxable income because the trust is not taxed on that income. The final regulations remove the provision that would exclude distributions from taxable income for purposes of determining whether taxable income for a trust or estate exceeds the threshold amount. The final regulations specifically provide that for purposes of determining whether a trust or estate has taxable income that exceeds the threshold amount, the taxable income of the trust or estate is determined after taking into account any distribution deduction under sections 651 or 661.

5. Allocation between Trust or Estate and Beneficiaries

One commenter argued that proposed § 1.199A–6(d)(3)(v)(C) and (D) and the accompanying example are wrong in allocating the whole depreciation deduction to the trust. Instead, the commenter said that the depreciation should be allocated based on fiduciary accounting income. Another commenter stated that the QBI net loss should be allocated entirely to the trust or estate and not passed through to the beneficiaries. Another commenter argued that the example in proposed § 1.199A–6(d)(3)(vi) overlooks section 167(d) and that final regulations should clarify whether reporting of depreciation is being changed. An additional commenter stated that a charitable lead trust’s threshold amount should be the same as other trusts after the charitable deduction. Based on comments received, the final regulations provide that the treatment of depreciation applies solely for purposes of section 199A, and the example has been revised to clarify the allocation of QBI and depreciation to the trust and the beneficiaries. As an RPE, the final regulations continue to require that a trust or estate allocates QBI (which may be a negative amount) to its beneficiaries based on the relative portions of DNI distributed to its beneficiaries or retained by the trust or estate.

6. Section 199A Anti-Abuse Rule

One commenter requested clarification on whether a trust with a reasonable estate or business planning purpose would be respected. Another commenter argued that the rule is overbroad and lacks clarity as to what would be abusive and what the consequences would be of not respecting the trust for section 199A purposes. The commenter also stated that the rule is not needed because of § 1.643–1 and if both rules are retained, they should use the same test (principal versus significant purpose). Finally, the commenter asked for clarification on whether the rule applies to a single trust and suggested it apply on an annual basis. This last suggestion has not been adopted because the test goes to the creation of the trust, factors which would not change in later years. The final regulations clarify that the anti-abuse rule is designed to thwart the creation of even one single trust with a principal purpose of avoiding, or using more than one, threshold amount. If such trust creation violates the rule, the trust will be aggregated with the grantor or other trusts from which it was funded for purposes of determining the threshold amount for calculating the deduction under section 199A.

VIII. Treatment of Multiple Trusts

Two commenters requested clarification regarding whether multiple trusts will be aggregated if section 643(f) requirements are met. Specifically, the commenters asked for clarification on what it means to form or fund a trust with a significant purpose of receiving a section 199A deduction. These commenters state that trusts should not be combined simply because the section 199A deduction is increased if a legitimate non-tax reason led to the creation of the trusts.

Other commenters objected to the presumption of a tax-avoidance purpose, arguing that it will shift the focus to a requirement that there be a non-tax purpose for creating multiple trusts. The commenters also asked whether the reference to income tax includes state income tax, as the proposed rule refers to the avoidance of more than Federal income tax.

Another commenter agreed with the need for the rule but asked for clarification on the definitions of primary beneficiary, significant tax benefit, principal purpose, and arrangement involving multiple trusts; the application of the substantially the same beneficiary rule; and whether trusts for different children, with other children as default beneficiaries, are the same. Another commenter noted that the use of substantial purpose rather than principal purpose is inconsistent with the statutory language.

Another commenter asked for clarification of the effective date regarding modifications or contributions to pre-effective date trusts, and of the identification of trusts to which the regulation applies. Another commenter requested that final regulations address the applicability of the rule to the conversion of grantor trusts to non-grantor trusts post enactment of the TCJA.

One commenter requested that examples be given for each of the three requirements under section 643(f) and requested that § 1.643(f)–1, Example 2, be clarified to describe the trusts as non-grantor trusts.

Based on the comments received, the Treasury Department and IRS have removed the definition of “principal purpose” and the examples illustrating this rule that had been included in the proposed regulations, and are taking under advisement whether and how these questions should be addressed in future guidance. This includes questions of whether certain terms such as “principal purpose” and “substantially identical grantors and beneficiaries” should be defined or their meaning clarified in regulations or other guidance, along with providing illustrating examples for each of these terms. Nevertheless, the position of the Treasury Department and IRS remains that the determination of whether an arrangement involving multiple trusts is subject to treatment under section 643(f) may be made on the basis of the statute and the guidance provided regarding provision in the legislative history of section 643(f), in the case of any arrangement involving multiple trusts entered into or modified before the effective date of these final regulations.

Availability of IRS Documents

Request for Comments

The Treasury Department and the IRS request comments on various aspects of section 199A and these regulations, as described in this preamble. All comments that are submitted as prescribed in this preamble under the ADDRESSES heading will be available at www.regulations.gov and upon request.

Effective/Applicability Date

Section 7805(b)(1)(A) and (B) of the Code generally provide that no temporary, proposed, or final regulation relating to the internal revenue laws may apply to any taxable period ending before the earliest of (A) the date on which such regulation is filed with the Federal Register, or (B) in the case of a final regulation, the date on which a proposed or temporary regulation to which the final regulation relates was filed with the Federal Register.

Consistent with authority provided by section 7805(b)(1)(A), §§ 1.199A–1 through 1.199A–6 generally apply to taxable years ending after February 8, 2019. However, taxpayers may rely on the rules set forth in §§ 1.199A–1 through 1.199A–6, in their entirety, or on the proposed regulations under §§ 1.199A–1 through 1.199A–6 issued on August 16, 2018, in their entirety, for taxable years ending in calendar year 2018. In addition, to prevent abuse of section 199A and the regulations thereunder, the anti-abuse rules in §§ 1.199A–2(c)(1)(iv), 1.199A–3(c)(2)(ii), 1.199A–5(c)(2), 1.199A–5(d)(3), and 1.199A–6(d)(3)(vii) apply to taxable years ending after December 22, 2017, the date of enactment of the TCJA. Finally, the provisions of § 1.643–1, which prevent abuse of the Code generally through the use of trusts, apply to taxable years ending after August 16, 2018.

Section 199A(f)(1) provides that section 199A applies at the partner or S corporation shareholder level, and that each partner or shareholder takes into account such person’s allocable share of each qualified item. Section 199A(c)(3) provides that the term “qualified item” means items that are effectively connected with a U.S. trade or business, and “included or allowed in determining taxable income from the taxable year.” Section 199A applies to taxable years beginning after December 31, 2017. However, there is no statutory requirement under section 199A that a qualified item arise after December 31, 2017.

Section 1366(a) generally provides that, in determining the income tax of a shareholder for the shareholder’s taxable year in which the taxable year of the S corporation ends, the shareholder’s proportionate share of the corporation’s items is taken into account. Similarly, section 706(a) generally provides that, in computing the taxable income of a partner for a taxable year, the partner includes items of the partnership for any taxable year of the partnership ending within or with the partner’s taxable year. Therefore, income flowing to an individual from a partnership or S corporation is subject to the tax rates and rules in effect in the year of the individual in which the entity’s year closes, not the year in which the item actually arose.

Accordingly, for purposes of determining QBI, W–2 wages, UBIA of qualified property, and the aggregate amount of qualified REIT dividends and qualified PTP income, the effective date provisions provide that if an individual receives QBI, W–2 wages, UBIA of qualified property, and the aggregate amount of qualified REIT dividends and qualified PTP income from an RPE with a taxable year that begins before January 1, 2018, and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual’s tax year during which such RPE taxable year ends.

Special Analyses

I. Regulatory Planning and Review – Economic Analysis

Executive Orders 13563 and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing rules, and of promoting flexibility.

These final regulations have been designated as subject to review under Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget (OMB) regarding review of tax regulations. OIRA has designated this final regulation as economically significant under section 1(c) of the Memorandum of Agreement. Accordingly, these final regulations have been reviewed by the Office of Management and Budget. For more detail on the economic analysis, please refer to the following analysis.

A. Overview

Congress enacted section 199A to provide individuals, estates, and trusts a deduction of up to 20 percent of QBI from domestic businesses, which includes trades or businesses operated as a sole proprietorship or through a partnership, S corporation, trust, or estate. As stated in the Summary of Comments and Explanation of Revisions, these regulations are necessary to provide taxpayers with computational, definitional, and anti-avoidance guidance regarding the application of section 199A. The final regulations provide guidance to taxpayers for purposes of calculating the section 199A deduction. They provide clarity for taxpayers in determining their eligibility for the deduction and the amount of the allowed deduction. Among other benefits, this clarity helps ensure that taxpayers all calculate the deduction in a similar manner, which encourages decision-making that is economically efficient contingent on the provisions of the overall Code.

The final regulations contain seven sections, six under section 199A (§§ 1.199A–1 through 1.199A–6) and one under section 643(f) (§ 1.643(f)–1). Each of §§ 1.199A–1 through 1.199A–6 provides rules relevant to the section 199A deduction and § 1.643(f)–1 would establish anti-abuse rules to prevent taxpayers from establishing multiple non-grantor trusts or contributing additional capital to multiple existing non-grantor trusts in order to avoid Federal income tax, including abuse of section 199A. This economic analysis describes the economic benefits and costs of each of the seven sections of the final regulations.
B. Baseline

The analysis in this section compares the final regulation to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of these regulations.

C. Economic Analysis of Changes in Final Regulations

The Treasury Department and the IRS received comments from the public in response to the section 199A proposed regulations. This section discusses significant issues brought up in the comments for which economic reasoning would be particularly insightful. For a full discussion of comments received see the Summary of Comments and Explanation of Revisions section of this preamble.

1. UBIA of Qualified Property

Relative to the proposed 199A regulations, the final regulations make several changes in the determination of UBIA of qualified property. In particular, proposed § 1.199A–2 adjusted UBIA for (i) qualified property contributed to a partnership or S corporation in a nonrecognition transaction, (ii) like-kind exchanges, or (iii) involuntary conversions. Upon review of comments received addressing these rules, the Treasury Department and the IRS have amended these rules in the final regulations such that UBIA of qualified property generally remains unadjusted as a result of these three types of transactions. As several commenters pointed out, the proposed regulations would have introduced distortions into the economic incentives for businesses to invest or earn income. In cases where UBIA would have been reduced following a nonrecognition transfer under the proposed regulations, the treatment under the proposed regulations would have discouraged such transactions by introducing a financial cost (in the form of a reduced 199A deduction) where no resource cost exists. An analogous distortion exists for the other two types of transactions. Such distortions are economically inefficient.

To avoid such distortion, the final regulations establish that qualified property contributed to a partnership or S corporation in a nonrecognition transaction generally retains its UBIA on the date it was first placed in service by the contributing partner or shareholder. Similar rules are adopted for the other two transaction forms mentioned above. In particular, the final regulations provide that the UBIA of qualified property received in a section 1031 like-kind exchange is generally the UBIA of the relinquished property. The rule is the same for qualified property acquired pursuant to an involuntary conversion under section 1033.

2. Entity Aggregation

The final regulations allow an RPE to aggregate trades or businesses it operates directly or through lower-tier RPEs for the purposes of calculating the section 199A deduction in addition to allowing aggregation at the individual owner level. This change to the proposed rules allows RPEs, if they meet the ownership and other tests outlined in the regulations, to aggregate QBI, wages, and capital amounts and report aggregated figures to owners. This change was made in response to comments suggesting that allowing aggregation at the RPE level would simplify reporting and compliance efforts for owners because the RPEs may more easily obtain the information to determine whether the trades or businesses meet the tests for aggregation and whether it is beneficial to aggregate. Because RPEs that aggregate must meet all of the aggregation requirements, the change is consistent with the aggregation concept, which allows trades or businesses that operate across multiple entities but are commonly considered one business to benefit from calculating their section 199A deduction using combined income and expenses.

3. Anti-abuse Rules

The final regulations removed the “incidental to an SSTB” rule requiring that businesses with majority ownership and shared expenses with an SSTB be considered as part of the same trade or business for purposes of the section 199A deduction. This anti-abuse rule was intended to limit the ability of taxpayers to separate their SSTB and non-SSTB income into two trades or businesses in order to receive the deduction on their non-SSTB income. In response to comments, the rule was removed from the final regulations for a number of reasons. First, defining when two businesses have shared expenses is difficult to administer and could be overly inclusive. Second, there was a concern that start-up businesses could be excluded from the section 199A deduction if they shared expenses and ownership with a larger business that could be considered an SSTB.

The final regulations modify the anti-abuse rule concerning services or property provided to an SSTB. The rule is meant to disallow SSTBs from splitting their trade or business into two pieces with one providing services or leasing property to the other. For example, imagine a dentist office that owns a building. The dental practice would be considered an SSTB. Suppose the dentist split the business into two trades or businesses, the first of which was the dental practice and the second of which owned the building and leased it to the dental practice. This rule states that the income from leasing the building to the dental practice would also be considered SSTB income and ineligible for the section 199A deduction. Under the proposed regulations, a trade or business that provides more than 80 percent of its property or services to an SSTB is treated as an SSTB if there is 50 percent or more common ownership of the trades or businesses. In cases in which a trade or business provides less than 80 percent of its property or services to a commonly owned SSTB, the portion of the trade or business providing property to the commonly owned SSTB is treated as part of the SSTB with respect to the related parties. The final regulations remove the 80 percent threshold and allow any portion that is not provided to an SSTB to be eligible for the section 199A deduction. For example, if the dentist’s leasing trade or business leased 90 percent of the building to the dental office and 10 percent to a coffee shop, the 10 percent would now be eligible for the section 199A deduction. This change removed a threshold in the anti-abuse rule, which will remove any incentive to stay below the 80 percent threshold, while still disallowing the income from providing property or services...
to related SSTBs to be eligible for the deduction.

C. Economic Analysis of § 1.199A–1

1. Background

Because the section 199A deduction has not previously been available, a large number of the relevant terms and necessary calculations taxpayers are currently required to apply under the statute can benefit from greater specificity. For example, the statute uses the term trade or business to refer to the enterprise whose income would be potentially eligible for the deduction but does not define what constitutes a trade or business for purposes of section 199A; the final regulations provide that taxpayers should generally apply the trade or business standard used for section 162(a). The definition of trade or business in § 1.199A–1 is extended beyond the section 162 standard if a taxpayer chooses to aggregate businesses under the rules of § 1.199A–4. In addition, solely for purposes of section 199A, the rental or licensing of property to a related trade or business is treated as a trade or business if the rental or licensing and the other trade or business are commonly controlled under § 1.199A–4(b)(1)(i). The regulations also make clear that the section 199A deduction is allowed when calculating alternative minimum taxable income of individuals.

Because the section 199A deduction has multiple components that may interact in determining the deduction, it is also valuable to lay out rules for calculating the deduction since the statute does not provide each of those particulars.

Alternative approaches the Treasury Department and the IRS could have taken would be to remain silent on additional definitional specificities and to allow post-limitation netting in calculating the section 199A deduction. The Treasury Department and the IRS concluded these approaches would likely give rise to less economically efficient tax-related decisions than would relying on statutory language alone and requiring or leaving open the possibility of post-limitation netting.

2. Anticipated benefits of § 1.199A–1

The Treasury Department and the IRS expect that the definitions and guidance provided in § 1.199A–1 will implement the section 199A deduction in an economically efficient manner. An economically efficient tax system generally aims to treat income derived from similar economic decisions similarly in order to reduce incentives to make choices based on tax rather than market incentives. In this context, the principal benefit of § 1.199A–1 is to reduce taxpayer uncertainty regarding the calculation of the section 199A deduction relative to an alternative scenario in which no such regulations were issued. In the absence of the clarifications in § 1.199A–1 regarding, for example, the definition of an eligible trade or business, similarly situated taxpayers might interpret the statutory rules of section 199A differently, given the statute’s limited prescription or absence of implementation details. In addition, without these regulations it is likely that many taxpayers impacted by section 199A would take on more (or less) than the optimal level of risk in allocating resources within or across their businesses. Both of these actions would give rise to economic inefficiencies. The final regulations would provide a uniform signal to businesses and thus lead taxpayers to make decisions that are more economically efficient contingent on the overall Code. As an example, § 1.199A–1 prescribes the steps taxpayers must take to calculate the QBI deduction in a manner that avoids perverse incentives for shifting wages and capital assets across businesses. The statute does not address the ordering for how the W–2 wages and UBIA of qualified property limitations should be applied when taxpayers have both positive and negative QBI from different businesses. The final regulations clarify that in such cases the negative QBI should offset positive QBI prior to applying the wage and capital limitations. For taxpayers who would have assumed in the alternate that negative QBI offsets positive QBI after applying the wage and capital limitations, the regulations weaken the incentive to shift W–2 wage labor or capital (in the form of qualified property) from one business to another to maximize the section 199A deduction.

To illustrate this, consider a taxpayer who is above the statutory threshold and owns two non-service sector businesses, A and B. A has net qualified income of $10,000, while B has net qualified income of -$5,000. Suppose that A paid $3,000 in W–2 wages, B paid $1,000 in W–2 wages, and neither business has tangible capital. If negative QBI offsets positive QBI after applying the wage and capital limitations, then A generates a tentative deduction of $1,500, while B generates a tentative deduction of -$1,000, for a total deduction of $500. After moving B’s W–2 wages to A, A’s tentative deduction rises to $2,000, while B’s remains -$1,000, increasing the total deduction to $1,000. If, on the other hand, negative QBI offsets positive QBI prior to applying the wage and capital limitations (as in the final regulations), then A and B have combined income of $5,000, and the total deduction is $1,000 because the wage and capital limitations are non-binding. After moving B’s wages to A, the total deduction remains $1,000. Thus, an incentive to shift wages arises if negative QBI offsets positive QBI after applying the wage and capital limitations. By taking the opposite approach, § 1.199A–1 reduces incentives for such tax-motivated, economically inefficient reallocations of labor (or capital) relative to a scenario in which offsets were taken after wage and capital limitations were applied.

3. Anticipated costs of § 1.199A–1

The Treasury Department and the IRS do not anticipate any meaningful economic distortions to be induced by § 1.199A–1. However, changes to the collective paperwork burden arising from this and other sections of these regulations are discussed in section J, Anticipated impacts on administrative and compliance costs, of this analysis.

D. Economic Analysis of § 1.199A–2

1. Background

Section 199A provides a deduction of up to 20 percent of the taxpayer’s income from qualifying trades or businesses. Tax-
payers with incomes above a threshold amount cannot enjoy the full 20 percent deduction unless they determine that their businesses pay a sufficient amount of wages and/or maintain a sufficient stock of tangible capital, among other requirements.

Because this deduction has not previously been available, § 1.199A–2 provides greater specificity than is available from the statute regarding the definitions of W–2 wages and UBIA of qualified property (that is, depreciable capital stock) relevant to this aspect of the deduction. For example, the final regulations make clear that property that is transferred or acquired within a specific timeframe with a principal purpose of increasing the section 199A deduction is not considered qualified property for purposes of the section 199A deduction. In addition, § 1.199A–2 generally follows prior guidance for the former section 199 deduction in determining which W–2 wages are relevant for section 199A purposes, with additional rules for allocating wages amongst multiple trades or businesses. In these and other cases, the final regulations generally aim, within the context of the legislative language and other tax considerations, to ensure that only genuine business income is eligible for the section 199A deduction, and to reduce business compliance costs and government administrative costs.

Alternative approaches would be to remain silent or to choose different definitions of W–2 wages or qualified property for the purposes of claiming the deduction. The Treasury Department and the IRS rejected these alternatives as being inconsistent with other definitions or requirements under the Code and therefore unnecessarily costly for taxpayers to comply with and the IRS to administer.

2. Anticipated benefits of § 1.199A–2

The Treasury Department and the IRS expect that § 1.199A–2 will implement the section 199A deduction in an economically efficient manner. For example, § 1.199A–2 will discourage some inefficient transfers of capital given the statute’s silence regarding the circumstances in which certain property transfers would or would not be considered under section 199A. Specifically, the final rules make clear that property transferred or acquired within a specific timeframe with a principal purpose of increasing the section 199A deduction is not considered qualified for purposes of the section 199A deduction.

The final regulations will also reduce taxpayer uncertainty regarding the implementation of the section 199A deduction relative to a scenario in which no regulations were issued. In the absence of such clarification, similarly situated taxpayers would likely interpret the section 199A deduction differently to the extent that the statute does not adequately specify the particular implementation issues addressed by § 1.199A–2, such as the determination of UBIA for nonrecognition transfers and like-kind exchanges. As a result, taxpayers might take on more (or less) than the optimal level of risk in their interpretations. The final regulations would lead taxpayers to make decisions that were more economically efficient, conditional on the overall Code.

3. Anticipated costs of § 1.199A–2

The Treasury Department and the IRS do not anticipate any meaningful economic distortions to be induced by § 1.199A–2. However, changes to the collective paperwork burden arising from this and other sections of these regulations are discussed in section J, Anticipated impacts on administrative and compliance costs, of this analysis.

E. Economic Analysis of § 1.199A–3

1. Background

Section 199A provides a deduction of up to 20 percent of the taxpayer’s income from qualifying trades or businesses. In the absence of legislative and regulatory constraints, taxpayers would have an incentive to count as income some income that, from an economic standpoint, did not accrue specifically from qualifying economic activity. The final regulations clarify what does and does not constitute QBI for purposes of the section 199A deduction, providing greater implementation specificity than provided by the statute. Because guaranteed payments for capital, for example, are not at risk in the same way as other forms of income, it would generally be economically efficient to exclude them from QBI. Similarly, the Treasury Department and the IRS propose that income that is a guaranteed payment, but which is filtered through a tiered partnership in order to avoid being labeled as such, should be treated similarly to guaranteed payments in general and therefore excluded from QBI. This principle applies to other forms of income that similarly represent income that either is not at risk or does not flow from the specific economic value provided by a qualifying trade or business, such as returns on investments of working capital.

2. Anticipated benefits of § 1.199A–3

The Treasury Department and the IRS expect that the § 1.199A–3 regulations will implement the section 199A deduction in an economically efficient manner. For example, § 1.199A–3 will discourage the creation of tiered partnerships purely for the purposes of increasing the section 199A deduction. In the absence of regulation, some taxpayers would likely create tiered partnerships under which a lower-tier partnership would make a guaranteed payment to an upper-tier partnership, and the upper-tier partnership would pay out this income to its partners without guaranteeing it. Such an organizational structure would likely be economically inefficient because it was, apparently, created solely for tax minimization purposes and not for reasons related to efficient economic decision-making.

The Treasury Department and the IRS further expect that the final regulations will reduce uncertainty over whether particular forms of income do or do not constitute QBI relative to a scenario in which no regulations were issued. In the absence of regulations, taxpayers would still need to determine what income is considered QBI and similarly situated taxpayers might interpret the statutory rules differently and pursue income-generating activities based on different assumptions about whether that income would qualify for QBI. Section 1.199A–3 provides clearer guidance for how to determine QBI, helping to ensure that taxpayers face uniform
incentives when making economic decisions, a tenet of economic efficiency.

3. Anticipated costs of § 1.199A–3

The Treasury Department and the IRS do not anticipate any meaningful economic distortions to be induced by § 1.199A–3. However, changes to the collective paperwork burden arising from this and other sections of these regulations are discussed in section J, Anticipated impacts on administrative and compliance costs, of this analysis.

F. Economic Analysis of § 1.199A–4

1. Background

Businesses may organize either as C corporations, which are owned by stockholders, or in a form generally called a pass-through, which may take one of several legal forms including sole proprietorships, partnerships, under which there does not exist a clear separation between the owners and the business’s decision-makers. Each organizational structure, in some circumstance, may be economically efficient, depending on the risk profile, information asymmetries, and decision-making challenges pertaining to the specific business and on the risk preferences and economic situations of the individual owners. An economically efficient tax system would keep the choice among organizational structures neutral contingent on the provisions of the corporate income tax.

This principle of neutral tax treatment further applies to the various organizational structures that qualify as pass-throughs. Many pass-through business entities are connected through ownership, management, or shared decision-making. The aggregation rule allows individuals or entities to aggregate their trades or businesses for the purposes of calculating the section 199A deduction. It thus helps ensure that significant choices over ownership and management relationships within businesses are not chosen solely to increase the section 199A deduction.

An alternative approach would be not to allow aggregation for purposes of claiming the deduction. The Treasury Department and the IRS decided to allow aggregation in the specified circumstances to minimize or avoid distortions in organizational form that could arise if aggregation were not allowed.

2. Anticipated benefits of § 1.199A–4

The Treasury Department and the IRS expect that the aggregation guidance provided in § 1.199A–4 will implement the section 199A deduction in an economically efficient manner. Economic tax principles are called into play here because a large number of businesses that could commonly be thought of as a single trade or business actually may be divided across multiple entities for legal or economic reasons. Allowing individual owners and entities to aggregate trades or businesses offers taxpayers a means of putting together what they think of as their trade or business for the purposes of claiming the deduction under section 199A without otherwise changing market-driven ownership and management structure incentives. If such aggregation were not permitted, certain taxpayers would restructure their businesses solely for tax purposes, with the resulting structures leading to less efficient economic decision-making.

3. Anticipated costs of § 1.199A–4

The final regulations require common majority ownership, in addition to other requirements, to apply the aggregation rule. If no aggregation were allowed, taxpayers would have to combine businesses to calculate the deduction based on the combined income, wages, and capital. The majority ownership threshold may thus encourage owners to concentrate their ownership in order to benefit from the aggregation rule. The additional costs of the final regulations would be limited to those owners who would find merging entities too costly based on other market conditions, but under these regulations taxpayers may find it beneficial to increase their ownership share in order to aggregate their businesses and maximize their QBI deduction.

Changes to the collective paperwork burden arising from § 1.199A–4 and other sections of these regulations are discussed in section J, Anticipated impacts on administrative and compliance costs, of this analysis.

G. Economic Analysis of § 1.199A–5

1. Background

Section 199A provides a deduction of up to 20 percent of the taxpayer’s income from qualifying trades or businesses. In the absence of legislative and regulatory constraints, taxpayers have an incentive to receive labor income as income earned as a independent contractor or through ownership of an RPE, even though this income may not derive from the risk-bearing or decision-making efficiencies that are unique to being an independent contractor or to owning an equity interest in an RPE. The TCJA provided several provisions that bear on this distinction.

Section 1.199A–5 provides guidance on what trades or businesses would be characterized as an SSTB under each type of services trade or business listed in the legislative text. In addition, § 1.199A–5 provides an exception to the SSTB exclusion if the trade or business only earns a small fraction of its gross income from specified service activities (de minimis exception). Finally, the final regulations state that former employees providing services as independent contractors to their former employer will be presumed to be acting as employees unless they provide evidence that they are providing services in a capacity other than an employee.

An alternative approach to the de minimis exception would be to require businesses or their owners to trigger the SSTB exclusion regardless of the share of gross income from specified service activities. The Treasury Department and the IRS concluded that providing a de minimis exception is necessary to avoid very small amounts of SSTB activity within a trade or business making the entire trade or business ineligible for the deduction, an outcome that is inefficient in the context of section 199A.

2. Anticipated benefits of § 1.199A–5

The Treasury Department and the IRS expect that § 1.199A–5 will implement the section 199A deduction in an economically efficient manner. To this end, § 1.199A–5 clarifies the definition of an SSTB. In the absence of such clarification,
similarly situated taxpayers might interpret the legislative text differently, leading some taxpayers to invest in particular businesses under the assumption income earned from that entity was eligible for the deduction while other taxpayers might forgo that investment due to the opposite assumption. These disparate investment signals generate economic inefficiencies. Additionally, similarly situated taxpayers may interpret the legislative text differently leading to equity concerns and possibly disadvantaging taxpayers who take a less aggressive approach. These distortions are reduced by the specificity provided in these final regulations relative to a scenario without regulations.

Furthermore, in the absence of the regulations, some owners of businesses may find it advantageous to separate their business activity into SSTB and non-SSTB businesses in order to receive the section 199A deduction on their non-SSTB activity. The final regulations would disallow this behavior by stating that a taxpayer that provides property or services to an SSTB that is commonly-owned will have the portion of property or services provided to the SSTB treated as attributable to an SSTB. Additionally without these regulations, some businesses may have an incentive to change employment relationships in favor of independent contractors. Either of these actions would entail some loss of economic efficiency due to changes in businesses’ decision-making structures based on tax incentives. The final regulations help to avoid these sources of inefficiency.

In addition to the statutory threshold amount, below which SSTB status is not relevant, § 1.199A–5 provides a de minimis rule with tiered thresholds of gross revenues arising from specified service activity in determining whether a trade or business is classified as an SSTB. The threshold for trades or businesses with less than $25 million of gross receipts is 10 percent, and for trades or businesses with more than $25 million of gross receipts it is 5 percent. This de minimis rule allows trades and businesses that have very little SSTB activity to benefit from the deduction. Absent these regulations, any income from SSTB activity could make the entire trade or business ineligible for the deduction.

The de minimis thresholds were set at these levels to balance the desire of the Treasury Department and the IRS to allow the deduction for trades and businesses with very small amounts of SSTB activity with the intent of the legislation to disallow the deduction for trades or businesses involving SSTB activity. The $25 million threshold is used in multiple statutory provisions enacted into law by the TCJA as a threshold to apply certain rules to smaller businesses. For example, businesses with average annual gross receipts under $25 million are exempt from the application of the interest deduction limitation under section 163(j), the uniform capitalization (UNICAP) rules under section 263A, and the inventory accounting rules of section 471. The Treasury Department and the IRS chose to adopt this threshold for § 1.199A–5 because of its prevalent use in the TCJA as a threshold applicable to smaller businesses and to avoid a proliferation of varying thresholds applicable to such businesses in TCJA-related rulemaking.

The SSTB gross revenue percentages for businesses above and below the $25 million threshold were selected to represent small fractions of income. At present, the Treasury and IRS do not have data to determine what fraction of activity within a trade or business arises from SSTB activity. Treasury and the IRS also do not have data to determine whether or to what extent it would be advantageous for businesses to restructure in order to avoid the SSTB classification based on de minimis standards set at various percentage levels nor, if businesses were to restructure, what the economic consequences would be at those various percentage levels. The stipulated percentages represent the best judgment of Treasury and the IRS regarding percentages that efficiently balance compliance costs for taxpayers, effective administration of section 199A, and revenue considerations. Treasury and the IRS received several comments on these percentages and discuss these comments in the preamble.

3. Anticipated costs of § 1.199A–5

By providing a de minimis rule to allow a small fraction of gross receipts to be derived from SSTB activity, the regulations may cause businesses near the threshold to decrease their specified service activities or increase their non-specified service activities to avoid being classified as an SSTB. Additionally, the de minimis rule may encourage smaller entities engaged in SSTBs to merge with larger entities not engaged in an SSTB. The economic costs of these mergers are difficult to quantify.

Changes to the collective paperwork burden arising from § 1.199A–5 and other sections of these regulations are discussed in section J, Anticipated impacts on administrative and compliance costs, of this analysis.

H. Economic Analysis of § 1.199A–6

1. Background

The section 199A deduction is reduced below 20 percent for some businesses and taxpayers. The attributes that determine any such reduction must be determined by taxpayers claiming the section 199A deduction. Section 1.199A–6 provides rules for RPEs, PTPs, trusts, and estates relevant to making these determinations. In particular, RPEs are required to calculate and report their owners’ QBI, SSTB status, W–2 wages, UBIA of qualified property, REIT dividends, and PTP income. Similarly, PTPs must calculate and report their owners’ QBI, SSTB status, REIT dividends, and other PTP income.

2. Anticipated benefits of § 1.199A–6

The Treasury Department and the IRS expect that § 1.199A–6 will implement the section 199A deduction in an economically efficient manner. As with other regulations discussed in these Analyses, a principal benefit of § 1.199A–6 is to increase the likelihood that all taxpayers interpret the statutory rules of section 199A similarly. Additionally, we expect that requiring RPEs to determine and report the information necessary to compute the section 199A deduction will result in a more accurate and uniform application of the regulations and statute relative to an alternative approach under which individual owners would most likely determine these items.
3. Anticipated costs of § 1.199A–6 relative to the baseline

The Treasury Department and the IRS do not anticipate any meaningful economic distortions to be induced by § 1.199A–6. However, changes to the collective paperwork burden arising from this and other sections of these regulations are discussed in section J, Anticipated impacts on administrative and compliance costs, of this analysis.

I. Economic Analysis of § 1.643(f)–1

1. Background

Section 1.643(f)–1 provides that taxpayers cannot set up multiple trusts in certain cases with a principal purpose of tax avoidance, which would include the avoidance of the statutory threshold amounts under section 199A.

2. Anticipated benefits of § 1.643(f)–1 relative to the baseline

The Treasury Department and the IRS expect that the § 1.643(f)–1 will implement the section 199A deduction in an economically efficient manner. Because § 1.643(f)–1 defines the manner in which multiple trusts are subject to the threshold amount, the Treasury Department and the IRS anticipate that the final regulations will lead to fewer resources being devoted to setting up trusts in attempts to avoid the threshold amount rules under section 199A. If multiple trusts have substantially the same grantors and beneficiaries, and a principal purpose for establishing such trusts or contributing additional cash or other property to such trusts is the avoidance of Federal income tax, then the various trusts would be generally considered one trust, including for section 199A purposes.

3. Anticipated costs of § 1.643(f)–1 relative to the baseline

The Treasury Department and the IRS do not anticipate any meaningful economic distortions to be induced by § 1.643(f)–1. However, changes to the collective paperwork burden arising from this and other sections of these regulations are discussed in section J, Anticipated impacts on administrative and compliance costs, of this analysis.

J. Anticipated impacts on administrative and compliance costs

1. Discussion

The final regulations have a number of effects on taxpayers’ compliance costs. Section 1.199A–2 provides guidance in determining a taxpayer’s share of W–2 wages and UBIA of qualified property. The Treasury Department and the IRS expect that this guidance reduces the tax compliance costs of making this determination and reduces uncertainty. In the absence of the regulations, taxpayers would still need to determine how to allocate W–2 wages and UBIA of qualified property, among other calculations. These regulations provide clear instructions for how to do this, simplifying the process of complying with the law.

Section 1.199A–4 requires that owners who decide to aggregate their trades or businesses report the aggregation annually. This reporting requirement adds to the tax compliance burden of these owners. For owners who consider aggregating, these regulations increase compliance costs because the owners must calculate their deduction for both disaggregated and aggregated trades or businesses to make the aggregation decision. These additional compliance costs would be voluntary and accrue only to owners who find it beneficial to aggregate for the purposes of calculating their section 199A deduction. The final regulations also allow for aggregation at the entity level. This will generally reduce reporting and compliance costs for individual owners, relative to allowing aggregation only at the individual owner level, because the entity may have easier access to the facts and circumstances required for aggregation.

Section 1.199A–5 includes a requirement for former employees working as independent contractors for their former employer to show that their employment relationship has changed in order to be eligible for the section 199A deduction. The burden to substantiate employment status exists without these regulations; however, the final regulation may increase these individuals’ compliance costs slightly.

Section 1.199A–6 specifies that RPEs must report relevant section 199A information to owners. Due to these entity reporting requirements, the final regulations will increase compliance costs for RPEs. These entities will need to keep records of new information relevant to the calculation of their owners’ section 199A deduction, such as QBI, W–2 wages, SSTB status, and UBIA of qualified property. This recordkeeping is costly. Without these regulations, it is likely that only some RPEs would engage in this record keeping.

Section 1.199A–6 reduces the compliance burden on many individuals that own RPEs relative a scenario in which no regulations were issued or regulatory alternatives that assigned each owner of an RPE the responsibility to acquire the required information were issued without any requirement for the RPE to provide such information. Under the final regulations, owners will receive information pertaining to the section 199A deduction from the RPE, such as whether a given trade or business is an SSTB, whereas in the alternative they could have been required to make such determinations themselves.

Overall, it is likely to be more efficient for RPEs, rather than individual owners, to keep records of section 199A deduction information. Therefore, the Treasury Department and the IRS expect that § 1.199A–6 will reduce compliance costs on net and relative to these alternative scenarios.

2. Estimated effect on compliance costs

As explained above, key provisions of §§ 1.199A–1 through 1.199A–6 will reduce compliance costs that taxpayers would likely have incurred in the absence of the regulations. Most notably, the de minimis rule of § 1.199A–5 provides that a trade or business will not be considered to be an SSTB merely because it provides a small amount of services in a specified service activity. This provision is expected to reduce compliance costs associated with section 199A for millions of U.S. businesses. In addition, the aggregation rules will reduce overall costs for
taxpayers because some taxpayers would otherwise restructure their business arrangements in order to receive the benefit of the deduction. These and other discretionary choices by the Treasury Department and the IRS in the final regulations will substantially reduce taxpayers’ compliance costs.

The Treasury Department and the IRS also assessed the provisions of the final regulations that could increase compliance burdens. The Treasury Department and the IRS estimate that these regulations will lead to a gross (not net) increase in total reporting burden of 25 million hours annually. This estimate primarily reflects two effects of the regulations. First, the Treasury Department and the IRS project that approximately 1.2 million individuals with more than one directly owned or pass-through business who voluntarily choose to aggregate will spend 0.66 hours annually complying with §1.199A–4, resulting in a 0.7 million hour increase in reporting burden. Second, the Treasury Department and the IRS project that—in complying with the §1.199A–6 requirement to report relevant section 199A information to their approximately 8.8 million owners—RPEs will spend 2.75 hours annually per owner, resulting in a 24.2 million hour increase in reporting burden. These estimates do not include the decrease in compliance costs to individuals who would no longer find it necessary to compute the quantities detailed in §1.199A–6 because they would receive this information from each RPE. Nor do these estimates reflect the decrease in compliance costs outlined above.

Valuations of the burden hours of $39/hour in the case of individuals making aggregation decisions and $53/hour in the case of RPEs reporting section 199A information lead to gross reporting annualized costs to taxpayers of $1.36 billion (3 percent rate) to $1.37 billion (7 percent rate) ($2017). These estimates do not account for the provisions of the final regulations that will substantially reduce compliance costs. These estimates assume that the costs are approximately the same proportion of GDP each year. It is possible, however, that costs will be higher in the first years that the deduction is allowed and lower in future years once taxpayers have more experience with the calculations and reporting requirements associated with the deduction. Finally, the estimates reflect data for entities of a size and form expected to be impacted by section 199A. More specifically, because of the scope of the section 199A deduction, the Treasury Department and the IRS expect the majority of affected entities to be primarily small, and medium in size.

The Treasury Department and the IRS received a comment that the hours assumptions for the compliance costs were too small. The hours estimates were not revised because the commenter’s discussion focused mainly on the effort required to compute the values necessary to calculate the deduction not on the specific aggregation or reporting requirements estimated here.

<table>
<thead>
<tr>
<th>Annualized Monetized Effect on Compliance</th>
<th>Years 2018 to 2027</th>
<th>(3% Discount Rate, millions $2017)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Costs from Final Regulations</td>
<td>$1,357</td>
<td></td>
</tr>
<tr>
<td>Estimated Gross Costs</td>
<td>Not quantified</td>
<td></td>
</tr>
<tr>
<td>Estimated Savings</td>
<td>Not quantified</td>
<td></td>
</tr>
<tr>
<td>Estimated net change in compliance costs</td>
<td>Not quantified</td>
<td></td>
</tr>
</tbody>
</table>

OMB control number 1545-0123 represents a total estimated burden time, including all other related forms and schedules, of 3.157 billion hours and total estimated monetized costs of $58.148 billion (available at: https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms–1065–1065-b–1066–1120–c–1120-f–1120-h–1120-nd). Likewise, OMB control number 1545-0074 represents a total estimated burden time, including all other related forms and schedules, of 1.784 billion hours and total estimated monetized costs of $31.764 billion. OMB Control number 1545-0092 represents burden hours of roughly 917,800 hours. The burden estimates provided by the IRS under the OMB Numbers listed in the above table are aggregate amounts that relate to the entire package of forms associated with the OMB control number, and do not include the estimated burden changes related to the additional burdens contemplated in this final rule such as attaching the applicable statement to Form 1040 or Schedule K–1 for the Form 1041, Form 1065, or Form 1120S, as appropriate, to ensure the correct amount of deduction is reported under section 199A. The Treasury department anticipates incorporating these burdens in the next annual cycle of the above aggregated collections, and the public will have an opportunity to comment on those estimates at that time.

K. Executive Order 13771.

These final regulations have been designated as regulatory under E.O. 13771.

II. Regulatory Flexibility Act

It is hereby certified that the collections of information in §§1.199A–4 and 1.199A–6 will not have a significant economic impact on a substantial number of small entities. Based on Joint Committee on Taxation (JCT) analysis of 2014 tax returns, there were approximately 4.3 million S corporations, 3.6 million partnerships, 24.6 million non-farm sole proprietorships with receipts below $10 million, and 1.8 million farm sole proprietorships with gross income below $10 million. See Present Law and Background Regarding the Federal Income Taxation of Small Businesses JCX–32–17. The Treasury Department and the IRS have determined that the regulations may affect a substantial number of small entities (businesses entities with receipts below $10 million) but have also concluded that the economic
impact on small entities as a result of the collections of information in this regulation is not expected to be significant.

The collection in § 1.199A–4 may apply to RPEs, individuals, and certain trusts or estates that have qualified business income (QBI) under section 199A and that choose to aggregate two or more trades or businesses for purposes of section 199A. If a taxpayer chooses to aggregate its trades or businesses, the taxpayer, must include an attachment to its tax return identifying and describing each trade or business aggregated, describing changes to the aggregated group, and providing other information as the Commissioner may require in forms, instructions, or other published guidance. Aggregation is not required by a person claiming the section 199A deduction, and therefore, the collection of information in § 1.199A–4 is required only if the person or RPE chooses to aggregate multiple trades or businesses. Because the Treasury Department and the IRS do not yet have data on how many small entities will choose to aggregate multiple trades or businesses, the number of affected entities is not estimated at this time. However, the Treasury Department and the IRS have determined that the majority of businesses and particularly small businesses (businesses entities with receipts below $10 million) will choose not to aggregate or will have no call to do so. Aggregation is potentially beneficial to businesses with individual owners who have taxable income above $315,000 for married filing joint taxpayers and $157,500 for others. Approximately three-quarters of passthrough businesses are structured as a sole proprietorship and therefore only have one owner. The Treasury Department and the IRS estimate that approximately 95 percent of these businesses have owners below the income threshold and therefore, would not need to aggregate to receive the full benefit of the section 199A deduction.

The small entities subject to the collection of information in § 1.199A–6 are business entities formed as estates, trusts, partnerships, or S corporations that conduct, directly or indirectly, one or more trades or businesses. Section 1.199A–6 requires such an entity to attach a statement describing the QBI, W–2 wages, and UBIA of qualified property for each separate trade or business to the Schedule K–1 required under existing law to be issued to each beneficiary, partner, or shareholder. Although data is not available to estimate the number of small entities (business entities with receipts below $10 million) affected by the § 1.199A–6 requirements, the Treasury Department and the IRS project that number would include a substantial number of small entities.

As discussed elsewhere in this preambles, the reporting burden is estimated at 30 minutes to 20 hours, depending on individual circumstances, with an estimated average of 2.5 hours for all affected entities, regardless of size. The burden on entities (those with business receipts below $10 million) is expected to be at the lower end of the range (30 minutes to 2.5 hours). Using the IRS’s taxpayer compliance cost estimates, taxpayers who are self-employed with multiple businesses are estimated to have a monetization rate of $39 per hour. Passthroughs that issue K–1s have a monetization rate of $53 per hour. Thus, the annual aggregate burden on businesses with gross receipts below $10 million is between $19.50 and $132.50 per business.

Moreover, the Treasury Department and the IRS have determined that there would be no significant economic impact on affected entities. Based on published information from the Conference Report accompanying the Act, H.R. Rep. No. 115–446, at 683 (2017), and Statistics of Income aggregate data, the projected net tax revenue losses from section 199A are estimated to be only a small fraction of the business receipts of S corporations (including subchapter S banks), partnerships, and non-farm sole proprietors projected to 2027. See the following table in this Part II. These revenue projections, which represent a reduced tax liability for these businesses, include both the effects of the statute as well as the regulations. The reduction in tax liability varies from 0.02 percent to 0.49 percent of gross receipts, an economic impact that is not regarded as substantial under the Regulatory Flexibility Act.

<table>
<thead>
<tr>
<th>Fiscal Years</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
<th>2021</th>
<th>2022</th>
<th>2023</th>
<th>2024</th>
<th>2025</th>
<th>2026</th>
<th>2027</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Tax Reduction¹ ($billions)</td>
<td>27.7</td>
<td>47.1</td>
<td>49.9</td>
<td>51.8</td>
<td>52.8</td>
<td>52.2</td>
<td>53.5</td>
<td>53.2</td>
<td>53.2</td>
<td>24.2</td>
</tr>
<tr>
<td>Total Business Receipts² ($ billions)</td>
<td>10095.1</td>
<td>10306.7</td>
<td>10415.2</td>
<td>10525.7</td>
<td>10638.0</td>
<td>10752.2</td>
<td>10868.4</td>
<td>10986.5</td>
<td>11016.96</td>
<td>11228.7</td>
</tr>
<tr>
<td>Percent</td>
<td>0.27</td>
<td>0.46</td>
<td>0.48</td>
<td>0.49</td>
<td>0.50</td>
<td>0.49</td>
<td>0.49</td>
<td>0.48</td>
<td>0.22</td>
<td>0.02</td>
</tr>
</tbody>
</table>

¹Tax revenue effects of 199A are from the Conference Report accompanying the Act.

²To the extent that some “not small” passthroughs are reflected in this table, the percentages reported represent an under-estimate of the tax cut that those small businesses will receive.

Finally, no comments regarding the economic impact of these regulations on small entities were received. For these reasons, the Treasury Department and the IRS have determined that the collection of information in this final rulemaking will not have a significant economic impact. Accordingly, a regulatory flexibility analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

Pursuant to section 7805(f) of the Code, this final rulemaking has been sub-
mitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are Robert D. Alinsky, Vishal R. Amin, Margaret Burow, Frank J. Fisher, and Wendy L. Kribell, Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and record-keeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding sectional authorities for §§ 1.199A–1 through 1.199A–6 and § 1.643(f) to read in part as follows:

Authority: 26 U.S.C. 7805 * * *
Section 1.199A–1 also issued under 26 U.S.C. 199A(f)(4).
Section 1.199A–2 also issued under 26 U.S.C. 199A(b)(5), (f)(1)(A), (f)(4), and (h).
Section 1.199A–3 also issued under 26 U.S.C. 199A(c)(4)(C) and (f)(4).
Section 1.199A–5 also issued under 26 U.S.C. 199A(c)(4)(C) and (f)(4).
Section 1.199A–6 also issued under 26 U.S.C. 199A(f)(1)(B) and (f)(4).

* * * * *
Section 1.643(f)–1 also issued under 26 U.S.C. 643(f).
* * * * *
Par. 2. Section 1.199A–0 is added to read as follows:

§ 1.199A–0 Table of contents.

This section lists the section headings that appear in §§ 1.199A–1 through 1.199A–6.

§ 1.199A–1 Operational rules.

(a) Overview.
(1) In general.
(2) Usage of term individual.
(b) Definitions.
(1) Aggregated trade or business.
(2) Applicable percentage.
(3) Net capital gain.
(4) Phase-in range.
(5) Qualified business income (QBI).
(6) QBI component.
(7) Qualified PTP income.
(8) Qualified REIT dividends.
(9) Reduction amount.
(10) Relevant passthrough entity (RPE).
(11) Specified service trade or business (SSTB).
(12) Threshold amount.
(13) Total QBI amount.
(14) Trade or business.
(15) Unadjusted basis immediately after the acquisition of qualified property (UBIA of qualified property).
(c) Computation of the section 199A deduction for individuals with taxable income not exceeding threshold amount.
(1) In general.
(2) Carryover rules.
(i) Negative total QBI amount.
(ii) Negative combined qualified REIT dividends/qualified PTP income amount.
(3) Examples.
(d) Computation of the section 199A deduction for individuals with taxable income above the threshold amount.
(1) In general.
(2) QBI component.
(i) SSTB exclusion.
(ii) Aggregated trade or business.
(iii) Netting and carryover.
(A) Netting.
(B) Carryover of negative total QBI amount.
(iv) QBI component calculation.
(A) General rule.
(B) Taxpayers with taxable income within phase-in range.
(3) Qualified REIT dividends/qualified PTP income component.
(i) In general.
(ii) SSTB exclusion.
(iii) Negative combined qualified REIT dividends/qualified PTP income.
(4) Examples.
(A) In general.
(B) Acquisition or disposition of a trade or business.
(1) In general.
(2) Acquisition or disposition.
(C) Application in the case of a person with a short taxable year.
(1) In general.
(2) Short taxable year that does not include December 31.
(D) Remuneration paid for services performed in the Commonwealth of Puerto Rico.
(3) Allocation of wages to trades or businesses.
(4) Allocation of wages to QBI.
(5) Non-duplication rule.
(c) UBIA of qualified property.
(1) Qualified property.
(i) In general.
(ii) Improvements to qualified property.
(iii) Adjustments under sections 734(b) and 743(b).
(iv) Property acquired at end of year.
(2) Depreciable period.
(i) In general.
(ii) Additional first-year depreciation under section 168.
(iii) Qualified property acquired in transactions subject to section 1031 or section 1033.
(A) Replacement property received in a section 1031 or 1033 transaction.
(B) Other property received in a section 1031 or 1033 transaction.
(iv) Qualified property acquired in transactions subject to section 168(i)(7)(B).
(v) Excess section 743(b) basis adjustment.
(3) Unadjusted basis immediately after acquisition.
(i) In general.
(ii) Qualified property acquired in a like-kind exchange.
(A) In general.
(B) Excess boot.
(iii) Qualified property acquired pursuant to an involuntary conversion.
(A) In general.
(B) Excess boot.
(iv) Qualified property acquired in transactions described in section 168(i)(7)(B).
(v) Qualified property acquired from a decedent.
(vi) Property acquired in a nonrecognition transaction with principal purpose of increasing UBIA.
(4) Examples.
(d) Applicability date.
(1) General rule.
(2) Exceptions.
(i) Anti-abuse rules.
(ii) Non-calendar year RPE.
§ 1.199A–3 Qualified business income, qualified REIT dividends, and qualified PTP income.
(a) In general.
(b) Definition of qualified business income.
(1) In general.
(ii) Guaranteed payments for the use of capital.
(iii) Section 481 adjustments.
(iv) Previously disallowed losses
(v) Net operating losses.
(vi) Other deductions.
(2) Qualified items of income, gain, deduction, and loss.
(i) In general.
(ii) Items not taken into account.
(3) Commonwealth of Puerto Rico.
(4) Wages.
(5) Allocation of items among directly-conducted trades or businesses.
(c) Qualified REIT dividends and qualified PTP income.
(1) In general.
(2) Qualified REIT dividend.
(3) Qualified PTP income.
(i) In general.
(ii) Special rules.
(d) [Reserved]
(e) Applicability date.
(1) General rule.
(2) Exceptions.
(i) Anti-abuse rules.
(ii) Non-calendar year RPE.
§ 1.199A–4 Aggregation.
(a) Scope and purpose.
(b) Aggregation rules.
(1) General rule.
(2) Operating rules.
(i) Individuals.
(ii) RPEs.
(c) Reporting and consistency.
(1) For individual.
(2) Individual disclosure.
(i) Required annual disclosure.
(ii) Failure to disclose.
(3) For RPEs.
(i) Required annual disclosure.
(ii) Failure to disclose.
(d) Examples.
(e) Applicability date.
(1) General rule.
(2) Exception for non-calendar year RPE.
§ 1.199A–5 Specified service trades or businesses and the trade or business of performing services as an employee.
(a) Scope and effect.
(1) Scope.
(2) Effect of being an SSTB.
(3) Trade or business of performing services as an employee.
(b) Definition of specified service trade or business.
(1) Listed SSTBs.
(2) Additional rules for applying section 199A(d)(2) and paragraph (b) of this section.
(i) In general.
(A) No effect on other tax rules.
(B) Hedging transactions.
(ii) Meaning of services performed in the field of health.
(iii) Meaning of services performed in the field of law.
(iv) Meaning of services performed in the field of accounting.
(v) Meaning of services performed in the field of actuarial science.
(vi) Meaning of services performed in the field of performing arts.
(vii) Meaning of services performed in the field of consulting.
(viii) Meaning of services performed in the field of athletics.
(ix) Meaning of services performed in the field of financial services.
(x) Meaning of services performed in the field of trading.
(xi) Meaning of the provision of services in investing and investment management.
(xii) Meaning of the provision of services in dealing.
(A) Dealing in securities.
(B) Dealing in commodities.

(1) Qualified active sale.
(2) Active conduct of a commodities business.
(3) Directly holds commodities as inventory or similar property.
(4) Directly incurs substantial expenses in the ordinary course.
(5) Significant activities for purposes of paragraph (b)(2)(xiii)(B) of this section.
(C) Dealing in partnership interests.
(xiv) Meaning of trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners.
(3) Examples.
(c) Special rules.
(1) De minimis rule.
(i) Gross receipts of $25 million or less.
(ii) Gross receipts of greater than $25 million.
(2) Services or property provided to an SSTB.
(b) Computational and reporting rules for PTPs.
(1) Computational rules.
(2) Reporting rules.
(d) Application to trusts, estates, and beneficiaries.
(1) In general.
(2) Grantor trusts.
(3) Non-grantor trusts and estates.
(i) Calculation at entity level.
(ii) Allocation among trust or estate and beneficiaries.
(iii) [Reserved]
(iv) Threshold amount.
(v) [Reserved]
(vi) Electing small business trusts.
(vii) Anti-abuse rule for creation of a trust to avoid exceeding the threshold amount.
(viii) Example.
(e) Applicability date.
(1) General rule.
(2) Exceptions.
(i) Anti-abuse rules.
(ii) Non-calendar year RPE.
Par. 3. Section 1.199A–1 is added to read as follows:
§ 1.199A–1 Operational rules.

(a) Overview—(1) In general. This section provides operational rules for calculating the section 199A(a) qualified business income deduction (section 199A deduction) under section 199A of the Internal Revenue Code (Code). This section refers to the rules in §§ 1.199A–2 through 1.199A–6. This paragraph (a) provides an overview of this section. Paragraph (b) of this section provides definitions that apply for purposes of section 199A and §§ 1.199A–1 through 1.199A–6. Paragraph (c) of this section provides computational rules and examples for individuals whose taxable income does not exceed the threshold amount. Paragraph (d) of this section provides computational rules and examples for individuals whose taxable income exceeds the threshold amount. Paragraph (e) of this section provides special rules for purposes of section 199A and §§ 1.199A–1 through 1.199A–6. This section and §§ 1.199A–2 through 1.199A–6 do not apply for purposes of calculating the deduction in section 199A(g) for specified agricultural and horticultural cooperatives.
(2) Usage of term individual. For purposes of applying the rules of §§ 1.199A–1 through 1.199A–6, a reference to an individual includes a reference to a trust (other than a grantor trust) or an estate to the extent that the section 199A deduction is determined by the trust or estate under the rules of § 1.199A–6.
(b) Definitions. For purposes of section 199A and §§ 1.199A–1 through 1.199A–6, the following definitions apply:
(1) Aggregated trade or business means two or more trades or businesses that have been aggregated pursuant to § 1.199A–4.
(2) Applicable percentage means, with respect to any taxable year, 100 percent reduced (not below zero) by the percentage equal to the ratio that the taxable income of the individual for the taxable year in excess of the threshold amount, bears to $50,000 (or $100,000 in the case of a joint return).
(3) Net capital gain means net capital gain as defined in section 1222(11) plus any qualified dividend income (as defined in section 1(h)(11)(B)) for the taxable year.
(4) Phase-in range means a range of taxable income between the threshold amount and the threshold amount plus $50,000 (or $100,000 in the case of a joint return).
(5) Qualified business income (QBI) means the net amount of qualified items of income, gain, deduction, and loss with respect to any trade or business (or aggregated trade or business) as determined under the rules of § 1.199A–3(b).
(6) QBI component means the amount determined under paragraph (d)(2) of this section.
(7) Qualified PTP income is defined in § 1.199A–3(c)(3).
(8) Qualified REIT dividends are defined in § 1.199A–3(c)(2).
(9) Reduction amount means, with respect to any taxable year, the excess amount multiplied by the ratio that the taxable income of the individual for the taxable year in excess of the threshold amount, bears to $50,000 (or $100,000 in the case of a joint return). For purposes of this paragraph (b)(9), the excess amount is the amount by which 20 percent of QBI
exceeds the greater of 50 percent of W–2 wages or the sum of 25 percent of W–2 wages plus 2.5 percent of the UBIA of qualified property.

(10) Relevant passthrough entity (RPE) means a partnership (other than a PTP) or an S corporation that is owned, directly or indirectly, by at least one individual, estate, or trust. Other passthrough entities including common trust funds as described in § 1.6032–T and religious or apostolic organizations described in section 501(d) are also treated as RPEs if the entity files a Form 1065, U.S. Return of Partnership Income, and is owned, directly or indirectly, by at least one individual, estate, or trust. A trust or estate is treated as an RPE to the extent it passes through QBI, W–2 wages, UBIA of qualified property, qualified REIT dividends, or qualified PTP income.

(11) Specified service trade or business (SSTB) means a specified service trade or business as defined in § 1.199A–5(b).

(12) Threshold amount means, for any taxable year beginning before 2019, $157,500 (or $315,000 in the case of a taxpayer filing a joint return). In the case of any taxable year beginning after 2018, the threshold amount is the dollar amount in the preceding sentence increased by an amount equal to such dollar amount, multiplied by the cost-of-living adjustment determined under section 1(f)(3) of the Code for the calendar year in which the taxable year begins, determined by substituting “calendar year 2017” for “calendar year 2016” in section 1(f)(3)(A)(i). The amount of any increase under the preceding sentence is rounded as provided in section 1(f)(7) of the Code.

(13) Total QBI amount means the net total QBI from all trades or businesses (including the individual’s share of QBI from trades or business conducted by RPEs).

(14) Trade or business means a trade or business that is a trade or business under section 162 (a section 162 trade or business) other than the trade or business of performing services as an employee. In addition, rental or licensing of tangible or intangible property (rental activity) that does not rise to the level of a section 162 trade or business is nevertheless treated as a trade or business for purposes of section 199A, if the property is rented or licensed to a trade or business conducted by an individual or an RPE which is commonly controlled under § 1.199A–4(b)(1)(i) (regardless of whether the rental activity and the trade or business are otherwise eligible to be aggregated under § 1.199A–4(b)(1)).

(15) Unadjusted basis immediately after acquisition of qualified property (UBIA of qualified property) is defined in § 1.199A–2(c).

(16) W–2 wages means W–2 wages of a trade or business (or aggregated trade or business) properly allocable to QBI as determined under § 1.199A–2(b).

(c) Computation of the section 199A deduction for individuals with taxable income not exceeding threshold amount—(1) In general. The section 199A deduction is determined for individuals with taxable income for the taxable year that does not exceed the threshold amount by adding 20 percent of the total QBI amount (including the individual’s share of QBI from an RPE and QBI attributable to an SSTB) and 20 percent of the combined amount of qualified REIT dividends and qualified PTP income (including the individual’s share of qualified REIT dividends and qualified PTP income from RPEs and qualified PTP income attributable to an SSTB). That sum is then compared to 20 percent of the amount by which the individual’s taxable income exceeds net capital gain. The lesser of these two amounts is the individual’s section 199A deduction.

(2) Carryover rules—(i) Negative total QBI amount. If the total QBI amount is less than zero, the portion of the individual’s section 199A deduction related to QBI is zero for the taxable year. The negative total QBI amount is treated as negative QBI from a separate trade or business in the succeeding taxable years of the individual for purposes of section 199A and this section. This carryover rule does not affect the deductibility of the loss for purposes of other provisions of the Code.

(ii) Negative combined qualified REIT dividends/qualified PTP income. If the combined amount of REIT dividends and qualified PTP income is less than zero, the portion of the individual’s section 199A deduction related to qualified REIT dividends and qualified PTP income is zero for the taxable year. The negative combined amount must be carried forward and used to offset the combined amount of REIT dividends and qualified PTP income in the succeeding taxable years of the individual for purposes of section 199A and this section. This carryover rule does not affect the deductibility of the loss for purposes of other provisions of the Code.

(3) Examples. The following examples illustrate the provisions of this paragraph (c). For purposes of these examples, unless indicated otherwise, assume that all of the trades or businesses are trades or businesses as defined in paragraph (b)(14) of this section and all of the tax items are effectively connected to a trade or business within the United States within the meaning of section 864(c). Total taxable income does not include the section 199A deduction.

(i) Example 1. A, an unmarried individual, owns and operates a computer repair shop as a sole proprietorship. The business generates $100,000 in net taxable income from operations in 2018. A has no capital gains or losses. After allowable deductions not relating to the business, A’s total taxable income for 2018 is $81,000. The business’s QBI is $100,000, the net amount of its qualified items of income, gain, deduction, and loss. A’s section 199A deduction for 2018 is equal to $16,200, the lesser of 20% of A’s QBI from the business ($100,000 x 20% = $20,000) and 20% of A’s total taxable income for the taxable year ($81,000 x 20% = $16,200).

(ii) Example 2. Assume the same facts as in Example 1 of paragraph (c)(3)(i) of this section, except that A also has $7,000 in net capital gain for 2018 and that, after allowable deductions not relating to the business, A’s taxable income for 2018 is $74,000. A’s taxable income minus net capital gain is $67,000 ($74,000 - $7,000). A’s section 199A deduction is equal to $13,400, the lesser of 20% of A’s QBI from the business ($100,000 x 20% = $20,000) and 20% of A’s total taxable income minus net capital gain for the taxable year ($67,000 x 20% = $13,400).

(iii) Example 3. B and C are married and file a joint individual income tax return. B earns $50,000 in wages as an employee of an unrelated company in 2018. C owns 100% of the shares of X, an S corporation that provides landscaping services. X generates $100,000 in net income from operations in 2018. X pays C $150,000 in wages in 2018. B and C have no capital gains or losses. After allowable deductions not related to X, B and C’s total taxable income for 2018 is $270,000. B’s and C’s wages are not considered to be income from a trade or business for purposes of the section 199A deduction. Because X is an S corporation, its QBI is determined at the S corporation level. X’s QBI is $100,000, the net amount of its qualified items of income, gain, deduction, and loss. The wages paid by X to C are considered to be a qualified item of deduction for purposes of determining X’s QBI. The section 199A deduction with respect to X’s QBI is then determined by C. X’s sole shareholder, and is claimed on the joint return filed by B and C. B and C’s section
199A deduction is equal to $20,000, the lesser of 20% of C’s QBI from the business ($100,000 x 20% = $20,000) and 20% of B and C’s total taxable income for the taxable year ($270,000 x 20% = $54,000).

(iv) Example 4. Assume the same facts as in Example 3 of paragraph (c)(3)(ii) of this section except that B also earns $1,000 in qualified REIT dividends and $500 in qualified PTP income in 2018, increasing taxable income to $271,500. B and C’s section 199A deduction is equal to $20,300, the lesser of:

(A) 20% of C’s QBI from the business ($100,000 x 20% = $20,000) plus 20% of B’s combined qualified REIT dividends and qualified PTP income ($1500 x 20% = $300); and

(B) 20% of B and C’s total taxable for the taxable year ($271,500 x 20% = $54,300).

(d) Computation of the section 199A deduction for individuals with taxable income above threshold amount—(1) In general. The section 199A deduction is determined for individuals with taxable income for the taxable year that exceeds the threshold amount by adding the QBI component described in paragraph (d)(2) of this section and the qualified REIT dividends/qualified PTP income component described in paragraph (d)(3) of this section (including the individual’s share of qualified REIT dividends and qualified PTP income from RPEs). That sum is then compared to 20 percent of the amount by which the individual’s taxable income exceeds net capital gain. The lesser of these two amounts is the individual’s section 199A deduction.

(2) QBI component. An individual with taxable income for the taxable year that exceeds the threshold amount determines the QBI component using the following computational rules, which are to be applied in the order they appear.

(i) SSTB exclusion. If the individual’s taxable income is within the phase-in range, then only the applicable percentage of QBI, W–2 wages, and UBIA of qualified property for each SSTB is taken into account for all purposes of determining the individual’s section 199A deduction, including the application of the netting and carryover rules described in paragraph (d)(2)(iii) of this section. If the individual’s taxable income exceeds the phase-in range, then none of the individual’s share of QBI, W–2 wages, or UBIA of qualified property attributable to an SSTB may be taken into account for purposes of determining the individual’s section 199A deduction.

(ii) Aggregated trade or business. If an individual chooses to aggregate trades or businesses under the rules of § 1.199A–4, the individual must combine the QBI, W–2 wages, and UBIA of qualified property of each trade or business within an aggregated trade or business prior to applying the netting and carryover rules described in paragraph (d)(2)(iii) of this section and the W–2 wage and UBIA of qualified property limitations described in paragraph (d)(2)(iv) of this section.

(iii) Netting and carryover—(A) Netting. If an individual’s QBI from at least one trade or business (including an aggregated trade or business) is less than zero, the individual must offset the QBI attributable to each trade or business (or aggregated trade or business) that produced net positive QBI with the QBI from each trade or business (or aggregated trade or business) that produced net negative QBI in proportion to the relative amounts of net QBI in the trades or businesses (or aggregated trades or businesses) with positive QBI. The adjusted QBI is then used in paragraph (d)(2)(iv) of this section. The W–2 wages and UBIA of qualified property from the trades or businesses (including aggregated trades or businesses) that produced net negative QBI are not taken into account for purposes of this paragraph (d) and are not carried over to the subsequent year.

(B) Carryover of negative total QBI amount. If an individual’s QBI from all trades or businesses (including aggregated trades or businesses) combined is less than zero, the QBI component is zero for the taxable year. This negative amount is treated as negative QBI from a separate trade or business in the succeeding taxable years of the individual for purposes of section 199A and this section. This carryover rule does not affect the deductibility of the loss for purposes of other provisions of the Code. The W–2 wages and UBIA of qualified property from the trades or businesses (including aggregated trades or businesses) that produced net negative QBI are not taken into account for purposes of this paragraph (d) and are not carried over to the subsequent year.

(iv) QBI component calculation—(A) General rule. Except as provided in paragraph (d)(2)(iv)(B) of this section, the QBI component is the sum of the amounts determined under this paragraph (d)(2)(iv)(A) for each trade or business (or aggregated trade or business). For each trade or business (or aggregated trade or business) (including trades or businesses operated through RPEs) the individual must determine the lesser of—

(I) 20 percent of the QBI for that trade or business (or aggregated trade or business); or

(II) The greater of—

(i) 50 percent of W–2 wages with respect to that trade or business (or aggregated trade or business); or

(ii) The sum of 25 percent of W–2 wages with respect to that trade or business (or aggregated trade or business) plus 2.5 percent of the UBIA of qualified property with respect to that trade or business (or aggregated trade or business).

(B) Taxpayers with taxable income within phase-in range. If the individual’s taxable income is within the phase-in range and the amount determined under paragraph (d)(2)(iv)(A)(2) of this section for a trade or business (or aggregated trade or business) is less than the amount determined under paragraph (d)(2)(iv)(A)(1) of this section for that trade or business (or aggregated trade or business), the amount determined under paragraph (d)(2)(iv)(A) of this section for such trade or business (or aggregated trade or business) is modified. Instead of the amount determined under paragraph (d)(2)(iv)(A)(2) of this section, the QBI component for the trade or business (or aggregated trade or business) is the amount determined under paragraph (d)(2)(iv)(A)(1) of this section reduced by the reduction amount as defined in paragraph (b)(9) of this section. This reduction amount does not apply if the amount determined in paragraph (d)(2)(iv)(A)(2) of this section is greater than the amount determined under paragraph (d)(2)(iv)(A)(1) of this section (in which circumstance the QBI component for the trade or business (or aggregated trade or business) will be the unreduced amount determined in paragraph (d)(2)(iv)(A)(1) of this section).

(3) Qualified REIT dividends/qualified PTP income component—(i) In general. The qualified REIT dividend/qualified PTP income component is 20 percent of the combined amount of qualified REIT dividends and qualified PTP income received by the individual (including the
individual’s share of qualified REIT dividends and qualified PTP income from REPs).

(ii) SSTB exclusion. If the individual’s taxable income is within the phase-in range, then only the applicable percentage of qualified PTP income generated by an SSTB is taken into account for purposes of determining the individual’s section 199A deduction, including the determination of the combined amount of qualified REIT dividends and qualified PTP income described in paragraph (d)(1) of this section. If the individual’s taxable income exceeds the phase-in range, then none of the individual’s share of qualified PTP income generated by an SSTB may be taken into account for purposes of determining the individual’s section 199A deduction.

(iii) Negative combined qualified REIT dividends/qualified PTP income. If the combined amount of REIT dividends and qualified PTP income is less than zero, the portion of the individual’s section 199A deduction related to qualified REIT dividends and qualified PTP income is zero for the taxable year. The negative combined amount must be carried forward and used to offset the combined amount of REIT dividends/qualified PTP income in the succeeding taxable years of the individual for purposes of section 199A and this section. This carryover rule does not affect the deductibility of the loss for purposes of other provisions of the Code.

(4) Examples. The following examples illustrate the provisions of this paragraph (d).

For purposes of these examples, unless indicated otherwise, assume that all of the trades or businesses are trades or businesses as defined in paragraph (b)(14) of this section, none of the trades or businesses are SSTBs as defined in paragraph (b)(11) of this section and § 1.199A-5(b); and all of the tax items associated with the trades or businesses are effectively connected to a trade or business within the United States within the meaning of section 864(c).

Also assume that the taxpayers report no capital gains or losses or other tax items not specified in the examples. Total taxable income does not include the section 199A deduction.

(i) Example 1. D, an unmarried individual, operates a business as a sole proprietorship. The business generates $1,000,000 of QBI in 2018. Solely for purposes of this example, assume that the business paid no wages and holds no qualified property for use in the business. After allowable deductions unrelated to the business, D’s total taxable income for 2018 is $980,000. Because D’s taxable income exceeds the applicable threshold amount, D’s section 199A deduction is subject to the W–2 wage and UBIA of qualified property limitations. D’s section 199A deduction is limited to zero because the business paid no wages and held no qualified property.

(ii) Example 2. Assume the same facts as in Example 1 of paragraph (d)(4)(i) of this section, except that D holds qualified property with a UBIA of $10,000,000 for use in the trade or business. D reports $4,000,000 of QBI for 2020. After allowable deductions unrelated to the business, D’s total taxable income for 2020 is $3,980,000. Because D’s taxable income is above the threshold amount, the QBI component of D’s section 199A deduction is subject to the W–2 wage and UBIA of qualified property limitations. Because the business has no W–2 wages, the QBI component of D’s section 199A deduction is limited to the lesser of 20% of the business’s QBI or 2.5% of its UBIA of qualified property. Twenty percent of the $4,000,000 of QBI is $800,000. Two and one-half percent of the $10,000,000 UBIA of qualified property is $250,000. The QBI component of D’s section 199A deduction is thus limited to $250,000. D’s section 199A deduction is equal to the lesser of:

(A) 20% of the QBI from the business as limited ($250,000); or

(B) 20% of D’s taxable income ($3,980,000 x 20% = $796,000). Therefore, D’s section 199A deduction for 2020 is $250,000.

(iii) Example 3. E, an unmarried individual, is a 30% owner of LLC, which is classified as a partnership for Federal income tax purposes. In 2018, the LLC has a single trade or business and reports QBI of $3,000,000. The LLC pays total W–2 wages of $1,000,000, and its total UBIA of qualified property is $100,000. E is allocated 30% of all items of the partnership. For the 2018 taxable year, E reports $900,000 of QBI from the LLC. After allowable deductions unrelated to LLC, E’s taxable income is $880,000. Because E’s taxable income is above the threshold amount, the QBI component of E’s section 199A deduction is limited to the lesser of 20% of E’s share of LLC’s QBI or the greater of 20% of E’s share of LLC’s W–2 wage or UBIA of qualified property limitations. Twenty percent of E’s share of LLC’s QBI of $900,000 is $180,000. The W–2 wage limitation equals $75,750, the sum of 25% of E’s share of LLC’s W–2 wages ($3,000,000) or $2,500. The greater of the limitation amounts ($250,000) is $250,000. The UBIA of qualified property limitation equals $252,500, the sum of 25% of E’s share of LLC’s W–2 wages ($1,000,000) or $500,000. The greater of the limitation amounts ($250,000 and $252,500) is $250,000. The QBI component of E’s section 199A deduction is thus limited to $250,000, the lesser of 20% of QBI ($600,000) and the greater of the limitation amounts ($500,000). F reports a qualified loss from a PTP and has no qualified REIT dividend. F does not net the ($10,000) loss from the PTP against QBI. Instead, the portion of F’s section 199A deduction related to qualified REIT dividends and qualified PTP income is zero for 2018. F’s section 199A deduction is equal to the lesser of 20% of F’s QBI from the business as limited ($500,000) or 20% of F’s taxable income over net capital gain ($1,880,000 x 20% = $376,000). Therefore, F’s section 199A deduction is $376,000 for 2018. F must also carry forward the ($10,000) qualified loss from a PTP to be netted against F’s qualified REIT dividends and qualified PTP income in the succeeding taxable year.

(iv) Example 5: Phase-in range. (A) B and C are married and file a joint individual income tax return. B is a shareholder in M, an entity taxed as an S corporation for Federal income tax purposes that conducts a single trade or business. M holds no qualified property. B’s share of M’s QBI is $300,000 in 2018. B’s share of the W–2 wages from M in 2018 is $40,000. E earns wage income from employment by an unrelated company. After allowable deductions unrelated to M, B and C’s taxable income for 2018 is $375,000. B and C are within the phase-in range because their taxable income exceeds the applicable threshold amount, $315,000, but does not exceed the threshold amount plus $100,000, or $415,000. Consequently, the QBI component of B and C’s section 199A deduction may be limited by the W–2 wage and UBIA of qualified property limitations but the limitations will be phased in.

(B) Because M does not hold qualified property, only the W–2 wage limitation must be calculated. In order to apply the W–2 wage limitation, B and C must first determine 20% of B’s share of M’s QBI. Twenty percent of B’s share of M’s QBI of $300,000 is $60,000. Next, B must determine 20% of B’s share of M’s W–2 wages. Fifty percent of B’s share of M’s W–2 wages of $40,000 is $20,000. Because 50% of B’s share of M’s W–2 wages would
($20,000) is less than 20% of B’s share of M’s QBI ($60,000), B and C must determine the QBI component of their section 199A deduction by reducing 20% of B’s share of M’s QBI by the reduction amount.

(C) B and C are 60% through the phase-in range (that is, their taxable income exceeds the threshold amount by $60,000 and their phase-in range is $100,000). B and C must determine the excess amount, which is the excess of 20% of B’s share of M’s QBI, or $60,000, over 50% of B’s share of M’s W–2 wages, or $20,000. Thus, the excess amount is $40,000. The reduction amount is equal to 60% of the excess amount, or $24,000. Thus, the QBI component of B and C’s section 199A deduction is equal to 60% of the excess amount, or $9,600. Therefore, B and C’s section 199A deduction is $14,400 for 2018.

(vii) Example 7. (A) F, an unmarried individual, owns as a sole proprietor 100 percent of three trades or businesses, Business X, Business Y, and Business Z. None of the businesses hold qualified property. F does not aggregate the trades or businesses under § 1.199A–4. For tax year 2018, Business X generates $1 million of QBI and pays $500,000 of W–2 wages with respect to the business. Business Y also generates $1 million of QBI but pays no wages. Business Z generates $2,000 of QBI and pays $500,000 of W–2 wages with respect to the business. F also has $750,000 of wage income from employment with an unrelated company. After allowable deductions unrelated to the businesses, F’s taxable income is $2,722,000.

(B) Because F’s taxable income is above the threshold amount, the QBI component of F’s section 199A deduction is subject to the W–2 wage and UBIA of qualified property limitations. These limitations must be applied on a business-by-business basis. None of the businesses hold qualified property, therefore only the 50% of W–2 wage limitation must be calculated. Because QBI from each business is positive, F applies the limitation by determining the lesser of 20% of QBI and 50% of W–2 wages for each business. For Business X, the lesser of 20% of QBI ($1,000,000 x 20% = $200,000) and 50% of Business X’s W–2 wages ($500,000 x 50% = $250,000) is $200,000. Business Y pays no W–2 wages. The lesser of 20% of Business Y’s QBI ($1,000,000 x 20% = $200,000) and 50% of its W–2 wages (zero) is zero. For Business Z, the lesser of 20% of QBI ($2,000 x 20% = $400) and 50% of its W–2 wages ($500,000 x 50% = $250,000) is $400.

(C) Next, F must then combine the amounts determined in paragraph (d)(4)(vii)(B) of this section and compare that sum to 20% of F’s taxable income. The lesser of these two amounts equals F’s section 199A deduction. The total of the combined amounts in paragraph (d)(4)(vii)(B) of this section is $200,400 ($200,000 + zero + $400). Twenty percent of F’s taxable income is $544,400 ($2,722,000 x 20%). Thus, F’s section 199A deduction for 2018 is $540,000.

(viii) Example 8. (A) Assume the same facts as in Example 7 of paragraph (d)(4)(vii) of this section, except that F aggregates Business X, Business Y, and Business Z under the rules of § 1.199A–4.

(B) Because F’s taxable income is above the threshold amount, the QBI component of F’s section 199A deduction is subject to the W–2 wage and UBIA of qualified property limitations. Because the businesses are aggregated, these limitations are applied on an aggregated basis. None of the businesses holds qualified property, therefore only the W–2 wage limitation must be calculated. F applies the limitation by determining the lesser of 20% of the QBI from the aggregated businesses ($1,400,000 x 20% = $280,000) and 50% of W–2 wages from the aggregated businesses ($1,000,000 x 50% = $500,000), or $280,000. F’s section 199A deduction is equal to the lesser of $280,000 and 50% of F’s taxable income ($2,722,000 x 20% = $544,400). Thus, F’s section 199A deduction for 2018 is $400,400.

(ix) Example 9. (A) Assume the same facts as in Example 7 of paragraph (d)(4)(vii) of this section, except that for tax year 2018, Business Z generates a loss that results in ($600,000) of negative QBI and pays $500,000 of W–2 wages. After allowable deductions unrelated to the businesses, F’s taxable income is $2,120,000. Because Business Z had negative QBI, F must offset the positive QBI from Business X and Business Y with the negative QBI from Business Z in proportion to the relative amounts of positive QBI from Business X and Business Y. Because Business X and Business Y produced the same amount of positive QBI, the negative QBI from Business Z is apportioned equally among Business X and Business Y. Therefore, the adjusted QBI for each of Business X and Business Y is $700,000 ($1 million plus 50% of the negative QBI of $600,000). The adjusted QBI in Business Z is $0, because its negative QBI has been fully apportioned to Business X and Business Y.

(B) Because F’s taxable income is above the threshold amount, the QBI component of F’s section 199A deduction is subject to the W–2 wage and UBIA of qualified property limitations. These limitations must be applied on a business-by-business basis. None of the businesses holds qualified property, therefore only the 50% of W–2 wage limitation must be calculated. For Business X, the lesser of 20% of QBI ($700,000 x 20% = $140,000) and 50% of W–2 wages ($500,000 x 50% = $250,000) is $140,000. Business Y pays no W–2 wages. The lesser of 20% of Business Y’s QBI ($700,000 x 20% = $140,000) and 50% of its W–2 wages (zero) is zero.

(C) F must combine the amounts determined in paragraph (d)(4)(ix)(B) of this section and compare the sum to 20% of taxable income. F’s section 199A deduction is equal to the lesser of these two amounts. The combined amount from paragraph (d)(4)(ix)(B) of this section is $140,000 ($140,000 + zero) and 20% of F’s taxable income is $424,000 ($2,120,000 x 20%). Thus, F’s section 199A deduction for 2018 is $140,000. There is no carryover of any loss into the following taxable year for purposes of section 199A.
Example 11. (A) Assume the same facts as in Example 7 of paragraph (d)(4)(vii) of this section, except that Business Z generates a loss that results in ($2,150,000) of negative QBI and pays $500,000 of W–2 wages with respect to the business in 2018. Thus, F has a negative combined QBI of ($150,000) when the QBI from all of the businesses are added together ($1 million plus $1 million minus the loss of ($2,150,000)). Because F has a negative combined QBI for 2018, F has no section 199A deduction with respect to any trade or business for 2018. Instead, the negative combined QBI of ($150,000) carries forward and will be treated as negative QBI from a separate trade or business for purposes of computing the section 199A deduction in the next taxable year. None of the W–2 wages carry forward. However, for income tax purposes, the $150,000 loss may offset F’s $750,000 of wage income (assuming the loss is otherwise allowable under the Code).

(B) In taxable year 2019, Business X generates $200,000 of net QBI and pays $100,000 of W–2 wages with respect to the business. Business Y generates $150,000 of net QBI but pays no wages. Business Z generates a loss that results in ($120,000) of negative QBI and pays $500 of W–2 wages with respect to the business. F also has $750,000 of wage income from employment with an unrelated company. After allowable deductions unrelated to the businesses, F’s taxable income is $960,000. Pursuant to paragraph (d)(2)(iii)(B) of this section, the ($150,000) of negative QBI from 2018 is treated as arising in 2019 from a separate trade or business. Thus, F has overall net QBI of $80,000 when all trades or businesses are taken together ($200,000 plus $150,000 minus $120,000 minus the carryover loss of $150,000). Because Business Z had negative QBI and F also has a negative QBI carryover amount, F must offset the positive QBI from Business X and Business Y with the negative QBI from Business Z and the carryover amount in proportion to the relative amounts of positive QBI from Business X and Business Y. Because Business X produced 57.14% of the total QBI from Business X and Business Y, 57.14% of the negative QBI from Business Z and the negative QBI carryforward must be apportioned to Business X, and the remaining 42.86% to Business Y. Therefore, the adjusted QBI in Business X is $45,722 ($200,000 minus 57.14% of the loss from Business Z ($68,568), minus 57.14% of the carryover loss ($85,710)). The adjusted QBI in Business Y is $34,278 ($150,000, minus 42.86% of the loss from Business Z ($51,432) minus 42.86% of the carryover loss ($64,290)). The adjusted QBI in Business Z is $0, because its negative QBI has been apportioned to Business X and Business Y.

(C) Because F’s taxable income is above the threshold amount, the QBI component of F’s section 199A deduction is subject to the W–2 wage and UBIA of qualified property limitations. These limitations must be applied on a business-by-business basis. None of the businesses hold qualified property, therefore only the 50% of W–2 wage limitation must be calculated. For the aggregated trade or business, the lesser of 20% of QBI ($80,000 x 20% = $16,000) and 50% of W–2 wages ($100,500 x 50% = $50,250) is $16,000. F’s section 199A deduction equals the lesser of that amount ($16,000) and 20% of F’s taxable income ($192,000 [$960,000 x 20%] minus $120,000 minus the carryover loss of $150,000). Thus, F’s section 199A deduction for 2019 is $9,144 ($9,144 plus zero) and 20% of F’s taxable income is $192,000 ($960,000 x 20%). Thus, F’s section 199A deduction for 2019 is $9,144. There is no carryover of any negative QBI into the following taxable year for purposes of section 199A.

Example 12. (A) Assume the same facts as in Example 11 of paragraph (d)(4)(xi) of this section, except that F aggregates Business X, Business Y, and Business Z under the rules of § 1.199A–4. For 2018, F’s QBI from the aggregated trade or business is ($150,000). Because F has a combined negative QBI for 2018, F has no section 199A deduction with respect to any trade or business for 2018. Instead, the negative combined QBI of ($150,000) carries forward and will be treated as negative QBI from a separate trade or business for purposes of computing the section 199A deduction in the next taxable year. However, for income tax purposes, the $150,000 loss may offset taxpayer’s $750,000 of wage income (assuming the loss is otherwise allowable under the Code).

(B) In taxable year 2019, F will have QBI of $230,000 and W–2 wages of $100,500 from the aggregated trade or business. F also has $750,000 of wage income from employment with an unrelated company. After allowable deductions unrelated to the businesses, F’s taxable income is $960,000. F must treat the negative QBI carryover loss ($150,000) from 2018 as a loss from a separate trade or business for purposes of section 199A. This loss will offset the positive QBI from the aggregated trade or business, resulting in an adjusted QBI of ($80,000 ($230,000 - $150,000)).

(C) Because F’s taxable income is above the threshold amount, the QBI component of F’s section 199A deduction is subject to the W–2 wage and UBIA of qualified property limitations. These limitations must be applied on a business-by-business basis. None of the businesses hold qualified property, therefore only the 50% of W–2 wage limitation must be calculated. For the aggregated trade or business, the lesser of 20% of QBI ($80,000 x 20% = $16,000) and 50% of W–2 wages ($100,500 x 50% = $50,250) is $16,000. F’s section 199A deduction equals the lesser of that amount ($16,000) and 20% of F’s taxable income ($960,000 x 20% = $192,000). Thus, F’s section 199A deduction for 2019 is $16,000. There is no carryover of any negative QBI from the following taxable year for purposes of section 199A.

(e) Special rules—(1) Effect of deduction. In the case of a partnership or S corporation, section 199A is applied at the partner or shareholder level. The rules of subchapter K and subchapter S of the Code apply in their entirety for purposes of determining each partner’s or shareholder’s share of QBI, W–2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income or loss. The section 199A deduction has no effect on the adjusted basis of a partner’s interest in the partnership, the adjusted basis of a shareholder’s stock in an S corporation, or an S corporation’s accumulated adjustments account.

(2) Disregarded entities. An entity with a single owner that is treated as disregarded as an entity separate from its owner under any provision of the Code is disregarded for purposes of section 199A and §§ 1.199A–1 through 1.199A–6.

(3) Self-employment tax and net investment income tax. The deduction allowed under section 199A does not reduce net earnings from self-employment under section 1402 or net investment income under section 1411.

(4) Commonwealth of Puerto Rico. If all of an individual’s QBI from sources within the Commonwealth of Puerto Rico is taxable under section 1 of the Code for a taxable year, then for purposes of determining the QBI of such individual for such taxable year, the term “United States” includes the Commonwealth of Puerto Rico.

(5) Coordination with alternative minimum tax. For purposes of determining alternative minimum taxable income under section 55, the deduction allowed under section 199A(a) for a taxable year is equal in amount to the deduction allowed under section 199A(a) in determining taxable income for that taxable year (that is, without regard to any adjustments under sections 56 through 59).

(6) Imposition of accuracy-related penalty on underpayments. For rules related to the imposition of the accuracy-related penalty on underpayments for taxpayers who claim the deduction allowed under section 199A, see section 6662(d)(1)(C).

(7) Reduction for income received from cooperatives. In the case of any trade or business of a patron of a specified agricultural or horticultural cooperative, as defined in section 199A(g)(4), the amount of section 199A deduction determined under paragraph (c) or (d) of this section with respect to such trade or business must be reduced by the lesser of:

(i) Nine percent of the QBI with respect to such trade or business as is properly allocable to qualified payments received from such cooperative; or
(ii) 50 percent of the W–2 wages with respect to such trade or business as are so allocable as determined under § 1.199A–2.

(f) Applicability date—(1) General rule. Except as provided in paragraph (f)(2) of this section, the provisions of this section apply to taxable years ending after February 8, 2019.

(2) Exception for non-calendar year RPE. For purposes of determining QBI, W–2 wages, UBIA of qualified property, and the aggregate amount of qualified REIT dividends and qualified PTP income, if an individual receives any of these items from an RPE with a taxable year that begins before January 1, 2018, and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual’s taxable year in which or with which such RPE taxable year ends.

Par. 4. Section 1.199A–2 is added to read as follows:

§ 1.199A–2 Determination of W–2 wages and unadjusted basis immediately after acquisition of qualified property.

(a) Scope—(1) In general. This section provides guidance on calculating a trade or business’s W–2 wages properly allocable to QBI (W–2 wages) and the trade or business’s unadjusted basis immediately after acquisition of all qualified property (UBIA of qualified property). The provisions of this section apply solely for purposes of section 199A of the Internal Revenue Code (Code).

(2) W–2 wages. Paragraph (b) of this section provides guidance on the determination of W–2 wages. The determination of W–2 wages must be made for each trade or business by the individual or RPE that directly conducts the trade or business (or aggregated trade or business). In the case of W–2 wages paid by an RPE, the RPE must determine and report W–2 wages for each trade or business (or aggregated trade or business) conducted by the RPE. W–2 wages are presumed to be zero if not determined and reported for each trade or business (or aggregated trade or business).

(3) UBIA of qualified property—(i) In general. Paragraph (c) of this section provides guidance on the determination of the UBIA of qualified property. The determination of the UBIA of qualified property must be made for each trade or business (or aggregated trade or business) by the individual or RPE that directly conducts the trade or business (or aggregated trade or business). The UBIA of qualified property is presumed to be zero if not determined and reported for each trade or business (or aggregated trade or business).

(ii) UBIA of qualified property held by a partnership. In the case of qualified property held by a partnership, each partner’s share of the UBIA of qualified property is determined in accordance with how the partnership would allocate depreciation under § 1.1704–1(b)(2)(iv)(g) on the last day of the taxable year.

(iii) UBIA of qualified property held by an S corporation. In the case of qualified property held by an S corporation, each shareholder’s share of the UBIA of qualified property is the share of the unadjusted basis proportionate to the ratio of shares in the S corporation held by the shareholder on the last day of the taxable year over the total issued and outstanding shares of the S corporation.

(iv) UBIA and section 743(b) basis adjustments.—(A) In general. A partner will be allowed to take into account UBIA with respect to an item of qualified property in addition to the amount of UBIA with respect to such qualified property determined under paragraphs (a)(3)(i) and (c) of this section and allocated to such partner under paragraph (a)(3)(ii) of this section to the extent of the partner’s excess section 743(b) basis adjustment with respect to such item of qualified property.

(B) Excess section 743(b) basis adjustments. A partner’s excess section 743(b) basis adjustment is an amount that is determined with respect to each item of qualified property and is equal to an amount that would represent the partner’s section 743(b) basis adjustment with respect to the same item of qualified property, as determined under §§ 1.743–1(b) and 1.755–1, but calculated as if the adjusted basis of all of the partnership’s property was equal to the UBIA of such property. The absolute value of the excess section 743(b) basis adjustment cannot exceed the absolute value of the total section 743(b) basis adjustment with respect to qualified property.

(C) Computation of partner’s share of UBIA with excess section 743(b) basis adjustments. The partnership first computes its UBIA with respect to qualified property under paragraphs (a)(3)(i) and (c) of this section and allocates such UBIA under paragraph (a)(3)(ii) of this section. If the sum of the excess section 743(b) basis adjustment for all of the items of qualified property is a negative number, that amount will be subtracted from the partner’s UBIA of qualified property determined under paragraphs (a)(3)(i) and (c) of this section and allocated under paragraph (a)(3)(ii) of this section. A partner’s UBIA of qualified property may not be below $0. Excess section 743(b) basis adjustments are computed with respect to all section 743(b) adjustments, including adjustments made as a result of a substantial built-in loss under section 743(d).

(D) Examples. The provisions of this paragraph (a)(3)(iv) are illustrated by the following examples:

(1) Example 1—(i) Facts. A, B, and C are equal partners in partnership, PRS. PRS has a single trade or business that generates QBI. PRS has no liabilities and only one asset, a single item of qualified property with a UBIA equal to $900,000. Each partner’s share of the UBIA is $300,000. A sells its one-third interest in PRS to T for $350,000 when a section 754 election is in effect. At the time of the sale, the tax basis of the qualified property held by PRS is $750,000. The amount of gain that would be allocated to T from a hypothetical transaction under § 1.743–1(d)(2) is $100,000. Thus, T’s interest in PRS’s previously taxed capital is equal to $250,000 ($350,000, the amount of cash T would receive if PRS liquidated immediately after the hypothetical transaction, decreased by $100,000, T’s share of gain from the hypothetical transaction). The amount of T’s section 743(b) basis adjustment to PRS’s qualified property is $100,000 (the excess of $350,000, T’s cost basis for its interest, over $250,000, T’s share of the adjusted basis to PRS of the partnership’s property).

(ii) Analysis. In order for T to determine its UBIA, T must calculate its excess section 743(b) basis adjustment. T’s excess section 743(b) basis adjustment is equal to an amount that would represent T’s section 743(b) basis adjustment with respect to the same item of qualified property, as determined under §§ 1.743–1(b) and 1.755–1, but calculated as if the adjusted basis of all of PRS’s property was equal to the UBIA of such property. T’s section 743(b) basis adjustment calculated as if adjusted basis of the qualified property were equal to its UBIA is $50,000 (the excess of $350,000, T’s cost basis for its interest, over $300,000, T’s share of the adjusted basis to PRS of the partnership’s property). Thus, T’s excess section 743(b) basis adjustment is equal to $50,000. For purposes of applying the
individual or RPE must determine its total properly allocable to QBI. First, each individual or RPE must determine the amount of such wages with respect to each trade or business, which are allocable to the QBI of the trade or business (or aggregated trade or business) under the rules in paragraph (b)(4) of this section.

(2) Definition of W–2 wages—(i) In general. Section 199A(b)(4)(A) provides that the term W–2 wages means with respect to any person for any taxable year of such person, the amounts described in section 6051(a)(3) and (8) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year. Thus, the term W–2 wages includes the total amount of wages as defined in section 3401(a) plus the total amount of elective deferrals (within the meaning of section 402(g)(3)), the compensation deferred under section 457, and the amount of designated Roth contributions (as defined in section 402A). For this purpose, except as provided in paragraphs (b)(2)(iv)(C)(2) and (b)(2)(iv)(D) of this section, the Forms W–2, “Wage and Tax Statement,” or any subsequent form or document used in determining the amount of W–2 wages, are those issued for the calendar year ending during the individual’s or RPE’s taxable year for wages paid to employees (or former employees) of the individual or RPE for employment by the individual or RPE. For purposes of this section, employees of the individual or RPE are limited to employees of the individual or RPE as defined in section 3121(d)(1) and (2).

(ii) Wages paid by a person other than a common law employer. In determining W–2 wages, an individual or RPE may take into account any W–2 wages paid by another person and reported by the other person on Forms W–2 with the other person as the employer listed in Box c of the Forms W–2, provided that the W–2 wages were paid to common law employees or officers of the individual or RPE for employment by the individual or RPE. In such cases, the person paying the W–2 wages and reporting the W–2 wages on Forms W–2 is precluded from taking into account such wages for purposes of determining W–2 wages with respect to that person. For purposes of this paragraph (b)(2)(ii), persons that pay and report W–2 wages on behalf of or with respect to others can include, but are not limited to, certified professional employer organizations under section 7705, statutory employers under section 3401(d)(1), and agents under section 3504.

(iii) Requirement that wages must be reported on return filed with the Social Security Administration (SSA)—(A) In general. Pursuant to section 199A(b)(4)(C), the term W–2 wages does not include any amount that is not properly included in a return filed with SSA on or before the 60th day after the due date (including extensions) for such return. Under § 31.6051–2 of this chapter, each Form W–2 and the transmittal Form W–3, “Transmittal of Wage and Tax Statements,” together constitute an information return to be filed with SSA. Similarly, each Form W–2c, “Corrected Wage and Tax Statement,” and the transmittal Form W–3 or W–3c, “Transmittal of Corrected Wage and Tax Statements,” together constitute an information return to be filed with SSA. In determining whether any amount has been properly included in a return filed with SSA on or before the 60th day after the due date (including extensions) for such return, each Form W–2 together with its accompanying Form W–3 will be considered a separate information return and each Form W–2c together with its accompanying Form W–3 or Form W–3c will be considered a separate information return. Section 6071(c) provides that Forms W–2 and W–3 must be filed on or before January 31 of the year following the calendar year to which such returns relate (but see the special rule in § 31.6071(a)–1T(a)(3)(1) of this chapter for monthly returns filed under § 31.6011(a)–5(a) of this chapter). Corrected Forms W–2 are required to be filed with SSA on or before January 31 of the year following the year in which the correction is made.

(B) Corrected return filed to correct a return that was filed within 60 days of the due date. If a corrected information return (Return B) is filed with SSA on or before the 60th day after the due date (including extensions) of Return A to correct an information return (Return A) that was filed.
with SSA on or before the 60th day after the due date (including extensions) of the information return (Return A) and paragraph (b)(2)(iii)(C) of this section does not apply, then the wage information on Return B must be included in determining W–2 wages. If a corrected information return (Return D) is filed with SSA later than the 60th day after the due date (including extensions) of the information return (Return C), and if Return D reports an increase (or decreases) in wages included in determining W–2 wages from the wage amounts reported on Return C, then such increase (or decreases) on Return D will be disregarded in determining W–2 wages (and only the wage amounts on Return C may be included in determining W–2 wages). If Return D reports a decrease (or increases) in wages included in determining W–2 wages from the amounts reported on Return C, then, in determining W–2 wages, the wages reported on Return C must be reduced by the decrease (or increases) reflected on Return D.

(C) Corrected return filed to correct a return that was filed later than 60 days after the due date. If an information return (Return F) is filed to correct an information return (Return E) that was not filed with SSA on or before the 60th day after the due date (including extensions) of Return E, then Return F (and any subsequent information returns filed with respect to Return E) will not be considered filed on or before the 60th day after the due date (including extensions) of Return F (or the subsequent corrected information return). Thus, if a Form W–2c is filed to correct a Form W–2 that was not filed with SSA on or before the 60th day after the due date (including extensions) of the Form W–2 (or to correct a Form W–2c relating to Form W–2 that had not been filed with SSA on or before the 60th day after the due date (including extensions) of the Form W–2), then this Form W–2c will not be considered to have been filed with SSA on or before the 60th day after the due date (including extensions) for this Form W–2c (or corrected Form W–2), regardless of when the Form W–2c is filed.

(iv) Methods for calculating W–2 wages—(A) In general. The Secretary may provide for methods to be used in calculating W–2 wages, including W–2 wages for short taxable years by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(b) of this chapter).

(B) Acquisition or disposition of a trade or business—(1) In general. In the case of an acquisition or disposition of a trade or business, the major portion of a trade or business, or the major portion of a separate unit of a trade or business that causes more than one individual or entity to be an employer of the employees of the acquired or disposed of trade or business during the calendar year, the W–2 wages of the individual or entity for the calendar year of the acquisition or disposition are allocated between each individual or entity based on the period during which the employees of the acquired or disposed of trade or business were employed by the individual or entity, regardless of which permissible method is used for reporting predecessor and successor wages on Form W–2, “Wage and Tax Statement.” For this purpose, the period of employment is determined consistently with the principles for determining whether an individual is an employee described in paragraph (b) of this section.

(2) Acquisition or disposition. For purposes of this paragraph (b)(2)(iv)(B), the term acquisition or disposition includes an incorporation, a formation, a liquidation, a reorganization, or a purchase or sale of assets.

(C) Application in the case of a person with a short taxable year—(1) In general. In the case of an individual or RPE with a short taxable year, subject to the rules of paragraph (b)(2) of this section, the W–2 wages of the individual or RPE for the short taxable year include only those wages paid during the short taxable year to employees of the individuals or RPE, only those elective deferrals (within the meaning of section 402(g)(3)) made during the short taxable year by employees of the individual or RPE and only compensation actually deferred under section 457 during the short taxable year with respect to employees of the individual or RPE.

(2) Short taxable year that does not include December 31. If an individual or RPE has a short taxable year that does not contain a calendar year ending during such short taxable year, wages paid to employees for employment by such individual or RPE during the short taxable year are treated as W–2 wages for such short taxable year for purposes of paragraph (b) of this section (if the wages would otherwise meet the requirements to be W–2 wages under this section but for the requirement that a calendar year must end during the short taxable year).

(D) Remuneration paid for services performed in the Commonwealth of Puerto Rico. In the case of an individual or RPE that conducts a trade or business in the Commonwealth of Puerto Rico, the determination of W–2 wages of such individual or RPE will be made without regard to any exclusion under section 3401(a)(8) for remuneration paid for services performed in the Commonwealth of Puerto Rico. The individual or RPE must maintain sufficient documentation (for example, Forms 499R–2/W–2PR) to substantiate the amount of remuneration paid for services performed in the Commonwealth of Puerto Rico that is used in determining the W–2 wages of such individual or RPE with respect to any trade or business conducted in the Commonwealth of Puerto Rico.

(3) Allocation of wages to trades or businesses. After calculating total W–2 wages for a taxable year, each individual or RPE that directly conducts more than one trade or business must allocate those wages among its various trades or businesses. W–2 wages must be allocated to the trade or business that generated those wages. In the case of W–2 wages that are allocable to more than one trade or business, the portion of the W–2 wages allocable to each trade or business is determined in the same manner as the expenses associated with those wages are allocated among the trades or businesses under § 1.199A–3(b)(5).

(4) Allocation of wages to QBI. Once W–2 wages for each trade or business have been determined, each individual or RPE must identify the amount of W–2 wages properly allocable to QBI for each trade or business (or aggregated trade or business). W–2 wages are properly allocable to QBI if the associated wage expense is taken into account in computing QBI under § 1.199A–3. In the case of an
RPE, the wage expense must be allocated and reported to the partners or shareholders of the RPE as required by the Code, including subchapters K and S of chapter 1 of subtitle A of the Code. The RPE must also identify and report the associated W–2 wages to its partners or shareholders.

(5) Non-duplication rule. Amounts that are treated as W–2 wages for a taxable year under any method cannot be treated as W–2 wages of any other taxable year. Also, an amount cannot be treated as W–2 wages by more than one trade or business (or aggregated trade or business).

(c) UBIA of qualified property—(1) Qualified property—(i) In general. The term qualified property means, with respect to any trade or business (or aggregated trade or business) of an individual or RPE for a taxable year, tangible property of a character subject to the allowance for depreciation under section 167(a)—

(A) Which is held by, and available for use in, the trade or business (or aggregated trade or business) at the close of the taxable year;

(B) Which is used at any point during the taxable year in the trade or business’s (or aggregated trade or business’s) production of QBI; and

(C) The depreciable period for which has not ended before the close of the individual’s or RPE’s taxable year.

(ii) Improvements to qualified property. In the case of any addition to, or improvement of, qualified property that has already been placed in service by the individual or RPE, such addition or improvement is treated as separate qualified property first placed in service on the date such addition or improvement is placed in service for purposes of paragraph (c)(2) of this section.

(iii) Adjustments under sections 743(b) and 743(b). Excess section 743(b) basis adjustments as defined in paragraph (a)(3)(iv)(B) of this section are treated as qualified property. Otherwise, basis adjustments under sections 734(b) and 743(b) are not treated as qualified property.

(iv) Property acquired at end of year. Property is not qualified property if the property is acquired within 60 days of the end of the taxable year and disposed of within 120 days of acquisition without having been used in a trade or business for at least 45 days prior to disposition, unless the taxpayer demonstrates that the principal purpose of the acquisition and disposition was a purpose other than increasing the section 199A deduction.

(2) Depreciable period—(i) In general. The term depreciable period means, with respect to qualified property of a trade or business, the period beginning on the date the property was first placed in service by the individual or RPE and ending on the later of—

(A) The date that is 10 years after such date; or

(B) The last day of the last full year in the applicable recovery period that would apply to the property under section 168(c), regardless of any application of section 168(g).

(ii) Additional first-year depreciation under section 168. The additional first-year depreciation deduction allowable under section 168 (for example, under section 168(k) or (m)) does not affect the applicable recovery period under this paragraph for the qualified property.

(iii) Qualified property acquired in transactions subject to section 1031 or section 1033. Solely for purposes of paragraph (c)(2)(i) of this section, the following rules apply to qualified property acquired in a like-kind exchange or in an involuntary conversion (replacement property).

(A) Replacement property received in a section 1031 or 1033 transaction. The date on which replacement property that is of like-kind to relinquished property or is similar or related in service or use to involuntarily converted property was first placed in service by the individual or RPE is determined as follows—

(I) For the portion of the individual’s or RPE’s UBIA, as defined in paragraph (c)(3) of this section, in such replacement property that exceeds the individual’s or RPE’s UBIA in the relinquished property or involuntarily converted property, such portion in the replacement property is treated as separate qualified property that the individual or RPE first placed in service on the date on which the replacement property was first placed in service by the individual or RPE.

(B) Other property received in a section 1031 or 1033 transaction. Other property, as defined in paragraph (c)(3)(ii) or (iii) of this section, that is qualified property is treated as separate qualified property that the individual or RPE first placed in service on the date on which such other property was first placed in service by the individual or RPE.

(iv) Qualified property acquired in transactions described in section 168(i)(7)(B). If an individual or RPE acquires qualified property in a transaction described in section 168(i)(7)(B) (pertaining to treatment of transfers in certain nonrecognition transactions), the individual or RPE must determine the date on which the qualified property was first placed in service solely for purposes of paragraph (c)(2)(i) of this section as follows—

(A) For the portion of the transferee’s UBIA in the qualified property that does not exceed the transferor’s UBIA in such property, the date such portion was first placed in service by the transferee is the date on which the transferor first placed the qualified property in service; and

(B) For the portion of the transferee’s UBIA in the qualified property that exceeds the transferor’s UBIA in such property, such portion is treated as separate qualified property that the transferee first placed in service on the date of the transfer.

(v) Excess section 743(b) basis adjustment. Solely for purposes of paragraph (c)(2)(i) of this section, an excess section 743(b) basis adjustment with respect to an item of partnership property that is qualified property is treated as being placed in service when the transfer of the partnership interest occurs, and the recovery period for such property is determined under § 1.743–1(j)(4)(i)(B) with respect to positive basis adjustments and § 1.743–1(j)(4)(ii)(B) with respect to negative basis adjustments.

(3) Unadjusted basis immediately after acquisition—(i) In general. Except as pro-
vided in paragraphs (c)(3)(ii) through (v) of this section, the term unadjusted basis immediately after acquisition (UBIA) means the basis on the placed in service date of the property as determined under section 1012 or other applicable sections of chapter 1 of the Code, including the provisions of subchapters O (relating to gain or loss on dispositions of property), C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). UBIA is determined without regard to any adjustments described in section 1016(a)(2) or (3), to any adjustments for tax credits claimed by the individual or RPE (for example, under section 50(c)), or to any adjustments for any portion of the basis which the individual or RPE has elected to treat as an expense (for example, under sections 179, 179B, or 179C). However, UBIA does reflect the reduction in basis for the percentage of the individual’s or RPE’s use of property for the taxable year other than in the trade or business.

(ii) Qualified property acquired in a like-kind exchange—(A) In general. Solely for purposes of this section, if qualified property (replacement property) is acquired in a like-kind exchange that qualifies for deferral of gain under section 1033 and qualified replacement property is acquired in a transaction that qualifies for deferral of gain under section 1033, then the UBIA of the replacement property is the same as the UBIA of the converted property, decreased by excess boot or increased by the amount of money paid or the fair market value of property not of alike kind to the relinquished property (other property) transferred by the taxpayer to acquire the replacement property. If the taxpayer acquires more than one piece of qualified replacement property that meets the similar or related in service or use requirements of section 1033, UBIA is apportioned between the qualified replacement properties in proportion to their relative fair market values. Other property acquired by the taxpayer with the proceeds of an involuntary conversion that is qualified property has a UBIA equal to the fair market value of such other property.

(B) Excess boot. For purposes of paragraph (c)(3)(iii)(A) of this section, excess boot is the amount of any money or the fair market value of other property received by the taxpayer in the exchange over the amount of appreciation in the relinquished property. Appreciation for this purpose is the excess of the fair market value of the relinquished property on the date of the exchange over the fair market value of the relinquished property on the date of the acquisition by the taxpayer.

(iii) Qualified property acquired pursuant to an involuntary conversion—(A) In general. Solely for purposes of this section, if qualified property is compulsorily or involuntarily converted (converted property) within the meaning of section 1033 and qualified replacement property is acquired in a transaction that qualifies for deferral of gain under section 1033, then the UBIA of the replacement property is the same as the UBIA of the converted property, decreased by excess boot or increased by the amount of money paid or the fair market value of property not similar or related in service or use to the converted property (other property) transferred by the taxpayer to acquire the replacement property. If the taxpayer acquires more than one piece of qualified replacement property that meets the similar or related in service or use requirements of section 1033, UBIA is apportioned between the qualified replacement properties in proportion to their relative fair market values. Other property acquired by the taxpayer with the proceeds of an involuntary conversion that is qualified property has a UBIA equal to the fair market value of such other property.

(iv) Qualified property acquired in transactions described in section 168(i)(7)(B). Solely for purposes of this section, if qualified property is acquired in a transaction described in section 168(i)(7)(B) (pertaining to treatment of transferees in certain nonrecognition transactions), the transferee’s UBIA in the qualified property shall be the same as the transferor’s UBIA in the property, decreased by the amount of money paid by the transferee to acquire the property in the transaction.

(v) Qualified property acquired from a decedent. In the case of qualified property acquired from a decedent and immediately placed in service, the UBIA of the property will generally be the fair market value at the date of the decedent’s death under section 1014. See section 1014 and the regulations thereunder. Solely for purposes of paragraph (c)(2)(i) of this section, a new depreciable period for the property commences as of the date of the decedent’s death.

(vi) Property acquired in a nonrecognition transaction with principal purpose of increasing UBIA. If qualified property is acquired in a transaction described in section 1031, 1033, or 168(i)(7) with the principal purpose of increasing the UBIA of the qualified property, the UBIA of the acquired qualified property is its basis as determined under relevant Code sections and not under the rules described in paragraphs (c)(3)(i) through (iv) of this section. For example, in a section 1031 transaction undertaken with the principal purpose of increasing the UBIA of the replacement property, the UBIA of the replacement property is its basis as determined under section 1031(d).

(4) Examples. The provisions of this paragraph (c) are illustrated by the following examples:

(i) Example 1. (A) On January 5, 2012, A purchases Real Property X for $1 million and places it in service in A’s trade or business. A’s trade or business is not an SSTB. A’s basis in Real Property X under section 1012 is $1 million. Real Property X is qualified property within the meaning of section 199A(b)(6). As of December 31, 2018, A’s basis in Real Property X, as adjusted under section 1016(a)(2) for depreciation deductions under section 168(a), is $821,550.

(B) For purposes of section 199A(b)(2)(B)(ii) and this section, A’s UBIA of Real Property X is its $1 million cost basis under section 1012, regardless of any later depreciation deductions under section 168(a) and resulting basis adjustments under section 1016(a)(2).

(ii) Example 2. (A) The facts are the same as in Example 1 of paragraph (c)(4)(i) of this section, except that on January 15, 2019, A enters into a like-kind exchange under section 1031 in which A exchanges Real Property X for Real Property Y. Real Property Y has a value of $1 million. No cash or other property is involved in the exchange. As of
January 15, 2019, A’s basis in Real Property X, as adjusted under section 1016(a)(2) for depreciation deductions under section 168(a), is $820,482.  

(B) A’s UBIA in Real Property Y is $1 million as determined under paragraph (c)(3)(ii) of this section. Pursuant to paragraph (c)(2)(iii)(A) of this section, Real Property Y is first placed in service by A on January 5, 2012, which is the date on which Real Property X was first placed in service by A.

(iii) Example 3. (A) The facts are the same as in Example 1 of paragraph (c)(4)(i) of this section, except that on January 15, 2019, A enters into a like-kind exchange under section 1031, in which A exchanges Real Property X for Real Property Y. Real Property X has appreciated in value to $1.3 million, and Real Property Y also has a value of $1.3 million. No cash or other property is involved in the exchange. As of January 15, 2019, A’s basis in Real Property X, as adjusted under section 1016(a)(2), is $820,482.  

(B) A’s UBIA in Real Property Y is $1 million as determined under paragraph (c)(3)(ii) of this section. Pursuant to paragraph (c)(2)(iii)(A) of this section, Real Property Y is first placed in service by A on January 5, 2012, which is the date on which Real Property X was first placed in service by A.

(iv) Example 4. (A) The facts are the same as in Example 1 of paragraph (c)(4)(i) of this section, except that on January 15, 2019, A enters into a like-kind exchange under section 1031, in which A exchanges Real Property X for Real Property Y. Real Property X has appreciated in value to $1.3 million, but Real Property Y has a value of $1.5 million. A therefore adds $200,000 in cash to the exchange of Real Property X for Real Property Y. On January 15, 2019, A places Real Property Y in service. As of January 15, 2019, A’s basis in Real Property X, as adjusted under section 1016(a)(2), is $820,482.  

(B) A’s UBIA in Real Property Y is $1.2 million as determined under paragraph (c)(3)(ii) of this section ($1 million in UBIA from Real Property X plus $200,000 cash paid by A to acquire Real Property Y). Because the UBIA of Real Property Y exceeds the UBIA of Real Property X, Real Property Y is treated as being two separate qualified properties for purposes of applying paragraph (c)(2)(vii)(A) of this section. One property has a UBIA of $1 million (the portion of A’s UBIA of $1.2 million in Real Property Y that does not exceed A’s UBIA of $1 million in Real Property X) and it is first placed in service by A on January 5, 2012, which is the date on which Real Property X was first placed in service by A. The other property has a UBIA of $200,000 (the portion of A’s UBIA of $1.2 million in Real Property Y that exceeds A’s UBIA of $1 million in Real Property X) and it is first placed in service by A on January 15, 2019, which is the date on which Real Property X was first placed in service by A.

(v) Example 5. (A) The facts are the same as in Example 1 of paragraph (c)(4)(i) of this section, except that on January 15, 2019, A enters into a like-kind exchange under section 1031, in which A exchanges Real Property X for Real Property Y. Real Property X has appreciated in value to $1.3 million. Real Property Y has a fair market value of $1 million. As of January 15, 2019, A’s basis in Real Property X, as adjusted under section 1016(a)(2), is $820,482. Pursuant to the exchange, A receives Real Property Y and $300,000 in cash.  

(B) A’s UBIA in Real Property Y is $1 million as determined under paragraph (c)(3)(ii) of this section ($1 million in UBIA from Real Property X, less $0 excess boot ($300,000 cash received in the exchange over $300,000 in appreciation in Property X, which is equal to the excess of the $1.3 million fair market value of Property X on the date of the exchange over $1 million fair market value of Property X on the date of acquisition by the taxpayer)). Pursuant to paragraph (c)(2)(iii)(A) of this section, Real Property Y is first placed in service by A on January 5, 2012, which is the date on which Real Property X was first placed in service by A.

(vi) Example 6. (A) The facts are the same as in Example 1 of paragraph (c)(4)(i) of this section, except that on January 15, 2019, A enters into a like-kind exchange under section 1031, in which A exchanges Real Property X for Real Property Y. Real Property X has appreciated in value to $1.3 million. Real Property Y has a fair market value of $900,000. Pursuant to the exchange, A receives Real Property Y and $400,000 in cash. As of January 15, 2019, A’s basis in Real Property X, as adjusted under section 1016(a)(2), is $820,482.  

(B) A’s UBIA in Real Property Y is $900,000 as determined under paragraph (c)(3)(i) of this section ($1 million in UBIA from Real Property X less $100,000 excess boot ($400,000 in cash received in the exchange over $300,000 in appreciation in Property X, which is equal to the excess of the $1.3 million fair market value of Property X on the date of the exchange over the $1 million fair market value of Property X on the date of acquisition by the taxpayer)). Pursuant to paragraph (c)(2)(vii)(A) of this section, Real Property Y is first placed in service by A on January 5, 2012, which is the date on which Real Property X was first placed in service by A.

(vii) Example 7. (A) The facts are the same as in Example 1 of paragraph (c)(4)(i) of this section, except that on January 15, 2019, A enters into a like-kind exchange under section 1031, in which A exchanges Real Property X for Real Property Y. Real Property X has declined in value to $900,000, and Real Property Y also has a value of $900,000. No cash or other property is involved in the exchange. As of January 15, 2019, A’s basis in Real Property X, as adjusted under section 1016(a)(2), is $820,482.  

(B) Even though Real Property Y is worth only $900,000, A’s UBIA in Real Property Y is $1 million as determined under paragraph (c)(3)(ii) of this section because no cash or other property was involved in the exchange. Pursuant to paragraph (c)(2)(iii)(A) of this section, Real Property Y is first placed in service by A on January 5, 2012, which is the date on which Real Property X was first placed in service by A.

(viii) Example 8. (A) C operates a trade or business that is not an SSTB as a sole proprietorship. On January 5, 2011, C purchases Machinery Y for $10,000 and places it in service in C’s trade or business. C’s basis in Machinery Y is $2,500, the basis of the property under section 362 at the time the S corporation places the property in service. Pursuant to paragraph (c)(3)(iv) of this section, S corporation’s UBIA of Machinery Y is $10,000, which is C’s UBIA of Machinery Y. Pursuant to paragraph (c)(2)(vii)(A) of this section, for purposes of determining the depreciable period of Machinery Y, the S corporation’s placed in service date of Machinery Y will be January 5, 2011, which is the date C originally placed the property in service in 2011. Therefore, Machinery Y may be qualified property of the S corporation (assuming it continues to be used in the business) for 2019 and 2020 and will not be qualified property of the S corporation after 2020, because its depreciable period will have expired.

(ix) Example 9. (A) LLC, a partnership, operates a trade or business that is not an SSTB. On January 5, 2011, LLC purchases Machinery Z for $30,000 and places it in service in LLC’s trade or business. LLC’s basis in Machinery Z under section 1012 is $30,000. Machinery Z is qualified property within the meaning of section 199A(b)(6). Assume that Machinery Z’s recovery period under section 168(c) is 10 years, and LLC depreciates Machinery Z under the general depreciation system by using the straight-line depreciation method, a 10-year recovery period, and the half-year convention. As of December 31, 2018, LLC’s basis in Machinery Z, as adjusted under section 1016(a)(2) for depreciation deductions under section 168(a), is $7,500. On January 1, 2019, LLC distributes Machinery Z to Partner A in full liquidation of Partner A’s interest in LLC. Partner A’s outside basis in LLC is $35,000.

(B) For purposes of section 199A(b)(2)(B)(iii) and this section, LLC’s UBIA of Machinery Z from 2011 through 2018 is its $30,000 cost basis under section 1012, regardless of any later depreciation deductions under section 168(a) and resulting basis adjustments under section 1016(a)(2). The S corporation’s basis of Machinery Z is $2,500, the basis of the property under section 362 at the time the S corporation places the property in service. Pursuant to paragraph (c)(3)(iv) of this section, S corporation’s UBIA of Machinery Z is $10,000, which is C’s UBIA of Machinery Y. Pursuant to paragraph (c)(2)(vii)(A) of this section, for purposes of determining the depreciable period of Machinery Y, the S corporation’s placed in service date of Machinery Y will be January 5, 2011, which is the date C originally placed the property in service in 2011. Therefore, Machinery Y may be qualified property of the S corporation (assuming it continues to be used in the business) for 2019 and 2020 and will not be qualified property of the S corporation after 2020, because its depreciable period will have expired.

General.
(2) Exceptions—(i) Anti-abuse rules. The provisions of paragraph (c)(1)(iv) of this section apply to taxable years ending after December 22, 2017.

(ii) Non-calendar year RPE. For purposes of determining QBI, W–2 wages, UBIA of qualified property, and the aggregate amount of qualified REIT dividends and qualified PTP income if an individual receives any of these items from an RPE with a taxable year that begins before January 1, 2018, and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual’s taxable year in which or with which such RPE taxable year ends.

Par. 5. Section 1.199A–3 is added to read as follows:

§ 1.199A–3 Qualified business income, qualified REIT dividends, and qualified PTP income.

(a) In general. This section provides rules on the determination of a trade or business’s qualified business income (QBI), as well as the determination of qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership (PTP) income. The provisions of this section apply solely for purposes of section 199A of the Internal Revenue Code (Code). Paragraph (b) of this section provides rules for the determination of QBI. Paragraph (c) of this section provides rules for the determination of qualified REIT dividends and qualified PTP income. QBI must be determined and reported for each trade or business by the individual or relevant pass-through entity (RPE) that directly conducts the trade or business before applying the aggregation rules of § 1.199A–4.

(b) Definition of qualified business income—(1) In general. For purposes of this section, the term qualified business income or QBI means, for any taxable year, the net amount of qualified items of income, gain, deduction, and loss with respect to any trade or business of the taxpayer as described in paragraph (b)(2) of this section, provided the other requirements of this section and section 199A are satisfied (including, for example, the exclusion of income not effectively connected with a United States trade or business).

(i) Section 751 gain. With respect to a partnership, if section 751(a) or (b) applies, then gain or loss attributable to assets of the partnership arising to ordinary income under section 751(a) or (b) is considered attributable to the trades or businesses conducted by the partnership, and is taken into account for purposes of computing QBI.

(ii) Guaranteed payments for the use of capital. Income attributable to a guaranteed payment for the use of capital is not considered to be attributable to a trade or business, and thus is not taken into account for purposes of computing QBI except to the extent properly allocable to a trade or business of the recipient. The partnership’s deduction associated with the guaranteed payment will be taken into account for purposes of computing QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for Federal income tax purposes.

(iii) Section 481 adjustments. Section 481 adjustments (whether positive or negative) are taken into account for purposes of computing QBI to the extent that the requirements of this section and section 199A are otherwise satisfied, but only if the adjustment arises in taxable years ending after December 31, 2017.

(iv) Previously disallowed losses. Generally, previously disallowed losses or deductions (including under sections 465, 469, 704(d), and 1366(d)) allowed in the taxable year are taken into account for purposes of computing QBI. These losses shall be used, for purposes of section 199A and these regulations, in order from the oldest to the most recent on a first-in, first-out (FIFO) basis. However, losses or deductions that were disallowed, suspended, limited, or carried over from taxable years ending before January 1, 2018 (including under sections 465, 469, 704(d), and 1366(d)), are not taken into account in a later taxable year for purposes of computing QBI.

(v) Net operating losses. Generally, a net operating loss deduction under section 172 is not considered with respect to a trade or business and therefore, is not taken into account in computing QBI. However, an excess business loss under section 461(l) is treated as a net operating loss carryover to the following taxable year and is taken into account for purposes of computing QBI in the subsequent taxable year in which it is deducted.

(vi) Other deductions. Generally, deductions attributable to a trade or business are taken into account for purposes of computing QBI to the extent that the requirements of section 199A and this section are otherwise satisfied. For purposes of section 199A only, deductions such as the deductible portion of the tax on self-employment income under section 164(f), the self-employed health insurance deduction under section 162(l), and the deduction for contributions to qualified retirement plans under section 404 are considered attributable to a trade or business to the extent that the individual’s gross income from the trade or business is taken into account in calculating the allowable deduction, on a proportionate basis to the gross income received from the trade or business.

(2) Qualified items of income, gain, deduction, and loss—(i) In general. The term qualified items of income, gain, deduction, and loss means items of gross income, gain, deduction, and loss to the extent such items are—

(A) Effectively connected with the conduct of a trade or business within the United States (within the meaning of section 864(c), determined by substituting “trade or business (within the meaning of section 199A)” for “nonresident alien individual or a foreign corporation” or for “a foreign corporation” each place it appears); and

(B) Included or allowed in determining taxable income for the taxable year.

(ii) Items not taken into account. Notwithstanding paragraph (b)(2)(i) of this section and in accordance with section 199A(c)(3)(B) and (c)(4), the following items are not taken into account as qualified items of income, gain, deduction, or loss and thus are not included in determining QBI:

(A) Any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss, including any item treated as one of such items under any other provision of the Code. This provision does not apply to the extent an item is treated as anything other than short-term capital gain, short-term
Qualified PTP Income—(1) In general. A qualified PTP income is capped at $50,000. The qualified PTP income for a calendar year is determined separately for each person who is a qualified PTP. The qualified PTP income for a calendar year includes all items of income attributable to the trade or business conducted by a qualified PTP during the calendar year, unless the item is excluded from the trade or business or included in the income of another person. The qualified PTP income is multiplied by a fraction that is the ratio of the qualified PTP income for the taxable year to the total qualified PTP income for the taxable year. The qualified PTP income is reduced by the amount of the net qualified PTP income for the previous taxable year.

(2) Qualified REIT dividend—(i) The term qualified REIT dividend means any dividend from a REIT received during the taxable year which—

(A) Is not a capital gain dividend, as defined in section 857(b)(3); and

(B) Is not qualified dividend income, as defined in section 1(h)(11).

(ii) The term qualified REIT dividend does not include any REIT dividend received with respect to any share of REIT stock—

(A) That is held by the shareholder for 45 days or less (taking into account the principles of section 246(c)(3) and (4)) during the 91-day period beginning on the date which is 45 days before the date on which such share becomes ex-dividend with respect to such dividend; or

(B) To the extent that the shareholder is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

(3) Qualified PTP income—(i) In general. The term qualified PTP income means the sum of—

(A) The net amount of such taxpayer’s allocable share of income, gain, deduction, and loss from a PTP as defined in section 7704(b) that is not taxed as a corporation under section 7704(a); plus

(B) Any gain or loss attributable to assets of the PTP giving rise to ordinary income under section 751(a) or (b) that is considered attributable to the trades or businesses conducted by the partnership.

(ii) Special rules. The rules applicable to the determination of QBI described in paragraph (b) of this section also apply to the determination of a taxpayer’s allocable share of income, gain, deduction, and loss from a PTP. An individual’s allocable share of income from a PTP, and any section 751 gain or loss is qualified PTP income only to the extent the items meet the qualifications of section 199A and this section, including the requirement that the item is included or allowed in determining taxable income for the taxable year, and the requirement that the item be effectively connected with the conduct of a trade or business within the United States. For example, if an individual owns an
§ 1.199A–4 Aggregation

(a) Scope and purpose. An individual or RPE may be engaged in more than one trade or business. Except as provided in this section, each trade or business is a separate trade or business for purposes of applying the limitations described in § 1.199A–1(d)(2)(iv). This section sets forth rules to allow individuals and RPEs to aggregate trades or businesses, treating the aggregate as a single trade or business for purposes of applying the limitations described in § 1.199A–1(d)(2)(iv). Trades or businesses may be aggregated only to the extent provided in this section, but aggregation by taxpayers is not required.

(b) Aggregation rules—(1) General rule. Trades or businesses may be aggregated only if an individual or RPE can demonstrate that—

(i) The same person or group of persons, directly or by attribution under sections 267(b) or 707(b), owns 50 percent or more of each trade or business to be aggregated, meaning in the case of such trades or businesses owned by an S corporation, 50 percent or more of the issued and outstanding shares of the corporation, or, in the case of such trades or businesses owned by a partnership, 50 percent or more of the capital or profits in the partnership;

(ii) The ownership described in paragraph (b)(1)(i) of this section exists for a majority of the taxable year, including the last day of the taxable year, in which the items attributable to each trade or business to be aggregated are included in income;

(iii) All of the items attributable to each trade or business to be aggregated are reported on returns with the same taxable year, not taking into account short taxable years;

(iv) None of the trades or businesses to be aggregated is a specified service trade or business (SSTB) as defined in § 1.199A–5; and

(v) The trades or businesses to be aggregated satisfy at least two of the following factors (based on all of the facts and circumstances):

(A) The trades or businesses provide products, property, or services that are the same or customarily offered together.

(B) The trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources.

(C) The trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group (for example, supply chain interdependencies).

(2) Operating rules—(i) Individuals. An individual may aggregate trades or businesses operated directly or through an RPE to the extent an aggregation is not inconsistent with the aggregation of an RPE. If an RPE itself does not aggregate, multiple owners of an RPE need not aggregate in the same manner. An RPE that aggregates multiple trades or businesses under paragraph (b)(1) of this section, the RPE must compute and report QBI, W–2 wages, and UBIA of qualified property for the aggregated trade or business under the rules described in § 1.199A–6(b). An RPE may not subtract from the trades or businesses aggregated by a lower-tier RPE but may aggregate additional trades or businesses with a lower-tier RPE’s aggregation if the rules of this section are otherwise satisfied.

(ii) RPEs. An RPE may aggregate trades or businesses operated directly or through a lower-tier RPE to the extent an aggregation is not inconsistent with the aggregation of a lower-tier RPE. If an RPE itself does not aggregate, multiple owners of an RPE need not aggregate in the same manner. An RPE that aggregates multiple trades or businesses under paragraph (b)(1) of this section, the RPE must compute and report QBI, W–2 wages, and UBIA of qualified property for the aggregated trade or business under the rules described in § 1.199A–6(b). An RPE may not subtract from the trades or businesses aggregated by a lower-tier RPE but may aggregate additional trades or businesses with a lower-tier RPE’s aggregation if the rules of this section are otherwise satisfied.

(c) Reporting and consistency requirements—(1) Individuals. Once an individual chooses to aggregate two or more trades or businesses, the individual must consistently report the aggregated trades or businesses in all subsequent taxable years. A failure to aggregate will not be considered to be an aggregation for purposes of this rule. An individual that fails to aggregate may not aggregate trades or businesses on an amended return (other than an amended return for the 2018 taxable year). However, an individual may add a newly created or newly acquired (including through non-recognition transfers) trade or business to an existing aggregated trade or business (including the aggregated trade or business of an RPE) if the requirements of paragraph (b)(1) of this section are satisfied. In a subsequent year, if there is a significant change in facts and circumstances such that an individual’s prior aggregation of trades or businesses no longer qualifies for aggregation under the rules of this section, then the trades or businesses will no longer be
aggregated within the meaning of this section, and the individual must reapply the rules in paragraph (b)(1) of this section to determine a new permissible aggregation (if any). An individual also must report aggregated trades or businesses of an RPE in which the individual holds a direct or indirect interest.

(2) Individual disclosure—(i) Required annual disclosure. For each taxable year, individuals must attach a statement to their returns identifying each trade or business aggregated under paragraph (b)(1) of this section. The statement must contain —

(A) A description of each trade or business;
(B) The name and EIN of each entity in which a trade or business is operated;
(C) Information identifying any trade or business that was formed, ceased operations, was acquired, or was disposed of during the taxable year;
(D) Information identifying any aggregated trade or business of an RPE in which the individual holds an ownership interest; and
(E) Such other information as the Commissioner may require in forms, instructions, or other published guidance.

(ii) Failure to disclose. If an individual fails to attach the statement required in paragraph (c)(2)(i) of this section, the Commissioner may disaggregate the individual’s trades or businesses. The individual may not aggregate trades or businesses that are disaggregated by the Commissioner for the subsequent three taxable years.

(3) RPEs. Once an RPE chooses to aggregate two or more trades or businesses, the RPE must consistently report the aggregated trades or businesses in all subsequent taxable years. A failure to aggregate will not be considered to be an aggregation for purposes of this rule. An RPE that fails to aggregate may not aggregate trades or businesses on an amended return (other than an amended return for the 2018 taxable year). However, an RPE may add a newly created or newly acquired (including through non-recognition transfers) trade or business to an existing aggregated trade or business (other than the aggregated trade or business of a lower-tier RPE) if the requirements of paragraph (b)(1) of this section are satisfied. In a subsequent year, if there is a significant change in facts and circumstances such that an RPE’s prior aggregation of trades or businesses no longer qualifies for aggregation under the rules of this section, then the trades or businesses will no longer be aggregated within the meaning of this section, and the RPE must reapply the rules in paragraph (b)(1) of this section to determine a new permissible aggregation (if any). An RPE also must report aggregated trades or businesses of a lower-tier RPE in which the RPE holds a direct or indirect interest.

(4) RPE disclosure.—(i) Required annual disclosure. For each taxable year, RPEs (including each RPE in a tiered structure) must attach a statement to each owner’s Schedule K–1 identifying each trade or business aggregated under paragraph (b)(1) of this section. The statement must contain —

(A) A description of each trade or business;
(B) The name and EIN of each entity in which a trade or business is operated;
(C) Information identifying any trade or business that was formed, ceased operations, was acquired, or was disposed of during the taxable year;
(D) Information identifying any aggregated trade or business of an RPE in which the RPE holds an ownership interest; and
(E) Such other information as the Commissioner may require in forms, instructions, or other published guidance.

(ii) Failure to disclose. If an RPE fails to attach the statement required in paragraph (c)(2)(i) of this section, the Commissioner may disaggregate the RPE’s trades or businesses. The RPE may not aggregate trades or businesses that are disaggregated by the Commissioner for the subsequent three taxable years.

(4) Examples. The following examples illustrate the principles of this section. For purposes of these examples, assume the taxpayer is a United States citizen, all tax items are effectively connected, a single capital letter denotes an individual taxpayer.

(1) Example 1—(i) Facts. A wholly owns and operates a catering business and a restaurant through separate disregarded entities. The catering business and the restaurant share centralized purchasing to obtain volume discounts and a centralized accounting office that performs all of the bookkeeping, tracks and issues statements on all of the receivables, and prepares the payroll for each business. A maintains a website and print advertising materials that reference both the catering business and the restaurant. A uses the restaurant kitchen to prepare food for the catering business. The catering business employs its own staff and owns equipment and trucks that are not used or associated with the restaurant.

(ii) Analysis. Because the restaurant and catering business are held in disregarded entities, A will be treated as operating each of these businesses directly and thereby satisfies paragraph (b)(1)(i) of this section. Under paragraph (b)(1)(v) of this section, A satisfies the following factors: paragraph (b)(1)(v)(A) of this section is met as both businesses offer prepared food to customers; and paragraph (b)(1)(v)(B) of this section is met because the two businesses share the same kitchen facilities in addition to centralized purchasing, marketing, and accounting. Having satisfied paragraphs (b)(1)(i) through (v) of this section, A may treat the catering business and the restaurant as a single trade or business for purposes of applying § 1.199A–1(d).

(2) Example 2—(i) Facts. Assume the same facts as in Example 1 of paragraph (d)(1) of this section, but the catering and restaurant businesses are owned in separate partnerships and A, B, C, and D each own a 25% interest in each of the two partnerships. A, B, C, and D are unrelated.

(ii) Analysis. Because under paragraph (b)(1)(i) of this section A, B, C, and D together own more than 50% of each of the two partnerships, they may each treat the catering business and the restaurant for a single trade or business for purposes of applying § 1.199A–1(d).

(3) Example 3—(i) Facts. W owns a 75% interest in S1, an S corporation, and a 75% interest in PRS, a partnership. S1 manufactures clothing and PRS is a retail pet food store. W manages S1 and PRS.

(ii) Analysis. W owns more than 50% of the stock of S1 and more than 50% of PRS thereby satisfying paragraph (b)(1)(i) of this section. Although W manages both S1 and PRS, W is not able to satisfy the requirements of paragraph (b)(1)(v) of this section as the two businesses do not provide goods or services that are the same or customarily offered together; there are no significant centralized business elements; and no facts indicate that the businesses are operated in coordination with, or reliance upon, one another. W must treat S1 and PRS as separate trades or businesses for purposes of applying § 1.199A–1(d).

(4) Example 4—(i) Facts. E owns a 60% interest in each of four partnerships (PRS1, PRS2, PRS3, and PRS4). Each partnership operates a hardware store. A team of executives oversees the operations of all four of the businesses and controls the policy decisions involving the business as a whole. Human
resources and accounting are centralized for the four businesses. E reports PRS1, PRS3, and PRS4 as an aggregated trade or business under paragraph (b)(1) of this section and reports PRS2 as a separate trade or business. Only PRS2 generates a net taxable loss.

(ii) Analysis. E owns more than 50% of each partnership thereby satisfying paragraph (b)(1)(i) of this section. Under paragraph (b)(1)(v) of this section, the following factors are satisfied: paragraph (b)(1)(v)(A) of this section because each partnership operates a hardware store; and paragraph (b)(1)(v)(B) of this section because the businesses share accounting and human resource functions. E’s decision to aggregate only PRS1, PRS3, and PRS4 into a single trade or business for purposes of applying § 1.199A–1(d) is permissible. The loss from PRS2 will be netted against the aggregate profits of PRS1, PRS3, and PRS4 pursuant to § 1.199A–1(d)(2)(ii).

(5) Example 5—(i) Facts. Assume the same facts as Example 4 of paragraph (d)(4) of this section, and that F owns a 10% interest in PRS1, PRS2, PRS3, and PRS4.

(ii) Analysis. Because under paragraph (b)(1)(i) of this section E owns more than 50% of the four partnerships, F may aggregate PRS 1, PRS2, PRS3, and PRS4 as a single trade or business for purposes of applying § 1.199A–1(d), provided that F can demonstrate that the ownership test is met by E. F cannot demonstrate that the ownership test is met by E.

(6) Example 6—(i) Facts. D owns 75% of the stock of S1, S2, and S3, each of which is an S corporation. Each S corporation operates a grocery store in a separate state. S1 and S2 share centralized purchasing functions to obtain volume discounts and a centralized accounting office that performs all of the bookkeeping, tracks and issues statements on all of the receivables, and prepares the payroll for each business. S3 is operated independently from the other businesses.

(ii) Analysis. D owns more than 50% of the stock of each S corporation thereby satisfying paragraph (b)(1)(i) of this section. Under paragraph (b)(1)(v) of this section, the grocery stores satisfy paragraph (b)(1)(v)(A) of this section because they are in the same trade or business. Only S1 and S2 satisfy paragraph (b)(1)(v)(B) of this section because of their centralized purchasing and accounting offices. D only owns 75% of the stock of S3; therefore, the requirement of paragraph (b)(1)(v)(B) of this section are satisfied for S1 and S2; therefore, D only may aggregate S1 and S2 into a single trade or business for purposes of § 1.199A–1(d). D must report S3 as a separate trade or business for purposes of applying § 1.199A–1(d).

(7) Example 7—(i) Facts. Assume the same facts as Example 6 of paragraph (d)(6) of this section except each store is independently operated and S1 and S2 do not have centralized purchasing or accounting functions.

(ii) Analysis. Although the stores provide the same products and services within the meaning of paragraph (b)(1)(v)(A) of this section, D cannot show that another factor under paragraph (b)(1)(v) of this section is present. Therefore, D must report S1, S2, and S3 as separate trades or businesses for purposes of applying § 1.199A–1(d).

(8) Example 8—(i) Facts. G owns 80% of the stock in S1, an S corporation and 80% of LLC1 and LLC2, each of which is a partnership for Federal tax purposes. LLC1 manufactures and supplies all of the widgets sold by LLC2. LLC2 operates a retail store that sells LLC1’s widgets. S1 owns the real property leased to LLC1 and LLC2 for use by the factory and retail store. The entities share common advertising and management.

(ii) Analysis. G owns more than 50% of the stock of S1 and more than 50% of LLC1 and LLC2 thus satisfying paragraph (b)(1)(i) of this section. LLC1, LLC2, and S1 share significant centralized business elements and are operated in coordination with, or in reliance upon, one or more of the businesses in the aggregated group. G can treat the business operations of LLC1 and LLC2 as a single trade or business for purposes of applying § 1.199A–1(d). S1 is eligible to be included in the aggregated group because it leases property to a trade or business within the aggregated trade or business as described in § 1.199A–1(b)(14) and meets the requirements of paragraph (b)(1) of this section.

(9) Example 9—(i) Facts. Same facts as Example 8 of paragraph (d)(8) of this section, except G owns 80% of the stock in S1 and 20% of each of LLC1 and LLC2. B, G’s son, owns a majority interest in LLC2, and M, G’s mother, owns a majority interest in LLC1. B does not own an interest in S1 or LLC1, and M does not own an interest in S1 or LLC2.

(ii) Analysis. Under the rules in paragraph (b)(1) of this section, B and M’s interest in LLC2 and LLC1, respectively, are attributable to G and G is treated as owning a majority interest in LLC2 and LLC1; G thus satisfies paragraph (b)(1)(i) of this section. G may aggregate his interests in LLC1, LLC2, and S1 as a single trade or business for purposes of applying § 1.199A–1(d). Under paragraph (b)(1) of this section, S1 is eligible to be included in the aggregated group because it leases property to a trade or business within the aggregated trade or business as described in § 1.199A–1(b)(14) and meets the requirements of paragraph (b)(1) of this section.

(10) Example 10—(i) Facts. F owns a 75% interest and G owns a 5% interest in five partnerships (PRS1-PRS5). H owns 10% interest in PRS1 and PRS2. Each partnership operates a restaurant and each restaurant separately constitutes a trade or business for purposes of section 162. G is the executive chef of all of the restaurants and as such he creates the menus and orders the food supplies.

(ii) Analysis. F owns more than 50% of the partnerships thereby satisfying paragraph (b)(1)(i) of this section. Under paragraph (b)(1)(v) of this section, the restaurants satisfy paragraph (b)(1)(v)(A) of this section because they are in the same trade or business. Only H and G satisfy paragraph (b)(1)(v)(B) of this section because of their centralized purchasing and accounting offices. F is the executive chef of all of the restaurants; therefore, F owns more than 50% of the partnerships thereby satisfying paragraph (b)(1)(i) of this section. Under paragraph (b)(1)(v) of this section, the restaurants satisfy paragraph (b)(1)(v)(A) of this section because they are in the same trade or business, and paragraph (b)(1)(v)(B) of this section is satisfied as to all of the restaurants and the businesses share a centralized function for ordering food and supplies. F can show the requirements under paragraph (b)(1) of this section are satisfied as to all of the restaurants. Because F owns a majority interest in each of the partnerships, G can demonstrate that paragraph (b)(1)(i) of this section is satisfied. G can aggregate all five restaurants into a single trade or business for purposes of applying § 1.199A–1(d). H, however, only owns an interest in PRS1 and PRS2. Like G, H satisfies paragraph (b)(1)(i) of this section because F owns a majority interest. H can, therefore, aggregate PRS1 and PRS2 into a single trade or business for purposes of applying § 1.199A–1(d).

(11) Example 11—(i) Facts. H, J, K, and L own interests in PRS1 and PRS2, each a partnership, and S1 and S2, each an S corporation. H, J, K, and L also own interests in C, an entity taxable as a C corporation. H owns 30%, J owns 20%, K owns 5%, and L owns 45% of each of the five entities. All of the entities satisfy 2 of the 3 factors under paragraph (b)(1)(v) of this section. For purposes of section 199A the taxpayers report the following aggregated trades or businesses: H aggregates PRS1 and S1 together and aggregates PRS2 and S2 together; J aggregates PRS1, S1 and S2 together and reports PRS2 separately; K aggregates PRS1 and PRS2 together and aggregates S1 and S2 together; and L aggregates S1, S2, and PRS2 together and reports PRS1 separately. C cannot be aggregated.

(ii) Analysis. Under paragraph (b)(1)(i) of this section, because H, J, and K together own a majority interest in PRS1, PRS2, S1, and S2, H, J, K, and L are permitted to aggregate under paragraph (b)(1) of this section. Further, the aggregations reported by the taxpayers are permitted, but not required for each of H, J, K, and L. C’s income is not eligible for the section 199A deduction and it cannot be aggregated for purposes of applying § 1.199A–1(d).

(12) Example 12—(i) Facts. L owns 60% of PRS1, a partnership, a business that sells non-food items to grocery stores. L also owns 55% of PRS2, a partnership, which owns and operates a distribution trucking business. The predominant portion of PRS2’s business is transporting goods for PRS1.

(ii) Analysis. L is able to meet paragraph (b)(1)(i) of this section as the majority owner of PRS1 and PRS2. Under paragraph (b)(1)(v) of this section, L is only able to show the operations of PRS1 and PRS2 are operated in reliance of one another under paragraph (b)(1)(v)(C) of this section. For purposes of applying § 1.199A–1(d), L must treat PRS1 and PRS2 as separate trades or businesses.

(13) Example 13—(i) Facts. C owns a majority interest in a sailboat racing team and also owns an interest in PRS1 which operates a marina. PRS1 is a trade or business under section 162, but the sailboat racing team is not a trade or business within the meaning of section 162.

(ii) Analysis. C has only one trade or business for purposes of section 199A, and therefore, cannot aggregate the interest in the racing team with PRS1 under paragraph (b)(1) of this section.

(14) Example 14—(i) Facts. Trust wholly owns LLC1, LLC2, and LLC3. LLC1 operates a trucking company that delivers lumber and other supplies sold by LLC2. LLC2 operates a lumber yard and supplies LLC3 with building materials. LLC3 operates a construction business. LLC1, LLC2, and LLC3 have a centralized human resources department, payroll, and accounting department.

(ii) Analysis. Because Trust owns 100% of the interests in LLC1, LLC2, and LLC3, Trust satisfies paragraph (b)(1)(i) of this section. Trust can also show that it satisfies paragraph (b)(1)(v)(B) of this section as the trades or businesses have a centralized human resources department, payroll, and accounting department. Trust also can show is meets paragraph (b)(1)(v)(C) of this section as the trades or businesses are operated in coordination, or reliance
upon, one or more in the aggregated group. Trust can aggregate LLC1, LLC2, and LLC3 for purposes of applying § 1.199A–1(d).

(15) Example 15—(i) Facts. PRS1, a partnership, directly operates a food service trade or business and owns 60% of PRS2, which directly operates a movie theater trade or business and the movie theater and food service businesses operate in coordination with, or reliance upon, one another and share a centralized human resources department, payroll, and accounting department. PRS1’s and PRS2’s food service businesses provide products and services that are the same and share centralized purchasing and shipping to obtain volume discounts.

(ii) Analysis. PRS2 may aggregate its movie theater and food service businesses. Paragraph (b)(1)(v) of this section is satisfied because the businesses operate in coordination with one another and share centralized business elements. If PRS does aggregate the two businesses, PRS1 may not aggregate its food service business with PRS2’s aggregated trades or businesses. Because PRS1 owns more than 50% of PRS2, thereby satisfying paragraph (b)(1)(i) of this section, PRS1 may aggregate its food service businesses with PRS2’s food service business if PRS2 has not aggregated its movie theater and food service businesses. Paragraph (b)(1)(v) of this section is satisfied because the businesses provide the same products and services and share centralized business elements. Under either alternative, PRS1’s food service business and PRS2’s movie theater cannot be aggregated because there are no factors in paragraph (b)(1)(v) of this section present between the businesses.

(16) Example 16—(i) Facts. PRS1, a partnership, owns 60% of a commercial rental office building in state A, and 80% of a commercial rental office building in state B. Both commercial rental office building operations share centralized accounting, legal, and human resource functions. PRS1 treats the two commercial rental office buildings as an aggregated trade or business under paragraph (b)(1) of this section.

(ii) Analysis. PRS1 owns more than 50% of each trade or business thereby satisfying paragraph (b)(1)(i) of this section. Under paragraph (b)(1)(v) of this section, PRS1 may aggregate its commercial rental office buildings because the businesses provide the same type of property and share accounting, legal, and human resource functions.

(17) Example 17—(i) Facts. S, an S corporation owns 100% of the interests in a residential condominium building and 100% of the interests in a commercial rental office building. Both building operations share centralized accounting, legal, and human resource functions.

(ii) Analysis. S owns more than 50% of each trade or business thereby satisfying paragraph (b)(1)(i) of this section. Although both businesses share significant centralized business elements, S cannot show that another factor under paragraph (b)(1)(v) of this section is present because the two building operations are not of the same type of property. S must treat the residential condominium building and the commercial rental office building as separate trades or businesses for purposes of applying § 1.199A–1(d).

(18) Example 18—(i) Facts. M owns 75% of a residential apartment building. M also owns 80% of PRS2. PRS2 owns 80% of the interests in a residential condominium building and 80% of the interests in a residential apartment building. PRS2’s residential condominium building and residential apartment building operations share centralized business functions and management. M’s residential apartment building and PRS2’s residential condominium and apartment building operate in coordination with each other in renting apartments to tenants.

(ii) Analysis. PRS2 may aggregate its residential condominium and residential apartment building operations. PRS2 owns more than 50% of each trade or business thereby satisfying paragraph (b)(1)(i) of this section. Paragraph (b)(1)(v) of this section is satisfied because the businesses are of the same type of property and share centralized back office functions and management. M may also add its residential apartment building operations to PRS2’s aggregated residential condominium and apartment building operations. M owns more than 50% of each trade or business thereby satisfying paragraph (b)(1)(i) of this section. Paragraph (b)(1)(v) of this section is also satisfied because the businesses operate in coordination with each other.

(e) Applicability date—(1) General rule. Except as provided in paragraph (e)(2) of this section, the provisions of this section apply to taxable years ending after February 8, 2019.

(2) Exception for non-calendar year RPE. For purposes of determining QBI, W–2 wages, and UBIA of qualified property, and the aggregate amount of qualified REIT dividends and qualified PTP income, if an individual receives any of these items from an RPE with a taxable year that begins before January 1, 2018, and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual’s taxable year in which or with which such RPE taxable year ends.

Par. 7. Section 1.199A–5 is added to read as follows:

§ 1.199A–5 Specified service trades or businesses and the trade or business of performing services as an employee.

(a) Scope and effect—(1) Scope. This section provides guidance on specified service trades or businesses (SSTBs) and the trade or business of performing services as an employee. This paragraph (a) describes the effect of a trade or business being an SSTB and the trade or business of performing services as an employee. Paragraph (b) of this section provides definitional guidance on SSTBs. Paragraph (c) of this section provides special rules related to SSTBs. Paragraph (d) of this section provides guidance on the trade or business of performing services as an employee. The provisions of this section apply solely for purposes of section 199A of the Internal Revenue Code (Code).

(2) Effect of being an SSTB. If a trade or business is an SSTB, no qualified business income (QBI), W–2 wages, or unadjusted basis immediately after acquisition (UBIA) of qualified property from the SSTB may be taken into account by any individual whose taxable income exceeds the phase-in range as defined in § 1.199A–1(b)(4), even if the item is derived from an activity that is not itself a specified service activity. The SSTB limitation also applies to income earned from a publicly traded partnership (PTP). If a trade or business conducted by a relevant passthrough entity (RPE) or PTP is an SSTB, this limitation applies to any direct or indirect individual owners of the business, regardless of whether the owner is passive or participated in any specified service activity. However, the SSTB limitation does not apply to individuals with taxable income below the threshold amount as defined in § 1.199A–1(b)(12). A phase-in rule, provided in § 1.199A–1(d)(2), applies to individuals with taxable income within the phase-in range, allowing them to take into account a certain “applicable percentage” of QBI, W–2 wages, and UBIA of qualified property from an SSTB. The phase-in rule also applies to income earned from a PTP. A direct or indirect owner of a trade or business engaged in the performance of a specified service is engaged in the performance of the specified service for purposes of section 199A and this section, regardless of whether the owner is passive or participated in the specified service activity.

(3) Trade or business of performing services as an employee. The trade or business of performing services as an employee is not a trade or business for purposes of section 199A and the regulations thereunder. Therefore, no items of income, gain, deduction, or loss from the trade or business of performing services as an employee constitute QBI within the meaning of section 199A and § 1.199A–3. No taxpayer may claim a section 199A deduction for wage income, regardless of the amount of taxable income.
(b) Definition of specified service trade or business. Except as provided in paragraph (c)(1) of this section, the term specified service trade or business (SSTB) means any of the following:

(i) Health as described in paragraph (b)(2)(i) of this section;

(ii) Law as described in paragraph (b)(2)(iii) of this section;

(iii) Accounting as described in paragraph (b)(2)(iv) of this section;

(iv) Actuarial science as described in paragraph (b)(2)(v) of this section;

(v) Performing arts as described in paragraph (b)(2)(vi) of this section;

(vi) Consulting as described in paragraph (b)(2)(vii) of this section;

(vii) Athletics as described in paragraph (b)(2)(viii) of this section;

(viii) Financial services as described in paragraph (b)(2)(ix) of this section;

(ix) Brokerage services as described in paragraph (b)(2)(x) of this section;

(x) Investing and investment management as described in paragraph (b)(2)(xi) of this section;

(xi) Trading as described in paragraph (b)(2)(xii) of this section;

(xii) Dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)) as described in paragraph (b)(2)(xiii) of this section; or

(xiii) Any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners as defined in paragraph (b)(2)(xiv) of this section.

(2) Additional rules for applying section 199A(d)(2) and paragraph (b) of this section—(i) In general—(A) No effect on other tax rules. This paragraph (b)(2) provides additional rules for determining whether a business is an SSTB within the meaning of section 199A(d)(2) and paragraph (b) of this section only. The rules of this paragraph (b)(2) apply solely for purposes of section 199A and therefore may not be taken into account for purposes of applying any provision of law or regulation other than section 199A and the regulations thereunder, except to the extent such provision expressly refers to section 199A(d) or this section.

(B) Hedging transactions. Income, deduction, gain or loss from a hedging transaction (as defined in § 1.1221–2(b)) entered into by an individual or RPE in the normal course of the individual’s or RPE’s trade or business is treated as income, deduction, gain, or loss from that trade or business for purposes of this paragraph (b)(2). See also § 1.446–4.

(ii) Meaning of services performed in the field of health. For purposes of section 199A(d)(2) and paragraph (b)(1)(i) of this section only, the performance of services in the field of health means the provision of medical services by individuals such as physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and other similar healthcare professionals performing services in their capacity as such. The performance of services in the field of health does not include the provision of services not directly related to a medical services field, even though the services provided may purportedly relate to the health of the service recipient. For example, the performance of services in the field of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers, payment processing, or the research, testing, and manufacture and/or sales of pharmaceuticals or medical devices.

(iii) Meaning of services performed in the field of law. For purposes of section 199A(d)(2) and paragraph (b)(1)(ii) of this section only, the performance of services in the field of law means the performance of legal services by individuals such as lawyers, paralegals, legal arbitrators, mediators, and similar professionals performing services in their capacity as such. The performance of services in the field of law does not include the provision of services that do not require skills unique to the creation of performing arts, such as the maintenance and operation of equipment or facilities for use in the performing arts. Similarly, the performance of services in the field of the performing arts does not include the provision of services by persons who broadcast or otherwise disseminate video or audio of performing arts to the public.

(iv) Meaning of services performed in the field of consulting. For purposes of section 199A(d)(2) and paragraph (b)(1)(vi) of this section only, the performance of services in the field of consulting means the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems. Consulting includes providing advice and counsel regarding advocacy with the intention of influencing decisions made by a government or governmental agency and all attempts to influence legislators and other government officials on behalf of a client by lobbyists and other similar professionals performing services in their capacity as such. The performance of services in the field of consulting does not include the performance of services other than advice and counsel, such as sales (or economically similar services) or the provision of training and educational courses. For purposes of the preceding sen-
tence, the determination of whether a person’s services are sales or economically similar services will be based on all the facts and circumstances of that person’s business. Such facts and circumstances include, for example, the manner in which the taxpayer is compensated for the services provided. Performance of services in the field of consulting does not include the performance of consulting services embedded in, or ancillary to, the sale of goods or performance of services on behalf of a trade or business that is otherwise not an SSTB (such as typical services provided by a building contractor) if there is no separate payment for the consulting services. Services within the fields of architecture and engineering are not treated as consulting services.

(viii) Meaning of services performed in the field of athletics. For purposes of section 199A(d)(2) and paragraph (b)(1)(vii) of this section only, the performance of services in the field of athletics means the performance of services by individuals who participate in athletic competition such as athletes, coaches, and team managers in sports such as baseball, basketball, football, soccer, hockey, martial arts, boxing, bowling, tennis, golf, skiing, snowboarding, track and field, billiards, and racing. The performance of services in the field of athletics does not include the provision of services that do not require skills unique to athletic competition, such as the maintenance and operation of equipment or facilities for use in athletic events. Similarly, the performance of services in the field of athletics does not include the provision of services by persons who broadcast or otherwise disseminate video or audio of athletic events to the public.

(ix) Meaning of services performed in the field of financial services. For purposes of section 199A(d)(2) and paragraph (b)(1)(viii) of this section only, the performance of services in the field of financial services means the provision of financial services to clients including managing wealth, advising clients with respect to finances, developing retirement plans, developing wealth transition plans, the provision of advisory and other similar services regarding valuations, mergers, acquisitions, dispositions, restructurings (including in title 11 of the Code or similar cases), and raising financial capital by underwriting, or acting as a client’s agent in the issuance of securities and similar services. This includes services provided by financial advisors, investment bankers, wealth planners, retirement advisors, and other similar professionals performing services in their capacity as such. Solely for purposes of section 199A, the performance of services in the field of financial services does not include taking deposits or making loans, but does include arranging lending transactions between a lender and borrower.

(x) Meaning of services performed in the field of brokerage services. For purposes of section 199A(d)(2) and paragraph (b)(1)(ix) of this section only, the performance of services in the field of brokerage services includes services in which a person arranges transactions between a buyer and a seller with respect to securities (as defined in section 475(c)(2)) for a commission or fee. This includes services provided by stock brokers and other similar professionals, but does not include services provided by real estate agents and brokers, or insurance agents and brokers.

(xii) Meaning of the provision of services in investing and investment management. For purposes of section 199A(d)(2) and paragraph (b)(1)(x) of this section only, the performance of services that consist of investing and investment management refers to a trade or business involving the receipt of fees for providing investing, asset management, or investment management services, including providing advice with respect to buying and selling investments. The performance of services of investing and investment management does not include directly managing real property.

(xiii) Meaning of the provision of services in trading. For purposes of section 199A(d)(2) and paragraph (b)(1)(xi) of this section only, the performance of services that consist of trading means a trade or business of trading in securities (as defined in section 475(c)(2)), commodities (as defined in section 475(e)(2)), or partnership interests. Whether a person is a trader in securities, commodities, or partnership interests is determined by taking into account all relevant facts and circumstances, including the source and type of profit that is associated with engaging in the activity regardless of whether that person trades for the person’s own account, for the account of others, or any combination thereof.

(xv) Meaning of the provision of services in dealing. For purposes of section 199A(d)(2) and paragraph (b)(1)(xii) of this section only, the performance of services that consist of dealing in securities (as defined in section 475(c)(2)) means regularly purchasing securities from and selling securities to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. Solely for purposes of the preceding sentence, the performance of services to originate a loan is not treated as the purchase of a security from the borrower in determining whether the lender is dealing in securities.

(B) Dealing in commodities. For purposes of section 199A(d)(2) and paragraph (b)(1)(xii) of this section only, the performance of services that consist of dealing in commodities (as defined in section 475(e)(2)) means regularly purchasing commodities from and selling commodities to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in commodities with customers in the ordinary course of a trade or business. Solely for purposes of the preceding sentence, gains and losses from qualified active sales as defined in paragraph (b)(2)(xiii)(B)(i) of this section are not taken into account in determining whether a person is engaged in the trade or business of dealing in commodities.

(I) Qualified active sale. The term qualified active sale means the sale of commodities in the active conduct of a commodities business as a producer, processor, merchant, or handler of commodities if the trade or business is as an active producer, processor, merchant or handler of commodities. A hedging transaction described in paragraph (b)(2)(i)(B) of this section is treated as a qualified active sale. The sale of commodities held by a trade or business other than in its capacity as an active producer, processor, merchant, or handler of commodities is not a qualified active sale. For example, the sale by a
(2) Active conduct of a commodities business. For purposes of paragraph (b)(2)(xiii)(B)(1) of this section, a trade or business is engaged in the active conduct of a commodities business as a producer, processor, merchant, or handler of commodities only with respect to commodities for which each of the conditions described in paragraphs (b)(2)(xiii)(B)(3) through (5) of this section are satisfied.

(3) Directly holds commodities as inventory or similar property. The commodities trade or business holds the commodities directly, and not through an agent or independent contractor, as inventory or similar property. The term inventory or similar property means property that is stock in trade of the trade or business or other property of a kind that would properly be included in the inventory of the trade or business if on hand at the close of the taxable year, or property held by the trade or business primarily for sale to customers in the ordinary course of its trade or business.

(4) Directly incurs substantial expenses in the ordinary course. The commodities trade or business incurs substantial expenses in the ordinary course of the commodities trade or business from engaging in one or more of the following activities directly, and not through an agent or independent contractor—

(i) Substantial activities in the production of the commodities, including planting, tending or harvesting crops, raising or slaughtering livestock, or extracting minerals;

(ii) Substantial processing activities prior to the sale of the commodities, including the blending and drying of agricultural commodities, or the concentrating, refining, mixing, crushing, aeraating or milling of commodities; or

(iii) Significant activities as described in paragraph (b)(2)(xiii)(B)(5) of this section.

(5) Significant activities for purposes of paragraphs (b)(2)(xiii)(B)(4)(iii) of this section. The commodities trade or business performs significant activities with respect to the commodities that consists of—

(i) The physical movement, handling and storage of the commodities, including preparation of contracts and invoices, arranging transportation, insurance and credit, arranging for receipt, transfer or negotiation of shipping documents, arranging storage or warehousing, and dealing with quality claims;

(ii) Owning and operating facilities for storage or warehousing; or

(iii) Owning, chartering, or leasing vessels or vehicles for the transportation of the commodities.

(C) Dealing in partnership interests. For purposes of section 199A(d)(2) and paragraph (b)(1)(xii) of this section only, the performance of services that consist of dealing in partnership interests means regularly purchasing partnership interests from and selling partnership interests to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in partnership interests with customers in the ordinary course of a trade or business.

(xiv) Meaning of trade or business where the principal asset of such trade or business is the reputation or skill of one or more employees or owners. For purposes of section 199A(d)(2) and paragraph (b)(1)(xii) of this section only, the term any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners means any trade or business that consists of any of the following (or any combination thereof):

(A) A trade or business in which a person receives fees, compensation, or other income for endorsing products or services;

(B) A trade or business in which a person licenses or receives fees, compensation, or other income for the use of an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity; or

(C) Receiving fees, compensation, or other income for appearing at an event or on radio, television, or another media format.

(D) For purposes of paragraphs (b)(2)(xiv)(A) through (C) of this section, the term fees, compensation, or other income includes the receipt of a partnership interest and the corresponding distributive share of income, deduction, gain, or loss from the partnership, or the receipt of stock of an S corporation and the corresponding income, deduction, gain, or loss from the S corporation stock.

(3) Examples. The following examples illustrate the rules in paragraphs (a) and (b) of this section. The examples do not address all types of services that may or may not qualify as specified services. Unless otherwise provided, the individual in each example has taxable income in excess of the threshold amount.

(i) Example 1. B is a board-certified pharmacist who contracts as an independent contractor with X, a small medical facility in a rural area. X employs one full time pharmacist, but contracts with B when X’s needs exceed the capacity of its full-time staff. When engaged by X, B is responsible for receiving and reviewing orders from physicians providing medical care at the facility; making recommendations on dosing and alternatives to the ordering physician; performing inoculations, checking for drug interactions, and filling pharmaceutical orders for patients receiving care at X. B is engaged in the performance of services in the field of health within the meaning of section 199A(d)(2) and paragraphs (b)(1)(i) and (b)(2)(ii) of this section.

(ii) Example 2. X is the operator of a residential facility that provides a variety of services to senior citizens who reside on campus. For residents, X offers standard domestic services including housing management and maintenance, meals, laundry, entertainment, and other similar services. In addition, X contracts with local professional healthcare organizations to offer residents a range of medical and health services provided at the facility, including skilled nursing care, physical and occupational therapy, speech-language pathology services, medical social services, medications, medical supplies and equipment used in the facility, ambulance transportation to the nearest supplier of needed services, and dietary counseling. X receives all of its income from residents for the costs associated with residing at the facility. Any health and medical services are billed directly by the healthcare providers to the senior citizens for those professional healthcare services even though those services are provided at the facility. X does not perform services in the field of health within the meaning of section 199A(d)(2) and paragraphs (b)(1)(i) and (b)(2)(ii) of this section.

(iii) Example 3. Y operates specialty surgical centers that provide outpatient medical procedures that do not require the patient to remain overnight for recovery or observation following the procedure. Y is a private organization that owns a number of facilities throughout the country. For each facility, Y ensures compliance with state and Federal laws for medical facilities and manages the facility’s operations and performs all administrative functions. Y does not employ physicians, nurses, and medical assistants, but enters into agreements with other professional medical organizations or directly with medical professionals to perform the procedures and provide all medical care. Patients are billed by Y for
the facility costs relating to their procedure and by the healthcare professional or their affiliated organization for the actual costs of the procedure conducted by the physician and medical support team. Y does not perform services in the field of health within the meaning of section 199A(d)(2) and paragraphs (b)(1)(i) and (b)(2)(ii) of this section.

Example 4. Z is the developer and the only provider of a patented test used to detect a particular medical condition. Z accepts test orders only from health care professionals (Z’s clients), does not have contact with patients, and Z’s employees do not diagnose, treat, or manage any aspect of patient care. A, who manages Z’s testing operations, is the only employee with an advanced medical degree. All other employees are technical support staff and not healthcare professionals. Z’s workers are highly educated, but the skills the workers bring to the job are not often useful for Z’s testing methods. In order to perform the duties required by Z, employees receive more than a year of specialized training for working with Z’s test, which is of no use to other employers. Upon completion of an ordered test, Z analyses the results and provides its clients a report summarizing the findings. Z does not discuss the report’s results, or the patient’s diagnosis or treatment with any health care provider or the patient. Z is not informed by the healthcare provider as to the healthcare provider’s diagnosis or treatment. Z is not providing services in the field of health within the meaning of section 199A(d)(2) and paragraphs (b)(1)(i) and (b)(2)(ii) of this section or where the principal asset of the trade or business is the reputation or skill of one or more of its employees within the meaning of paragraphs (b)(1)(xiii) and (b)(2)(xiv) of this section.

Example 5. A, a singer and songwriter, writes and records a song. A is paid a mechanical royalty when the song is licensed or streamed. A also paid a performance royalty when the recorded song is played publicly. A is engaged in the performance of services in an SSTB in the field of performing arts within the meaning of section 199A(d)(2) or paragraphs (b)(1)(v) and (b)(2)(vi) of this section. The royalties that A receives for the song are not eligible for a deduction under section 199A.

Example 6. B is a partner in Movie LLC, a partnership that produces and distributes film. Movie LLC plans and coordinates film production. Movie LLC shares in the profits of the films that it produces. Therefore, Movie LLC is engaged in the performance of services in an SSTB in the field of performing arts within the meaning of section 199A(d)(2) or paragraphs (b)(1)(v) and (b)(2)(vi) of this section. B is a passive owner in Movie LLC and does not provide any services with respect to Movie LLC. However, because Movie LLC is engaged in an SSTB in the field of performing arts, B’s distributive share of the income, gain, deduction, and loss with respect to Movie LLC is not eligible for a deduction under section 199A.

Example 7. C is a partner in Partnership, which solely owns and operates a professional sports team. Partnership employs athletes and sells tickets and broadcast rights for games in which the sports team competes. Partnership sells the broadcast rights to Broadcast LLC, a separate trade or business. Broadcast LLC solely broadcasts the games. Partnership is engaged in the performance of services in an SSTB in the field of athletics within the meaning of section 199A(d)(2) or paragraphs (b)(1)(vii) and (b)(2)(viii) of this section. The tickets sales and the sale of the broadcast rights are both the performance of services in the field of athletics. C is a passive owner in Partnership and C does not provide any services with respect to Partnership or the sports team. However, because Partnership is engaged in an SSTB in the field of athletics, C’s distributive share of the income, gain, deduction, and loss with respect to Partnership is not eligible for a deduction under section 199A. Broadcast LLC is not engaged in the performance of services in an SSTB in the field of athletics.

Example 8. D is in the business of providing services that assist unrelated entities in making their personnel structures more efficient. D studies its client’s organization and structure and compares it to peers in its industry. D then makes recommendations and provides advice to its client regarding possible changes in the client’s personnel structure, including the use of temporary workers. D does not provide any temporary workers to its clients and D’s compensation and fees are not affected by whether D’s clients used temporary workers. D is engaged in the performance of services in an SSTB in the field of consulting within the meaning of section 199A(d)(2) or paragraphs (b)(1)(vii) and (b)(2)(vii) of this section.

Example 9. E is an individual who owns and operates a temporary worker staffing firm primarily focused on the software consulting industry. Business clients hire E to provide temporary workers that have the necessary technical skills and experience with a variety of business software to provide consulting and advice regarding the proper selection and operation of software most appropriate for the business they are advising. E does not have a technical software engineering background and does not provide software consulting advice herself. E reviews resumes and refers candidates to the client when the client indicates a need for temporary workers. E does not evaluate her clients’ needs about whether the client needs workers and does not evaluate the clients’ consulting contracts to determine the type of expertise needed. Rather, the client provides E with a list of their needs for the consulting and upcoming consulting project. E is paid a fixed fee for each temporary worker actually hired by the client and receives a bonus if that worker is hired permanently within a year of referral. E’s fee is not contingent on the profits of its clients. E is not considered to be engaged in the performance of services in the field of consulting within the meaning of section 199A(d)(2) or (b)(1)(vi) and (b)(2)(vii) of this section.

Example 10. F is in the business of licensing software to customers. F discusses and evaluates the customer’s software needs with the customer. The taxpayer advises the customer on the particular software products it licenses. F is paid a flat price for the software license. After the customer licenses the software, F helps to implement the software. F is engaged in the trade or business of licensing software and not engaged in an SSTB in the field of consulting within the meaning of section 199A(d)(2) or paragraphs (b)(1)(vi) and (b)(2)(vii) of this section.

Example 11. G is in the business of providing services to assist clients with their finances. G will study a particular client’s financial situation, including, the client’s present income, savings, and investments, and anticipated future economic and financial needs. Based on this study, G will then assist the client in making decisions and plans regarding the client’s financial activities. Such financial planning includes the design of a personal budget to assist the client in monitoring the client’s financial situation, the adoption of investment strategies tailored to the client’s needs, and other similar services. G is engaged in the performance of services in an SSTB in the field of financial services within the meaning of section 199A(d)(2) or paragraphs (b)(1)(viii) and (b)(2)(ix) of this section.

Example 12. H is in the business of franchising a brand of personal financial planning offices, which generally provide personal wealth management, retirement planning, and other financial advice services to customers for a fee. H does not provide financial planning services itself. H licenses the right to use the business trademark, other branding intellectual property, and a marketing plan to third-party financial planner franchisees that operate the franchised locations and provide all services to customers. In exchange, the franchisees compensate H based on a fee structure, which includes a one-time fee to acquire the franchise. H is not engaged in the performance of services in the field of financial services within the meaning of section 199A(d)(2) or paragraphs (b)(1)(viii) and (b)(2)(ix) of this section.

Example 13. J is in the business of executing transactions for customers involving various types of securities or commodities generally traded through organized exchanges or other similar networks. Customers place orders with J to trade securities or commodities based on the taxpayer’s recommendations. J’s compensation for its services typically is based on completion of the trade orders. J is engaged in an SSTB in the field of brokerage services within the meaning of section 199A(d)(2) or paragraphs (b)(1)(ix) and (b)(2)(x) of this section.

Example 14. K owns 100% of Corp, an S corporation, which operates a bicycle sales and repair business. Corp has 8 employees, including K. K owns 100% of Corp and is not interested in the sales of new and used bicycles and related goods, such as helmets, and bicycle-related equipment. The other half of Corp’s net income is generated from bicycle repair services performed by K and Corp’s other employees. Corp’s assets consist of inventory, fixtures, bicycle repair equipment, and a leasehold on its retail location. Several of the employees and G have worked in the bicycle business for many years, and have acquired substantial skill and reputation in the field. Customers often consult with the employees on the best bicycle for purchase. K is in the business of sales and repairs of bicycles and is not engaged in an SSTB within the meaning of section 199A(d)(2) or paragraphs (b)(1)(xiii) and (b)(2)(xiv) of this section.

Example 15. L is a well-known chef and the sole owner of multiple restaurants each of which is owned in a disregarded entity. Due to L’s skill and reputation as a chef, L receives an endorsement fee of $500,000 for the use of L’s name on a line of cooking utensils and cookware. L is in the trade or business of providing services to assist clients with their finances.
business of being a chef and owning restaurants and such trade or business is not an SSTB. However, L is also in the trade or business of receiving endorsement income. L’s trade or business consisting of the receipt of the endorsement fee for L’s skill and/or reputation is an SSTB within the meaning of section 199A(d)(2) or paragraphs (b)(1)(xiii) and (b)(2)(xiv) of this section.

(xvi) Example 16. M is a well-known actor. M entered into a partnership with Shoe Company, in which M contributed her likeness and the use of her name to the partnership in exchange for a 50% interest in the partnership and a guaranteed payment. M’s trade or business consisting of the receipt of the partnership interest and the corresponding distributive share with respect to the partnership interest for M’s likeness and the use of her name is an SSTB within the meaning of section 199A(d)(2) or paragraphs (b)(1)(xiii) and (b)(2)(xiv) of this section.

(c) Special rules—(1) De minimis rule—(i) Gross receipts of $25 million or less. For a trade or business with gross receipts of $25 million or less for the taxable year, a trade or business is not an SSTB if less than 10 percent of the gross receipts of the trade or business are attributable to the performance of services in a field described in paragraph (b) of this section. For purposes of determining whether this 10 percent test is satisfied, the performance of any activity incident to the actual performance of services in the field is considered the performance of services in that field.

(ii) Gross receipts of greater than $25 million. For a trade or business with gross receipts of greater than $25 million for the taxable year, the rules of paragraph (c)(1)(i) of this section are applied by substituting “5 percent” for “10 percent” each place it appears.

(iii) Examples. The following examples illustrate the provisions of paragraph (c)(1) of this section.

(A) Example 1. Landscape LLC sells lawn care and landscaping equipment and also provides advice and counsel on landscape design for large office parks and residential buildings. The landscape design services include advice on the selection and placement of trees, shrubs, and flowers and are considered to be the performance of services in the field of consulting under paragraphs (b)(1)(vi) and (b)(2)(viii) of this section. Landscape LLC separately invoices for its landscape design services and does not sell the trees, shrubs, or flowers it recommends for use in the landscape design. Landscape LLC maintains one set of books and records and treats the equipment sales and design services as a single trade or business for purposes of sections 162 and 199A. Landscape LLC has gross receipts of $2 million. $250,000 of the gross receipts is attributable to the landscape design services, an SSTB. Because the gross receipts from the consulting services exceed 10 percent of Landscape LLC’s total gross receipts, the entirety of Landscape LLC’s trade or business is considered an SSTB.

(B) Example 2. Animal Care LLC provides veterinary services performed by licensed staff and also develops and sells its own line of organic dog food at its veterinarian clinic and online. The veterinary services are considered to be the performance of services in the field of health under paragraphs (b)(1)(i) and (b)(2)(ii) of this section. Animal Care LLC separately invoices for its veterinary services and the sale of its organic dog food. Animal Care LLC maintains separate books and records for its veterinarian clinic and its development and sale of its dog food. Animal Care LLC also has separate employees who are unaffiliated with the veterinary clinic and who only work on the formulation, marketing, sales, and distribution of the organic dog food products. Animal Care LLC treats its veterinary practice and the dog food development and sales as separate trades or businesses under section 162.
person), is presumed, for three years after ceasing to be treated as an employee for Federal employment tax purposes, to be in the trade or business of performing services as an employee with regard to such services. As provided in paragraph (d)(3)(ii) of this section, this presumption may be rebutted upon a showing by the individual that, under Federal tax law, regulations, and principles (including common-law employee classification rules), the individual is performing services in a capacity other than as an employee. This presumption applies regardless of whether the individual provides services directly or indirectly through an entity or entities.

(ii) Rebuttal of presumption. Upon notice from the IRS, an individual rebuts the presumption in paragraph (d)(3)(i) of this section by providing records, such as contracts or partnership agreements, that provide sufficient evidence to corroborate the individual’s status as a non-employee.

(iii) Examples. The following examples illustrate the provision of paragraph (d)(3) of this section. Unless otherwise provided, the individual in each example has taxable income in excess of the threshold amount.

(A) Example 1. A is employed by PRS, a partnership for Federal tax purposes, as a full-time employee and is treated as such for Federal employment tax purposes. A quits his job for PRS and enters into a contract with PRS under which A provides substantially the same services that A previously provided to PRS in A’s capacity as an employee. Because A was treated as an employee for services he provided to PRS, and now is no longer treated as an employee with regard to such services, A is presumed (solely for purposes of section 199A(d)(1)(B) and paragraphs (a)(3) and (d) of this section) to be in the trade or business of performing services as an employee with regard to his services performed for PRS. Unless the presumption is rebutted with a showing that, under Federal tax law, regulations, and principles (including the common-law employee classification rules), A is not an employee, any amounts paid by PRS to A with respect to such services will not be QBI for purposes of section 199A. The presumption would apply even if, instead of contracting directly with PRS, A formed a disregarded entity, or a pass-through entity, and the entity entered into the contract with PRS.

(B) Example 2. C is an attorney employed as an associate in a law firm (Law Firm 1) and was treated as such for Federal employment tax purposes. C and the other associates in Law Firm 1 have taxable income below the threshold amount. Law Firm 1 terminates its employment relationship with C and its other associates. C and the other former associates form a new partnership, Law Firm 2, which contracts to perform legal services for Law Firm 1. Therefore, in form, C is now a partner in Law Firm 2 which earns income from providing legal services to Law Firm 1. C continues to provide substantially the same legal services to Law Firm 1 and its clients. Because C was previously treated as an employee for services she provided to Law Firm 1, and now is no longer treated as an employee with regard to such services, C is presumed (solely for purposes of section 199A(d)(1)(B) and paragraphs (a)(3) and (d) of this section) to be in the trade or business of performing services as an employee with respect to the services C provides to Law Firm 1 indirectly through Law Firm 2. Unless the presumption is rebutted with a showing that, under Federal tax law, regulations, and principles (including common-law employee classification rules), C’s distributive share of Law Firm 2 income (including any guaranteed payments) will not be QBI for purposes of section 199A. The results in this example would not change if, instead of contracting with Law Firm 1, Law Firm 2 was instead admitted as a partner in Law Firm 1.

(C) Example 3. E is an engineer employed as a senior project engineer in an engineering firm, Engineering Firm. Engineering Firm is a partnership for Federal tax purposes and structured such that after 10 years, senior project engineers are considered for partner if certain career milestones are met. After 10 years, E meets those career milestones and is admitted as a partner in Engineering Firm. As a partner in Engineering Firm, E shares in the net profits of Engineering Firm, and also otherwise satisfies the requirements under Federal tax law, regulations, and principles (including common-law employee classification rules) to be respected as a partner. E is presumed (solely for purposes of section 199A(d)(1)(B) and paragraphs (a)(3) and (d) of this section) to be in the trade or business of performing services as an employee with respect to the services E provides to Engineering Firm. However, E is able to rebut the presumption by showing that E became a partner in Engineering Firm as a career milestone, shares in the overall net profits in Engineering Firm, and otherwise satisfies the requirements under Federal tax law, regulations, and principles (including common-law employee classification rules) to be respected as a partner.

(D) Example 4. F is a financial advisor employed by a financial advisory firm, Advisory Firm, which offers F the opportunity to be admitted as a partner. F elects to be admitted as a partner in Advisory Firm. As a partner in Advisory Firm, F is presumed (solely for purposes of section 199A(d)(1)(B) and paragraphs (a)(3) and (d) of this section) to be in the trade or business of performing services as an employee with regard to such services, F provides to Advisory Firm, and also otherwise satisfies the requirements under Federal tax law, regulations, and principles (including common-law employee classification rules) to be respected as a partner.
gaged in necessary for its owners to determine their section 199A deduction.

(2) Computational rules. Using the following four rules, an RPE must determine the items necessary for individuals who own interests in the RPE to calculate their section 199A deduction under § 1.199A–1(c) or (d). An RPE that chooses to aggregate trades or businesses under the rules of § 1.199A–4 may determine these items for the aggregated trade or business.

(i) First, the RPE must determine if it is engaged in one or more trades or businesses. The RPE must also determine whether any of its trades or businesses is an SSTB under the rules of § 1.199A–5.

(ii) Second, the RPE must apply the rules in § 1.199A–3 to determine the QBI for each trade or business engaged in directly.

(iii) Third, the RPE must apply the rules in § 1.199A–2 to determine the W–2 wages and UBIA of qualified property for each trade or business engaged in directly.

(iv) Fourth, the RPE must determine whether it has any qualified REIT dividends as defined in § 1.199A–3(c)(1) earned directly or through another RPE. The RPE must also determine the amount of qualified PTP income as defined in § 1.199A–3(c)(2) earned directly or indirectly through investments in PTPs.

(3) Reporting rules for RPEs—(i) Trade or business directly engaged in. An RPE must separately identify and report on the Schedule K–1 issued to its owners for each trade or business (including an aggregated trade or business) engaged in directly by the RPE—

(A) Each owner’s allocable share of QBI, W–2 wages, and UBIA of qualified property attributable to each such trade or business; and

(B) Whether any of the trades or businesses described in paragraph (b)(3)(i) of this section is an SSTB.

(ii) Other items. An RPE must also report on an attachment to the Schedule K–1, any QBI, W–2 wages, UBIA of qualified property, or SSTB determinations, reported to it by any RPE in which the RPE owns a direct or indirect interest. The RPE must also report each owner’s allocated share of any qualified REIT dividends received by the RPE (including through another RPE) as well as any qualified PTP income or loss received by the RPE for each PTP in which the RPE holds an interest (including through another RPE). Such information can be reported on an amended or late filed return to the extent that the period of limitations remains open.

(iii) Failure to report information. If an RPE fails to separately identify or report on the Schedule K–1 (or any attachments thereto) issued to an owner an item described in paragraph (b)(3)(i) of this section, the owner’s share (and the share of any upper-tier indirect owner) of each unreported item of positive QBI, W–2 wages, or UBIA of qualified property attributable to trades or businesses engaged in by that RPE will be presumed to be zero.

(c) Computational and reporting rules for PTPs—(1) Computational rules. Each PTP must determine its QBI under the rules of § 1.199A–3 for each trade or business in which the PTP is engaged in directly. The PTP must also determine whether any of the trades or businesses it is engaged in directly is an SSTB.

(2) Reporting rules. Each PTP is required to separately identify and report the information described in paragraph (c)(1) of this section on Schedules K–1 issued to its partners. Each PTP must also determine and report any qualified REIT dividends or qualified PTP income or loss received by the PTP including through an RPE, a REIT, or another PTP. A PTP is not required to determine or report W–2 wages or the UBIA of qualified property attributable to trades or businesses it is engaged in directly.

(d) Application to trusts, estates, and beneficiaries—(1) In general. A trust or estate computes its section 199A deduction based on the QBI, W–2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income that are allocated to the trust or estate. An individual beneficiary of a trust or estate takes into account any QBI, W–2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income that are allocated to the trust or estate. An individual beneficiary of a trust or estate takes into account any QBI, W–2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income allocated from a trust or estate in calculating the beneficiary’s section 199A deduction, in the same manner as though the items had been allocated from an RPE. For purposes of this section and §§ 1.199A–1 through 1.199A–5, a trust or estate is treated as an RPE to the extent it allocates QBI and other items to its beneficiaries, and is treated as an individual to the extent it retains the QBI and other items.

(2) Grantor trusts. To the extent that the grantor or another person is treated as owning all or part of a trust under sections 671 through 679, such person computes its section 199A deduction as if that person directly conducted the activities of the trust with respect to the portion of the trust treated as owned by the grantor or other person.

(3) Non-grantor trusts and estates—(i) Calculation at entity level. A trust or estate must calculate its QBI, W–2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income. The QBI of a trust or estate must be computed by allocating qualified items of deduction described in section 199A(c)(3) in accordance with the classification of those deductions under § 1.652(b)(3)(a), and deductions not directly attributable within the meaning of § 1.652(b)(3)(b) (other deductions) are allocated in a manner consistent with the rules in § 1.652(b)(3)(b). Any depletion and depreciation deductions described in section 642(e) and any amortization deductions described in section 642(f) that otherwise are properly included in the computation of QBI are included in the computation of QBI of the trust or estate, regardless of how those deductions may otherwise be allocated between the trust or estate and its beneficiaries for other purposes of the Code.

(ii) Allocation among trust or estate and beneficiaries. The QBI (including any amounts that may be less than zero as calculated at the trust or estate level), W–2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income of a trust or estate are allocated to each beneficiary and to the trust or estate based on the relative proportion of the trust’s or estate’s distributable net income (DNI), as defined by section 643(a), for the taxable year that is distributed or required to be distributed to the beneficiary or is retained by the trust or estate. For this purpose, the trust’s or estate’s DNI is determined with regard to the separate share rule of section 663(c), but without regard to section 199A. If the trust or estate has no DNI for the taxable year, any QBI, W–2 wages, UBIA of qualified property,
qualified REIT dividends, and qualified PTP income are allocated entirely to the trust or estate.

(iii) [Reserved]

(iv) **Threshold amount.** The threshold amount applicable to a trust or estate is $157,500 for any taxable year beginning before 2019. For taxable years beginning after 2018, the threshold amount shall be $157,500 increased by the cost-of-living adjustment as outlined in § 1.199A–1(b)(12). For purposes of determining whether a trust or estate has taxable income in excess of the threshold amount, the taxable income of the trust or estate is determined after taking into account any distribution deduction under sections 651 or 661.

(v) [Reserved]

(vi) **Election of small business trusts.** An electing small business trust (ESBT) is entitled to the deduction under section 199A. Any section 199A deduction attributable to the assets in the S portion of the ESBT is to be taken into account by the S portion. The S portion of the ESBT must take into account the QBI and other items from any S corporation owned by the ESBT, the grantor portion of the ESBT must take into account the QBI and other items from any assets treated as owned by a grantor or another person (owned portion) of a trust under sections 671 through 679, and the non-S portion of the ESBT must take into account any QBI and other items from any other entities or assets owned by the ESBT. For purposes of determining whether the taxable income of an ESBT exceeds the threshold amount, the S portion and the non-S portion of an ESBT are treated as a single trust. See § 1.641(c)–1.

(vii) **Anti-abuse rule for creation of a trust to avoid exceeding the threshold amount.** A trust formed or funded with a principal purpose of avoiding, or of using more than one, threshold amount for purposes of calculating the deduction under section 199A will not be respected as a separate trust entity for purposes of determining the threshold amount for purposes of section 199A. See also § 1.643(f)–1 of the regulations.

(viii) **Example.** The following example illustrates the application of paragraph (d) of this section.

(A) Example—(I) **Computation of DNI and inclusion and deduction amounts—(i) Trust’s distributive share of partnership items.** Trust, an irrevocable testamentary complex trust, is a 25% partner in PRS, a family partnership that operates a restaurant that generates QBI and W–2 wages. A and B, Trust’s beneficiaries, own the remaining 75% of PRS directly. In 2018, PRS properly allocates gross income from the restaurant of $55,000, and expenses directly allocable to the restaurant of $45,000 (including W–2 wages of $25,000, and miscellaneous expenses of $20,000) to Trust. These items are properly included in Trust’s DNI. PRS distributes $10,000 of cash to Trust in 2018.

(ii) Trust’s activities. In addition to its interest in PRS, Trust also operates a family bakery conducted through an LLC wholly-owned by the Trust that is treated as a disregarded entity. In 2018, the bakery produces $100,000 of gross income and $155,000 of expenses directly allocable to operation of the bakery (including W–2 wages of $50,000, rental expense of $75,000, miscellaneous expenses of $25,000, and depreciation deductions of $5,000). (The net loss from the bakery operations is not subject to any loss disallowance provisions outside of section 199A.) Trust maintains a reserve of $5,000 for depreciation. Trust also has $125,000 of UBIA of qualified property in the bakery. For purposes of computing its section 199A deduction, Trust and its beneficiaries have properly chosen to aggregate the family restaurant conducted through PRS with the bakery conducted directly by Trust under § 1.199A–4. Trust also owns various investment assets that produce portfolio-type income consisting of dividends ($25,000), interest ($15,000), and tax-exempt interest ($15,000). Accordingly, Trust has the following items which are properly included in Trust’s DNI:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Income</td>
<td>15,000</td>
</tr>
<tr>
<td>Dividends</td>
<td>25,000</td>
</tr>
<tr>
<td>Tax-exempt interest</td>
<td>15,000</td>
</tr>
<tr>
<td>Net business loss from PRS and bakery</td>
<td>(45,000)</td>
</tr>
<tr>
<td>Trustee commissions</td>
<td>3,000</td>
</tr>
<tr>
<td>State and local taxes</td>
<td>5,000</td>
</tr>
</tbody>
</table>

(iii) **Allocation of deductions under § 1.652(b)–3 (Directly attributable expenses).** In computing Trust’s DNI for the taxable year, the distributive share of expenses of PRS are directly attributable under § 1.652(b)–3(a) to the distributive share of income of PRS. Accordingly, Trust has gross business income of $155,000 ($55,000 from PRS and $100,000 from the bakery) and direct business expenses of $200,000 ($45,000 from PRS and $155,000 from the bakery). In addition, $1,000 of the trustee commissions and $1,000 of state and local taxes are directly attributable under § 1.652(b)–3(a) to Trust’s business income. Accordingly, Trust has excess business deductions of $47,000. Pursuant to its authority recognized under § 1.652(b)–3(d), Trust allocates the $47,000 excess business deductions as follows: $15,000 to the interest income, resulting in $0 interest income, $25,000 to the dividends, resulting in $0 dividend income, and $7,000 to the tax exempt interest.

(iv) **Allocation of deductions under § 1.652(b)–3 (Non-directly attributable expenses).** The trustee must allocate the sum of the balance of the trustee commissions ($2,000) and state and local taxes ($4,000) to Trust’s remaining tax-exempt interest income, resulting in $2,000 of tax exempt interest.

(v) **Amounts included in taxable income.** For 2018, Trust has DNI of $2,000. Pursuant to Trust’s governing instrument, Trustee distributes 50%, or $1,000, of that DNI to A, an individual who is a discretionary beneficiary of Trust. In addition, Trustee is required to distribute 25%, or $500, of that DNI to B, a current income beneficiary of Trust. Trust retains the remaining 25% of DNI. Consequently, with respect to the $1,000 distribution A receives from Trust, A properly excludes $1,000 of tax-exempt interest income under section 662(b). With respect to the $500 distribution B receives from Trust, B properly excludes $500 of tax exempt interest income under section 662(b). Because the DNI consists entirely of tax-exempt income, Trust deducts $0 under section 661 with respect to the distributions to A and B.

(2) **Section 199A deduction—(i) Trust’s W–2 wages and QBI.** For the 2018 taxable year, prior to allocating the beneficiaries’ shares of the section 199A items, Trust has $75,000 ($25,000 from PRS + $50,000 of Trust) of W–2 wages. Trust also has $125,000 of UBIA of qualified property. Trust has negative QBI of ($47,000) ($155,000 gross income from aggregated businesses less the sum of $200,000 direct expenses from aggregated businesses and $2,000 directly attributable business expenses from Trust under the rules of § 1.652(b)–3(a)).

(ii) A’s Section 199A deduction computation. Because the $1,000 Trust distribution to A equals one-half of Trust’s DNI, A has W–2 wages from Trust of $37,500. A also has W–2 wages of $2,500 from a trade or business outside of Trust (computed without regard to A’s interest in Trust), which A has
properly aggregated under § 1.199A–4 with the Trust’s trade or businesses (the family’s restaurant and bakery), for a total of $40,000 of W–2 wages from the aggregate trade or businesses. A also has $62,500 of UBIA from Trust and $25,000 of UBIA of qualified property from the trade or business outside of Trust for $87,500 of total UBIA of qualified property. A has $100,000 of QBI from the non-Trust trade or businesses in which A owns an interest. Because the $1,000 Trust distribution to A equals one-half of Trust’s DNI, A has (negative) QBI from Trust of ($23,500). A’s total QBI is determined by combining the $100,000 QBI from non-Trust sources with the ($23,500) QBI from Trust for a total of $76,500 of QBI. Assume that A’s taxable income is $357,500, which exceeds A’s applicable threshold amount for 2018 by $200,000. A’s tentative deductible amount is $15,300 (20% x $357,500 of taxable income), limited to the greater of (i) $20,000 (50% x $40,000 of W–2 wages), or (ii) $12,187.50 ($10,000, 25% x $40,000 of W–2 wages, plus $2,187.50, 2.5% x $87,500 of UBIA of qualified property). A’s section 199A deduction is equal to the lesser of $15,300, or $71,500 (20% x $357,500 of taxable income). Accordingly, A’s section 199A deduction for 2018 is $15,300.

(ii) B’s Section 199A deduction computation. For 2018, B’s taxable income is below the threshold amount so B is not subject to the W–2 wage limitation. Because the $500 Trust distribution to B equals one-quarter of Trust’s DNI, B has a total of ($11,750) of QBI. B also has no QBI from non-Trust trades or businesses, so B has a total of ($11,750) of QBI. Accordingly, B’s section 199A deduction for 2018 is zero. The ($11,750) of QBI is carried over to 2019 as a loss from a qualified business in the hands of Trust pursuant to section 199A(c)(2).

(B) [Reserved]

(e) Applicability date—(1) General rule. Except as provided in paragraph (e)(2) of this section, the provisions of this section apply to taxable years ending after February 8, 2019.

(2) Exceptions—(i) Anti-abuse rules. The provisions of paragraph (d)(3)(vii) of this section apply to taxable years ending after December 22, 2017.

(ii) Non-calendar year RPE. For purposes of determining QBI, W–2 wages, UBIA of qualified property, and the aggregate amount of qualified REIT dividends and qualified PTP income, if an individual receives any of these items from an RPE with a taxable year that begins before January 1, 2018, and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual’s taxable year in which or with which such RPE taxable year ends.

Par. 9. Section 1.643(f)–1 is added to read as follows:

§ 1.643(f)–1 Treatment of multiple trusts.

(a) General rule. For purposes of subchapter J of chapter 1 of subtitle A of Title 26 of the United States Code, two or more trusts will be aggregated and treated as a single trust if such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and if a principal purpose for establishing one or more of such trusts or for contributing additional cash or other property to such trusts is the avoidance of Federal income tax. For purposes of applying this rule, spouses will be treated as one person.

(b) Applicability date. The provisions of this section apply to taxable years ending after August 16, 2018.

Kirsten Wielobob,  
Deputy Commissioner for Services and Enforcement.  
Approved: December 20, 2018.

David J. Kautter,  
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on February 4, 2019, 4:15 p.m., and published in the issue of the Federal Register for February 8, 2019, 84 F.R. 2952)
Part III. Administrative, Procedural, and Miscellaneous

Section 199A Trade or Business Safe Harbor: Rental Real Estate

Notice 2019–07

SECTION 1. PURPOSE

This notice contains a proposed revenue procedure that provides for a safe harbor under which a rental real estate enterprise will be treated as a trade or business solely for purposes of section 199A of the Internal Revenue Code (Code) and §§ 1.199A–1 through 1.199A–6 of the Income Tax Regulations (Regulations) (26 CFR Part 1), which are being published contemporaneously with this notice. To qualify for treatment as a trade or business under this safe harbor, the rental real estate enterprise must satisfy the requirements of the proposed revenue procedure. If an enterprise fails to satisfy these requirements, the rental real estate enterprise may still be treated as a trade or business for purposes of section 199A if the enterprise otherwise meets the definition of trade or business in § 1.199A–1(b)(14).

SECTION 2. BACKGROUND

Section 199A was enacted on December 22, 2017, as part of the act titled “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. 115–97, and was amended on March 23, 2018, retroactively to January 1, 2018, by the Consolidated Appropriations Act, 2018, Pub. L. No. 115–141. Congress enacted section 199A to provide a deduction to non-corporate taxpayers of up to 20 percent of the taxpayer’s qualified business income from each of the taxpayer’s qualified trades or businesses, including those operated through a partnership, S corporation, or sole proprietorship, as well as a deduction of up to 20 percent of aggregate qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership income.

Section 199A(d) defines a qualified trade or business as any trade or business other than a specified service trade or business (SSTB) or the trade or business of performing services as an employee. Section 1.199A–1(b)(14) defines trade or business, in relevant part, as a trade or business under section 162 other than the trade or business of performing services as an employee.

The Treasury Department and the IRS are aware that whether a rental real estate enterprise is a trade or business is the subject of uncertainty for some taxpayers. To help mitigate this uncertainty, the proposed revenue procedure set forth in section 6 of this notice provides for a safe harbor under which a rental real estate enterprise will be treated as a trade or business solely for purposes of the section 199A deduction.

SECTION 3. REQUEST FOR COMMENTS

The Treasury Department and the IRS request comments on the proposed revenue procedure set forth in section 6 of this notice. Interested parties are invited to submit comments on this notice by April 9, 2019. Taxpayers may submit comments electronically via the Federal eRulemaking Portal at www.regulations.gov (indicate IRS and NOT–133582–18). Alternatively, taxpayers may submit comments to: CC:PA:LPD:PR (Notice 2019–07), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, D.C., 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (Notice 2019–07), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224.

SECTION 4. EFFECTIVE DATE AND IMMEDIATE RELIANCE

The proposed revenue procedure is proposed to apply generally to taxpayers with taxable years ending after December 31, 2017. Until such time that the proposed revenue procedure is published in final form, taxpayers may use the safe harbor described in the proposed revenue procedure for purposes of determining when a rental real estate enterprise may be treated as a trade or business solely for purposes of section 199A.

SECTION 5. DRAFTING INFORMATION

The principal authors of this notice are Robert D. Alinsky, Vishal R. Amin, Margaret Burow, and Frank J. Fisher of the Office of the Associate Chief Counsel (Passthroughs & Special Industries). However, other personnel from the Treasury Department and the IRS participated in its development. For further information regarding this notice, contact Robert D. Alinsky or Margaret Burow at (202) 317–5279 or Vishal R. Amin or Frank J. Fisher at (202) 317–6850 (not a toll-free number).

SECTION 6. FORM OF PROPOSED REVENUE PROCEDURE

Set forth below is the form of the proposed revenue procedure that is proposed in this Notice:

FORM OF PROPOSED REVENUE PROCEDURE

26 CFR 1.199A–1: Trade or Business (Also: § 199A)

Rev. Proc. 2019–XX

SECTION 1. PURPOSE

Section 3 of this revenue procedure provides a safe harbor under which a rental real estate enterprise will be treated as a trade or business for purposes of section 199A of the Internal Revenue Code (Code) and §§ 1.199A–1 through 1.199A–6 of the Income Tax Regulations (26 CFR Part 1). The safe harbor provided by this revenue procedure applies solely for purposes of section 199A. If an enterprise fails to satisfy the requirements of this safe harbor, the rental real estate enterprise may still be treated as a trade or business for purposes of section 199A if the enterprise otherwise meets the definition of trade or business in § 1.199A–1(b)(14).

SECTION 2. BACKGROUND

Section 199A was enacted on December 22, 2017, as part of the act entitled “An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year
from otherwise establishing that a rental real estate enterprise is a trade or business for purposes of section 199A.

.02 Rental real estate enterprise. Solely for purposes of this safe harbor, a rental real estate enterprise is defined as an interest in real property held for the production of rents and may consist of an interest in multiple properties. The individual or RPE relying on this revenue procedure must hold the interest directly or through an entity disregarded as an entity separate from its owner under § 301.7701–3. Taxpayers must either treat each property held for the production of rents as a separate enterprise or treat all similar properties held for the production of rents (with the exception of those described in paragraph .05 of this section) as a single enterprise. Commercial and residential real estate may not be part of the same enterprise. Taxpayers may not vary this treatment from year-to-year unless there has been a significant change in facts and circumstances.

.03 Safe harbor. Solely for the purposes of section 199A, a rental real estate enterprise will be treated as a trade or business if the following requirements are satisfied during the taxable year with respect to the rental real estate enterprise:

(A) Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise;

(B) For taxable years beginning prior to January 1, 2023, 250 or more hours of rental services are performed (as described in this revenue procedure) per year with respect to the rental enterprise. For taxable years beginning after December 31, 2022, in any three of the five consecutive taxable years that end with the taxable year (or in each year for an enterprise held for less than five years), 250 or more hours of rental services are performed (as described in this revenue procedure) per year with respect to the rental real estate enterprise; and

(C) The taxpayer maintains contemporaneous records, including time reports, logs, or similar documents, regarding the following: (i) hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services. Such records are to be made available for inspection at the request of the IRS. The contemporaneous records requirement will not apply to taxable years beginning prior to January 1, 2019.

.04 Rental services. Rental services for purposes of this revenue procedure include: (i) advertising to rent or lease the real estate; (ii) negotiating and executing leases; (iii) verifying information contained in prospective tenant applications; (iv) collection of rent; (v) daily operation, maintenance, and repair of the property; (vi) management of the real estate; (vii) purchase of materials; and (viii) supervision of employees and independent contractors. Rental services may be performed by owners or by employees, agents, and/or independent contractors of the owners. The term rental services does not include financial or investment management activities, such as arranging financing; procuring property; studying and reviewing financial statements or reports on operations; planning, managing, or constructing long-term capital improvements; or hours spent traveling to and from the real estate.

.05 Certain rental real estate arrangements excluded. Real estate used by the taxpayer (including an owner or beneficiary of an RPE relying on this safe harbor) as a residence for any part of the year under section 280A is not eligible for this safe harbor. Real estate rented or leased under a triple net lease is also not eligible for this safe harbor. For purposes of this revenue procedure, a triple net lease includes a lease agreement that requires the tenant or lessee to pay taxes, fees, and insurance, and to be responsible for maintenance activities for a property in addition to rent and utilities. This includes a lease agreement that requires the tenant or lessee to pay a portion of the taxes, fees, and insurance, and to be responsible for maintenance activities allocable to the portion of the property rented by the tenant.

.06 Procedural requirements for application of safe harbor. A taxpayer or RPE must include a statement attached to the return on which it claims the section 199A
This revenue procedure applies to taxable years ending after December 31, 2017. Until such time that the proposed revenue procedure is published in final form, taxpayers may use the safe harbor described in this proposed revenue procedure for determining when a rental real estate enterprise may be treated as a trade or business solely for purposes of section 199A.

SECTION 5. DRAFTING INFORMATION

The principal authors of this revenue procedure are Robert D. Alinsky, Vishal R. Amin, Margaret Burow, and Frank J. Fisher of the Office of the Associate Chief Counsel (Passthroughs & Special Industries). However, other personnel from the Treasury Department and the IRS participated in its development. For further information regarding this revenue procedure contact Robert D. Alinsky or Margaret Burow at (202) 317-5279 or Vishal R. Amin or Frank J. Fisher at (202) 317-6850 (not a toll-free number).

26 CFR 1.199A–2: Determination of W–2 Wages (Also: § 199A)


SECTION 1. PURPOSE

This revenue procedure provides methods for calculating W–2 wages, as defined in section 199A(b)(4) and § 1.199A–2 of the Income Tax Regulations, (1) for purposes of section 199A(b)(2) of the Internal Revenue Code (Code) which, for certain taxpayers, provides a limitation based on W–2 wages to the amount of the deduction for qualified business income (QBI); and (2) for purposes of section 199A(b)(7), which, for certain specified agricultural and horticultural cooperative patrons, provides a reduction to the section 199A deduction based on W–2 wages.

SECTION 2. BACKGROUND

For taxpayers above a certain amount of taxable income, section 199A(b)(2) limits the amount of a taxpayer’s section 199A deduction for each qualified trade or business to the lesser of (1) 20 percent of the taxpayer’s QBI with respect to the qualified trade or business, or (2) the greater of (A) 50 percent of the W–2 wages with respect to the qualified trade or business, or (B) the sum of 25 percent of the W–2 wages with respect to the qualified trade or business plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property. Section 199A(b)(7) provides that in the case of any qualified trade or business of a patron of a specified agricultural or horticultural cooperative, the amount determined under section 199A(b)(2) with respect to such trade or business shall be reduced by the lesser of (A) 9 percent of so much of the qualified business income with respect to such trade or business as is properly allocable to qualified payments received from such cooperative, or (B) 50 percent of so much of the W–2 wages with respect to such trade or business as are so allocable.

Section 199A(b)(4)(A) defines the term “W–2 wages” to mean, with respect to any person for any taxable year of such person, the amounts described in section 6051(a)(3) and (8) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year. Section 199A(b)(4)(B) provides that W–2 wages does not include any amount which is not properly allocable to qualified business income for purposes of section 199A(c)(1). Section 199A(b)(4)(C) provides that W–2 wages shall not include any amount that is not properly included in a return filed with the Social Security Administration (SSA) on or before the 60th day after the due date (including extensions) for such return.

Section 1.199A–2(b)(2)(iv)(A) of the regulations provides the Internal Revenue Service with authority to issue guidance providing the methods that may be used to calculate W–2 wages.

This revenue procedure provides three methods for calculating W–2 wages, as defined in section 199A(b)(4) and § 1.199A–2, for purposes of section 199A(b) and the regulations thereunder. The first method (the unmodified Box method) allows for a simplified calculation while the second and third methods (the modified Box 1 method and the tracking wages method) provide greater accuracy.

W–2 wages calculated under this revenue procedure are not necessarily the W–2 wages that are properly allocable to QBI and eligible for use in computing the section 199A limitations. As mentioned above, only W–2 wages that are properly allocable to QBI may be taken into account in computing the section 199A(b)(2) W–2 wage limitations. Thus, after computing W–2 wages under this revenue procedure, under § 1.199A–2(b)(3), the taxpayer must determine the extent to which the W–2 wages are properly allocable to QBI. Then, the properly allocable W–2 wages amount is used in determining the W–2 wage limitations under section 199A(b)(2) for such trade or business as well as any reduction for income received from cooperatives under section 199A(b)(7).

SECTION 3. RULES FOR APPLICATION

.01 In general. In calculating W–2 wages for a taxable year under the methods described in this revenue procedure, include only wages properly reported on Forms W–2 that meet the applicable rules of § 1.199A–2(b). Specifically, § 1.199A–2(b)(2)(i) provides that, except as provided in § 1.199A–2(b)(2)(iv)(C)(2) (concerning short taxable years that do not include December 31) and § 1.199A–2(b)(2)(iv)(D) (concerning remuneration for services performed in the Commonwealth of Puerto Rico), the Forms W–2, “Wage and Tax Statement,” or any subsequent form or document used in determining the amount of W–2 wages are those that are issued for the calendar year end-
ing during the person’s taxable year for wages paid to employees (or former employees) of the person for employment by the person. Section 1.199A–2(b)(2)(i) also provides that, for purposes of § 1.199A–2, employees of the person are limited to employees of the person as defined in section 3121(d)(1) and (2) (that is, officers of a corporation and employees of the person under the common law rules). Therefore, Forms W–2 provided to statutory employees described in section 3121(d)(3) (that is, Forms W–2 in which the “Statutory Employee” box in Box 13 is checked) should not be included in calculating W–2 wages under any of the methods described in this revenue procedure.

.02 No application in determining whether amounts are wages for employment tax purposes. The discussions of “wages” in this revenue procedure and in the regulations under section 199A are for purposes of section 199A only and have no application in determining whether amounts are wages under section 3121(a) for purposes of the Federal Insurance Contributions Act, under section 3306(b) for purposes of the Federal Unemployment Tax Act, or under section 3401(a) for purposes of the Collection of Income Tax at Source on Wages (federal income tax withholding), or any other wage-related determination. See § 1.199A–2 of the regulations.

SECTION 4. DEFINITION OF W–2 WAGES AND CORRELATION WITH BOXES ON FORM W–2

.01 Definition of W–2 wages. Section 199A(b)(4)(A) provides that W–2 wages means, with respect to any person for any taxable year of such person, the sum of the amounts described in section 6051(a)(3) and (8) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year. Thus, W–2 wages include: (i) the total amount of wages as defined in section 3401(a); (ii) the total amount of elective deferrals (within the meaning of section 402(g)(3)); (iii) the compensation deferred under section 457; and (iv) the amount of designated Roth contributions (as defined in section 402A).

.02 Correlation with Form W–2. Under the 2018 Forms W–2, the elective deferrals under section 402(g)(3) and the amounts deferred under section 457 directly correlate to coded items reported in Box 12 on Form W–2. Box 12, Code D is for elective deferrals to a section 401(k) cash or deferred arrangement plan (including a SIMPLE 401(k) arrangement); Box 12, Code E is for elective deferrals under a section 403(b) salary reduction agreement; Box 12, Code F is for elective deferrals under a section 408(k)(6) salary reduction Simplified Employee Pension (SEP); Box 12, Code G is for elective deferrals and employer contributions (including nonelective deferrals) to any governmental or nongovernmental section 457(b) deferred compensation plan; Box 12, Code S is for employee salary reduction contributions under a section 408(p) SIMPLE (simple retirement account); Box 12, Code AA is for designated Roth contributions (as defined in section 402A) under a section 401(k) plan; and Box 12, Code BB is for designated Roth contributions (as defined in section 402A) under a section 403(b) salary reduction agreement. However, designated Roth contributions are also reported in Box 1, Wages, tips, other compensation, and are subject to income tax withholding.

SECTION 5. METHODS FOR CALCULATING W–2 WAGES

For any taxable year, a taxpayer must calculate W–2 wages for purposes of section 199A(b)(2) using one of the three methods described in sections 5.01, 5.02, and 5.03 of this revenue procedure. For a taxpayer with a short taxable year, see section 6 of this revenue procedure. In calculating W–2 wages for a taxable year under the methods below, the taxpayer includes only those Forms W–2 that are for the calendar year ending with or within the taxable year of the taxpayer and that meet the rules of application described in section 3 of this revenue procedure.

.01 Unmodified box method. Under the unmodified box method, W–2 wages are calculated by taking, without modification, the lesser of—

(A) The total entries in Box 1 of all Forms W–2 filed with SSA by the taxpayer with respect to employees of the taxpayer for employment by the taxpayer; or

(B) The total entries in Box 5 of all Forms W–2 filed with SSA by the taxpayer with respect to employees of the taxpayer for employment by the taxpayer.

.02 Modified Box 1 method. Under the Modified Box 1 method, the taxpayer makes modifications to the total entries in Box 1 of Forms W–2 filed with respect to employees of the taxpayer. W–2 wages under this method are calculated as follows—

(A) Total the amounts in Box 1 of all Forms W–2 filed with SSA by the taxpayer with respect to employees of the taxpayer for employment by the taxpayer;

(B) Subtract from the total in paragraph .02(A) of this section amounts included in Box 1 of Forms W–2 that are not wages for Federal income tax withholding purposes, including amounts that are treated as wages for purposes of income tax withholding under section 3402(o) (for example, supplemental unemployment compensation benefits within the meaning of Rev. Rul. 90–72); and

(C) Add to the amount obtained after paragraph .02(B) of this section the total of the amounts that are reported in Box 12 of Forms W–2 with respect to employees of the taxpayer for employment by the taxpayer and that are properly coded D, E, F, G, and S.

.03 Tracking wages method. Under the tracking wages method, the taxpayer actually tracks total wages subject to federal income tax withholding and makes appropriate modifications. W–2 wages under this method are calculated as follows—

(A) Total the amounts of wages subject to federal income tax withholding that are paid to employees of the taxpayer for employment by the taxpayer and that are reported on Forms W–2 filed with SSA by the taxpayer for the calendar year; plus

(B) The total of the amounts that are reported in Box 12 of Forms W–2 with respect to employees of the taxpayer for employment by the taxpayer and that are properly coded D, E, F, G, and S.

SECTION 6. APPLICATION IN CASE OF SHORT TAXABLE YEAR

.01 Special rule for taxpayers with a short taxable year. In the case of a tax-
pays a short taxable year, subject to the rules of application described in section 3 of this revenue procedure, the W–2 wages of the taxpayer for the short taxable year shall include only those wages paid during the short taxable year to employees of the taxpayer, only those elective deferrals (within the meaning of section 402(g)(3)) made during the short taxable year by employees of the taxpayer, and only compensation actually deferred under section 457 during the short taxable year with respect to employees of the taxpayer. See § 1.199A–2(b)(2)(iv)(C) of the regulations.

.02 Method required for a short taxable year and modifications required in application of method. The W–2 wages of a taxpayer with a short taxable year shall be determined under the tracking wages method described in section 5.03 of this revenue procedure. In applying the tracking wages method in the case of a short taxable year, the taxpayer must apply the method as follows—

(A) For purposes of section 5.03(A), the total amount of wages subject to federal income tax withholding and reported on Form W–2 must include only those wages subject to federal income tax withholding that are actually or constructively paid to employees during the short taxable year and reported on Form W–2 for the calendar year ending with or within that short taxable year (or, for a short taxable year that does not contain a calendar year ending with or within such short taxable year, wages subject to federal income tax withholding that are actually or constructively paid to employees during the short taxable year and reported on Form W–2 for the calendar year containing such short taxable year); and

(B) For purposes of section 5.03(B), only the portion of the total amounts reported in Box 12, Codes D, E, F, G, and S on Forms W–2, that are actually deferred or contributed during the short taxable year are included in W–2 wages.

SECTION 7. EFFECTIVE DATE

This revenue procedure applies to taxable years ending after December 31, 2017.
passenger automobile is subject to the limitations of § 280F(a) in the same manner as if it were a depreciation deduction allowable under § 168.

.07 Section 280F(d)(7) provides that the limitations of § 280F(a) will be adjusted for inflation for any passenger automobile placed in service by the taxpayer after 2018.

SECTION 3. SCOPE AND DEFINITIONS

.01 Scope. This revenue procedure applies to a passenger automobile (other than a leased passenger automobile):

(1) That is acquired and placed in service by the taxpayer after September 27, 2017;

(2) That is qualified property under § 168(k) for which the 100-percent additional first year depreciation deduction is allowable;

(3) That has an unadjusted depreciable basis, as defined in section 3.02(5) of this revenue procedure, exceeding the first year limitation amount under § 280F(a)(1)(A)(i); and

(4) For which the taxpayer did not elect to treat the cost or a portion of the cost as an expense under § 179.

.02 Definitions. Solely for purposes of this revenue procedure, the following definitions apply:

(1) Adjusted depreciable basis is the unadjusted depreciable basis, as defined in section 3.02(5) of this revenue procedure, of the passenger automobile reduced by the depreciation deductions allowable under the safe harbor method of accounting provided in section 4.03 of this revenue procedure.

(2) Applicable optional depreciation table is based on the depreciation system, depreciation method, recovery period, and convention applicable to the passenger automobile for its placed-in-service year, as provided in section 8 of Rev. Proc. 87–57, 1987–2 C.B. 687, 693. See Appendix A in IRS Publication 946 for the applicable optional depreciation tables.

(3) Passenger automobile is defined in § 280F(d)(5).

(4) Remaining adjusted depreciable basis is the unadjusted depreciable basis, as defined in section 3.02(5) of this revenue procedure, of the passenger automobile reduced by the first year limitation amount allowable under section 4.03(2) of this revenue procedure.

(5) Unadjusted depreciable basis is defined in § 1.168(b)–1(a)(3) of the Income Tax Regulations, except that there is no reduction by reason of an election to expense any portion of the basis under § 179.

(6) Unrecovered basis is defined in § 280F(d)(8).

SECTION 4. SAFE HARBOR FOR SECTION 280F(a) LIMITATIONS ON PASSENGER AUTOMOBILES

.01 In general. If the unadjusted depreciable basis of a passenger automobile for which the 100-percent additional first year depreciation deduction is allowable exceeds the first year limitation amount under § 280F(a)(1)(A)(i), the excess amount is the unrecovered basis of the passenger automobile for purposes of § 280F(a)(1)(B)(i) and, therefore, is treated as a deductible expense in the first taxable year succeeding the end of the recovery period subject to the limitation under § 280F(a)(1)(B)(ii). For example, if a calendar-year taxpayer places in service in December 2018 a passenger automobile that costs $50,000 and is qualified property for which the 100-percent additional first year depreciation deduction is allowable, the 100-percent additional first year depreciation deduction and any § 179 deduction for this property is limited to $18,000 under § 280F(a)(1)(A)(i) (see Table 2 of Rev. Proc. 2018–25 for the first year limitation amount under § 280F(a)(1)(A)(i) for a passenger automobile placed in service in calendar year 2018 for which the 100-percent additional first year depreciation deduction is allowable. For a passenger automobile placed in service after 2018, further guidance will be issued to provide the limitation amounts under § 280F(a)(1) for the applicable placed-in-service year.

(3) For the 12-month taxable year subsequent to the placed-in-service year and for each succeeding 12-month taxable year in the recovery period, the taxpayer determines the depreciation deduction for the passenger automobile by multiplying the remaining adjusted depreciable basis of the passenger automobile by the annual depreciation rate for each taxable year subsequent to the placed-in-service year specified in the applicable optional depreciation table, subject to the limitation amounts under § 280F(a)(1)(A).

(4) The adjusted depreciable basis of the passenger automobile as of the beginning of the first taxable year succeeding the end of the recovery period is treated as a deductible depreciation expense for the first taxable year succeeding the end of the recovery period, subject to the limitation under § 280F(a)(1)(B)(ii). Any excess is treated as a deductible depreciation expense for the succeeding taxable years, subject to the limitation under § 280F(a)(1)(B)(ii); and
(5) If § 280F(b) applies to the passenger automobile in a taxable year subsequent to the placed-in-service year, the safe harbor method of accounting ceases to apply beginning for the first year in which § 280F(b) applies. Any passenger automobile that is not predominantly used in a qualified business use, as defined in § 280F(d)(6)(B) and (C), for any taxable year is subject to § 280F(b) for such taxable year and any subsequent taxable year.

.04 Examples. The following examples illustrate the application of the safe harbor method of accounting.

(1) Example 1 — Application of § 280F(a) safe harbor method of accounting. In 2018, X, a calendar-year taxpayer, purchased and placed in service for use in its business a new passenger automobile that costs $60,000. The passenger automobile is 5-year property under § 168(e), is qualified property under § 168(k), for which the 100-percent additional first year depreciation deduction is allowable, and is used 100 percent in X’s trade or business. X does not claim a § 179 deduction for the passenger automobile and does not make an election under § 168(b), (g)(7), or (k). X depreciates the passenger automobile under the general depreciation system by using the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. X adopts the safe harbor method of accounting provided in section 4.03 of this revenue procedure. As a result:

(a) X must use the applicable optional depreciation table that corresponds with the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention, for determining the depreciation deductions for the passenger automobile (see Table A–1 in Appendix A of IRS Publication 946);

(b) For 2018, X deducts depreciation of $18,000 for the passenger automobile, which is the depreciation limitation for 2018 under § 280F(a)(1)(A)(i) (see Table 2 in Rev. Proc. 2018–25). As a result, the remaining adjusted depreciable basis of the passenger automobile as of January 1, 2019, is $42,000 ($60,000 unadjusted depreciable basis less $18,000 depreciation deduction claimed for 2018);

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<tr>
<th>Taxable year</th>
<th>Depreciation limitations under Table 2 of Rev. Proc. 2018–25</th>
<th>Depreciation deduction under the safe harbor</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018</td>
<td>$18,000</td>
<td>$18,000</td>
</tr>
<tr>
<td>2019</td>
<td>$16,000</td>
<td>$13,440 ($42,000 x .32)</td>
</tr>
<tr>
<td>2020</td>
<td>$9,600</td>
<td>$8,064 ($42,000 x .1920)</td>
</tr>
<tr>
<td>2021</td>
<td>$5,760</td>
<td>$4,838 ($42,000 x .1152)</td>
</tr>
<tr>
<td>2022</td>
<td>$5,760</td>
<td>$4,838 ($42,000 x .1152)</td>
</tr>
<tr>
<td>2023</td>
<td>$5,760</td>
<td>$2,419 ($42,000 x .0576)</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$51,599</td>
<td></td>
</tr>
</tbody>
</table>

(d) As of January 1, 2024 (the beginning of the first taxable year succeeding the end of the recovery period), the adjusted depreciable basis of the passenger automobile is $8,401 ($60,000 unadjusted depreciable basis less the total depreciation allowable of $51,599 for 2018–2023 (see above table)). Accordingly, for the 2024 taxable year, X deducts depreciation of $5,760 for the passenger automobile (the lesser of the adjusted depreciable basis of $8,401 as of January 1, 2024, or the § 280F(a)(1)(B)(ii) limitation of $5,760).

(e) As of January 1, 2025, the adjusted depreciable basis of the passenger automobile is $2,641 ($8,401 adjusted depreciable basis as of January 1, 2024, less the depreciation claimed of $5,760 for 2024). Accordingly, for the 2025 taxable year, X deducts depreciation of $2,641 for the passenger automobile (the lesser of the adjusted depreciable basis of $2,641 as of January 1, 2025, or the § 280F(a)(1)(B)(ii) limitation of $5,760).

(2) Example 2 — Section 179 deduction claimed. The facts are the same as in Example 1, except X elects to treat $18,000 of the cost of the passenger automobile as an expense under § 179. As a result, this passenger automobile is not within the scope of this revenue procedure pursuant to section 3.01(4) of this revenue procedure. Accordingly, the safe harbor method of accounting in section 4.03 of this revenue procedure does not apply to the passenger automobile. For 2018, the 100-percent additional first year depreciation deduction and the § 179 deduction for this passenger automobile is limited to $18,000 under § 280F(a)(1)(A)(i) (see Table 2 of Rev. Proc. 2018–25). Therefore, for 2018, X deducts $18,000 for the passenger automobile under § 179, and X deducts the excess amount of $42,000 beginning in 2024, subject to the annual limit of $5,760 under § 280F(a)(1)(B)(ii).

(3) Example 3 — Section 168(k)(7) election made. The facts are the same as in Example 1, except X makes an election under § 168(k)(7) to not claim the 100-percent additional first year depreciation deduction for 5-year property placed in service during 2018. As a result, the 100-percent additional first year depreciation deduction is not allowable for the passenger automobile. Accordingly, the passenger automobile is not within the scope of this revenue procedure pursuant to section 3.01(2) of this revenue procedure, and the safe harbor method of accounting in section 4.03 of this revenue procedure does not apply to the passenger automobile. For 2018 and subsequent taxable years, X determines the depreciation deductions for the passenger automobile in accordance with the general depreciation system of § 168(a), subject to the § 280F(a) limitations.

(c) For 2019 through 2023, the total depreciation allowable for the passenger automobile for each taxable year is determined by multiplying the annual depreciation rate in the applicable optional depreciation table by the remaining adjusted depreciable basis of $42,000, subject to the limitation under § 280F(a)(1)(A) for that year. Accordingly, for 2019, the total depreciation allowable for the passenger automobile is $13,440 (32 percent multiplied by the remaining adjusted depreciable basis of $42,000). Because this amount is less than the depreciation limitation of $16,000 for 2019 (see Table 2 in Rev. Proc. 2018–25), X deducts $13,440 as depreciation on its federal income tax return for the 2019 taxable year. For 2020, the total depreciation allowable for the passenger automobile is $8,064 (19.20 percent multiplied by $42,000). Because this amount is less than the depreciation limitation of $9,600 for 2020 (see Table 2 in Rev. Proc. 2018–25), X deducts $8,064 as depreciation on its federal income tax return for the 2020 taxable year. Below is a table showing the depreciation allowable for the passenger automobile under the safe harbor method of accounting for the 2018 through 2023 taxable years. X deducts these amounts.

SECTION 7. DRAFTING INFORMATION

The principal author of this revenue procedure is Jaime C. Park of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue procedure contact Ms. Park on (202) 317-7005 (not a toll free number).
Part IV. Items of General Interest

Qualified Business Income Deduction

REG–134652–18

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations concerning the deduction for qualified business income under section 199A of the Internal Revenue Code (Code). The proposed regulations will affect certain individuals, partnerships, S corporations, trusts, and estates. The proposed regulations provide guidance on the treatment of previously suspended losses that constitute qualified business income. The proposed regulations also provide guidance on the determination of the section 199A deduction for taxpayers that hold interests in regulated investment companies, charitable remainder trusts, and split-interest trusts.

DATES: Written or electronic comments and requests for a public hearing must be received by April 9, 2019.

ADDRESSES: Submit electronic submissions to the Federal eRulemaking Portal at www.regulations.gov (indicate IRS and REG–134652–18) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comment received to its public docket, whether submitted electronically or in hard copy. Send hard copy submissions to CC:PA:LDP:PR (REG–134652–18), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, D.C., 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LDP:PR (REG–134652–18), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C., 20224.

FOR FURTHER INFORMATION CONTACT: Concerning § 1.199A–3(d), Michael Y. Chin or Steven Harrison at (202) 317-6842; concerning §§ 1.199A–3(b) and 1.199A–6, Vishal R. Amin or Frank J. Fisher at (202) 317-6850 or Robert D. Alinsky or Margaret Burow at 202-317-5279; concerning submissions of comments or requests for a public hearing, Regina Johnson at (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under section 199A of the Code.


Section 199A provides a deduction of up to 20 percent of qualified business income from a U.S. trade or business operated as a sole proprietorship or through a partnership, S corporation, trust, or estate (section 199A deduction). The section 199A deduction may be taken by individuals and by some estates and trusts. A section 199A deduction is not available for wage income or for income earned through partnerships, S corporations, trusts, and estates. This component of the section 199A deduction is not limited by W–2 wages or UBIA of qualified property.

The section 199A deduction is the lesser of (1) the sum of the combined amounts described in the prior two paragraphs or (2) an amount equal to 20 percent of the excess (if any) of taxable income of the taxpayer for the taxable year over the net capital gain of the taxpayer for the taxable year.

Additionally, section 199A(g) provides that specified agricultural or horticultural cooperatives may claim a special entity-level deduction that is substantially similar to the domestic production activities deduction under former section 199.

The statute expressly grants the Secretary authority to prescribe such regulations as are necessary to carry out the purposes of the section 199A deduction. The Secretary of the Treasury is given the authority to prescribe such regulations as are necessary to carry out the purposes of section 199A (section 199A(f)(4)), and also provides specific grants of authority with respect to certain issues: the treatment of acquisitions, dispositions, and short-tax years (section 199A(h)(5)); certain payments to partners for services rendered in a non-partner capacity (section 199A(c)(4)(C)); the allocation of W–2 wages and UBIA of qualified property (section 199A(f)(1)(A)(iii)); restricting the allocation of items and wages under section 199A and such reporting requirements as the Secretary determines appropriate (section 199A(f)(4)(A)); the application of section 199A in the case of tiered entities (section 199A(f)(4)(B)); preventing the manipulation of the depreciable period of qualified property using transactions between related parties (section 199A(h)(1)); and determining the UBIA of qualified property acquired in like-kind exchanges or involuntary conversions (section 199A(h)(2)).

Section 199A also allows individuals and some trusts and estates (but not corporations) a deduction of up to 20 percent of their combined qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership (PTP) income, including qualified REIT dividends and qualified PTP income earned through passthrough entities. This component of the section 199A deduction is not limited by W–2 wages or UBIA of qualified property.
The Treasury Department and the Internal Revenue Service published proposed regulations interpreting section 199A on August 16, 2018 (the August Proposed Regulations) (83 FR 40884). The August Proposed Regulations contain six substantive sections, §§ 1.199A–1 through 1.199A–6, each of which provides rules relevant to the calculation of the section 199A deduction. The August Proposed Regulations, with modifications in response to comments and testimony received, were adopted as final regulations in TD 9847, issued concurrently with this notice of proposed rulemaking and published elsewhere in this issue of the Federal Register.

**Explanation of Provisions**

These proposed regulations propose rules addressing issues not addressed in the August Proposed Regulations that are necessary to provide taxpayers with computational, definitional, and anti-avoidance guidance regarding the application of section 199A. Specifically, these proposed regulations contain amendments to two substantive sections of the August Proposed Regulations, §§ 1.199A–3 and 1.199A–6, each of which provides rules relevant to the calculation of the section 199A deduction. These additional proposed rules respond to comments received on the August Proposed Regulations as well as address certain issues identified after additional study. This Explanation of Provisions describes each of the proposed rules contained in this document in turn. The Treasury Department and the IRS request comments on all aspects of these proposed regulations.

I. **Treatment of Previously Suspended Losses That Constitute QBI**

Section 1.199A–3(b)(1)(iv) of the final regulations provides that previously disallowed losses or deductions (including under sections 465, 469, 704(d), and 1366(d)) allowed in the taxable year are generally taken into account for purposes of computing QBI except to the extent the losses or deductions were disallowed, suspended, limited, or carried over from taxable years ending before January 1, 2018. The final regulations also provide a first-in-first-out ordering rule. One commenter on the August Proposed Regulations suggested that a special rule should be provided to identify the section 469 trade or business losses that are used to offset income if the taxpayer’s section 469 groupings differ from the taxpayer’s section 199A aggregations. The commenter recommended that any section 469 loss carryforward that is later used should be allocated across the taxpayer’s section 199A aggregations based on income with respect to such aggregations in the year the loss was generated.

The Treasury Department and the IRS believe that previously disallowed losses should be treated as losses from a separate trade or business for both the reasons stated by the commenter and because the losses may relate to a trade or business that is no longer in existence. Accordingly, these proposed regulations amend § 1.199A–3(b)(1)(iv) to provide that such losses are treated as loss from a separate trade or business. To the extent that losses relate to a PTP, they must be treated as losses from a separate PTP. Section 1.199A–3(b)(1)(iv)(B) provides that attributes of the disallowed loss are determined in the year the loss is incurred.

II. **Regulated Investment Companies with Interests in REITs and PTPs**

A. **REITs**

Section 1.199A–3 restates the definitions in section 199A(c) and provides additional guidance on the determination of QBI, qualified REIT dividends, and qualified PTP income. For simplicity, the regulations use the term individual when referring to an individual, trust, estate, or other person eligible to claim the section 199A deduction. See § 1.199A–1(a)(2). The term relevant passthrough entity (RPE) is used to describe passthrough entities that directly operate the trade or business or pass through the trade or business’ items of income, gain, loss, or deduction from lower-tier RPEs to the individual. See § 1.199A–1(b)(10).

A number of commenters on the August Proposed Regulations requested guidance that would allow a shareholder in a regulated investment company within the meaning of section 851(a) (RIC) to take a section 199A deduction with respect to certain income of, or distributions from, the RIC. Because a RIC is a subchapter C corporation, a shareholder in a RIC generally does not take into account a share of the RIC’s items of income, deduction, gain, or loss. Part 1 of subchapter M, however, has features that allow the tax consequences of investing in a RIC to approximate those of a direct investment in the assets of the RIC. The principal feature is the allowance of the deduction for dividends paid under section 852(b)(2)(D). If a corporation qualifies as a RIC under section 851 and meets the distribution requirements and other requirements in section 852(a), the RIC’s income tax is computed on its investment company taxable income (ICTI), which is its taxable income with certain adjustments, including the allowance of the deduction for dividends paid. See section 852(b)(2). ICTI also excludes the amount of the RIC’s net capital gain, but tax is separately imposed on that amount to the extent it exceeds the deduction for dividends paid, taking into account only capital gain dividends. See section 852(b)(3)(A). The deduction for dividends paid allows RICs to eliminate all or most of their corporate income tax liability.

If a RIC has certain items of income or gain, subchapter M also provides rules under which a RIC may pay dividends that a shareholder in the RIC may treat in the same manner (or a similar manner) as the shareholder would treat the underlying item of income or gain if the shareholder realized it directly. Although this treatment differs fundamentally from the pass-through treatment of partners or trust beneficiaries, this preamble refers to it as “conduit treatment.” For example, under section 852(b)(3), a RIC that has net capital gain for a taxable year generally may pay capital gain dividends, and shareholders receiving the capital gain dividends treat them as gain from the sale or exchange of a capital asset held for more than one year. Section 852(b)(3) provides necessary limits and procedures that apply to capital gain dividends. There are similar statutory provisions for exempt-interest dividends under section 852(b)(5), interest-related dividends under section 871(k)(1), short-term capital gain dividends under section 871(k)(2), dividends eligible for the dividends received deduction under section 854(b)(1)(A), and qualified dividend income under section 854(b)(1)(B). Rules for paying dividends corresponding to

Investing in RICs enables small investors to gain benefits, such as professional management and broad diversification, that otherwise would be available only to investors with more resources. The House Report for the enactment of the Internal Revenue Code of 1954 explained that the RIC regime “permits investors to pool their funds through the use of a corporation in order to obtain skilled, diversified investment in corporate securities without having to pay an additional layer of corporate tax.” H.R. Rep. No. 83–1337, p. 73 (1954). The ability to elect to be taxed as a RIC is available typically only to domestic corporations that, at all times during the taxable year, are registered under the Investment Company Act of 1940, as amended (15 U.S.C. 80a–1 to 80b–2). See section 851(a)(1)(A).

Section 199A(f)(4) directs the Secretary to prescribe such regulations as are necessary to carry out the purposes of section 199A, including regulations for its application in the case of tiered entities. The Treasury Department and the IRS have determined that it is consistent with the grant of authority under section 199A and the purposes of part 1 of subchapter M of chapter 1 of the Code to provide for conduit treatment of qualified REIT dividends. The Treasury Department and the IRS continue to consider whether it is appropriate to provide for conduit treatment of qualified PTP income.

These proposed regulations provide rules under which a RIC that receives qualified REIT dividends may pay section 199A dividends. Non-corporate shareholders receiving section 199A dividends would treat them as qualified REIT dividends under section 199A(e)(3), provided the shareholder meets the holding period requirements for its shares in the RIC. The rules under which a RIC would compute and report section 199A dividends are based on the rules for capital gain dividends in section 852(b)(3) and exempt-interest dividends in section 852(b)(5). The amount of a RIC’s section 199A dividends for a taxable year would be limited to the excess of the RIC’s qualified REIT dividends for the taxable year over allocable expenses. Section 199A dividends generally are also subject to the principles that apply to other RIC dividends. See, e.g., Rev. Rul. 2005–31, 2005–1 C.B. 1084; Rev. Rul. 89–81, 1989–1 C.B. 226.

B. PTPs

One of the commenters recommending that the regulations permit conduit treatment for qualified REIT dividends received by a RIC also recommended that the regulations permit conduit treatment for qualified PTP income received by a RIC. In response to this comment, the Treasury Department and the IRS have given significant consideration to including in this notice of proposed rulemaking regulations that would provide conduit treatment for qualified PTP income. However, unlike conduit treatment for qualified REIT dividends received by a RIC, conduit treatment of qualified PTP income received by a RIC presents several novel issues. The commenter recommending this conduit treatment did not address these issues or make any suggestions as to how they should be resolved. The need to resolve these issues in a way that would afford RIC shareholders treatment that is similar to the treatment they would receive if they held the PTP interests directly while preserving the relative simplicity of the tax treatment of RIC investors has prevented the Treasury Department and the IRS from crafting and including appropriate rules in these proposed regulations. As noted later in this part of the Explanation of Provisions, the Treasury Department and the IRS continue to consider permitting conduit treatment for qualified PTP income received by a RIC to further the purposes of section 199A(b)(1)(B) and seek public comment to assist in resolving these novel issues with a view to developing regulations permitting conduit treatment for qualified PTP income.

These issues arise in part from the fact that income attributable to a specified service trade or business within the meaning of section 199A(d)(2) (SSTB) of a PTP may be qualified PTP income for taxpayers with taxable income below the threshold amount, but not for taxpayers with taxable income above the top of the phase-out range. For taxpayers with taxable income in the phase-out range, a portion of PTP income attributable to an SSTB is qualified PTP income. There is no precedent for providing conduit treatment for a RIC (or any other C corporation) with respect to income of a PTP or other partnership taxed in this manner, and the complexity and potential confusion such treatment might create for RIC investors is arguably inconsistent with the relative simplicity that the tax system has historically provided for RIC investors. This is particularly true given the limitation on the portion of a RIC’s assets that can be invested in qualified PTPs as defined in section 851(h) (the type of PTP likely to be engaged in a trade or business) and the limited portion of the RIC’s dividends that would likely be attributable to income from such PTPs.

Another novel issue is presented by the rules relating to the treatment of losses for purposes of section 199A. First, a PTP may not net losses from an SSTB against income from a non-SSTB, and vice versa, in determining the amounts that it reports to its partners. Thus, PTPs are required to separately calculate income and deductions from SSTBs and non-SSTBs and report that information to their partners. Second, if a taxpayer has a net loss from an SSTB or a non-SSTB that is allowed in determining taxable income for a taxable year, that loss may be required to be carried over to the subsequent year for section 199A attribute purposes. In the case of a RIC, it is not clear to what extent these requirements can be implemented by permitting RIC dividends to reflect attributes of the RIC’s investment experiences in PTPs. For example, it is difficult to conceive how losses of a RIC can be passed through to shareholders upon the payment of a dividend, which would be inconsistent with the status of a RIC as a C corporation. See section 311(a). In addition, RICs and RIC shareholders would experience complexity inconsistent with the longstanding tax policy of providing simplified reporting for RIC investors.

Consistent with RICs’ status as C corporations, RICs could instead offset losses from PTPs against qualified REIT dividends received, with any excess PTP income
losses carried forward as negative qualified PTP income for section 199A attribute purposes at the RIC level. To the extent RICs would be required to carry forward PTP losses, it would appear that RICs would need to track separate loss carryforwards for SSTB PTP losses and non-SSTB PTP losses. While netting qualified non-SSTB losses from PTPs against larger amounts of qualified REIT dividends would support RIC dividends that could be treated as eligible for the section 199A deduction by the RICs’ shareholders regardless of income level, SSTB losses from PTPs would complicate the offset of qualified PTP losses against qualified REIT dividends by RICs because SSTB losses from a PTP do not offset qualified REIT dividends for taxpayers with taxable income above the phase-out range. Such losses do, however, offset qualified REIT dividends for taxpayers with income below the threshold amount. For taxpayers with income in the phase-out range, these losses partially offset qualified REIT dividends to a greater or lesser extent depending on where the taxpayer’s income falls in the phase-out range. It is not clear how a conduit regime for qualified PTP income could work in terms of treating RIC shareholders in the phase-out range in a manner that is consistent with the treatment they would receive if they received the qualified REIT dividend and the qualified PTP loss from an SSTB directly rather than through a RIC.

Providing conduit treatment for qualified PTP income would also raise potentially significant issues with respect to the treatment of RIC shareholders who are non-U.S. persons, tax-exempt organizations, and trusts underlying individual retirement accounts (IRAs) and qualified retirement plans. In order to be qualified conduit treatment for qualified PTP income through RICs, and request detailed comments on these novel issues. In particular, comments are requested concerning: (1) Whether RICs have sufficient qualified items of PTP income, gain, deduction, or loss to warrant a conduit regime that would permit RICs to pay qualified PTP dividends to shareholders; (2) How to provide conduit treatment for qualified PTP income for taxpayers with income below the threshold amount or within the phase-out range, particularly where a RIC has qualified REIT dividends and a qualified PTP loss from an SSTB; (3) How to treat losses of PTPs arising from SSTBs and non-SSTBs; (4) Whether conduit treatment for qualified PTP income can be disregarded for purposes of determining the effectively connected income or unrelated business taxable income of certain RIC shareholders; (5) Whether SSTB items are sufficiently rare or incidental for PTPs that a conduit regime for PTP dividends should exclude all SSTB items; and (6) How to implement conduit treatment for qualified PTP income in a way that is consistent with the policy goal of preserving the overall relative simplicity of the tax treatment of investors in RICs while still achieving the policy goals of section 199A and section 199A(b)(1)(B) in particular.

III. Special Rules for Trusts and Estates

Section 1.199A–6 provides guidance that certain specified entities (for example, trusts and estates) may need to follow to enable the computation of the section 199A deduction of the entity and each of its owners. Section 1.199A–6(d) contains special rules for applying section 199A to trusts and decedents’ estates. The August Proposed Regulations expressly requested comments, and comments were submitted, on whether and how certain trusts and other entities would be able to take a deduction under section 199A. These proposed regulations take those suggestions into consideration in proposing rules applicable to those particular situations identified by commenters.

In the case of a section 199A deduction claimed by a non-grantor trust or estate, section 199A(f)(1)(B) applies rules similar to the rules under former section 199(d)(1)(B)(i) for the apportionment of W–2 wages and the apportionment of UBIA of qualified property. In the case of a non-grantor trust or estate, the QBI and expenses properly allocable to the business, including the W–2 wages relevant to the computation of the wage limitation, and relevant UBIA of depreciable property must be allocated among the trust or estate and its various beneficiaries. Specifically, § 1.199A–6(d)(3)(ii) provides that each beneficiary’s share of the trust’s or estate’s QBI and W–2 wages is determined based on the proportion of the trust’s or estate’s DNI that is deemed to be distributed to that beneficiary for that taxable year. Similarly, the proportion of the entity’s DNI that is not deemed distributed by the trust or estate will determine the entity’s share of the QBI and W–2 wages. In addition, if the trust or estate has no DNI in a particular taxable year, any QBI and W–2 wages are allocated to the trust or estate, and not to any beneficiary.

In addition, § 1.199A–6(d)(3)(ii) provides that, to the extent the trust’s or estate’s UBIA of qualified property is relevant to a trust or estate and any beneficiary, the trust’s or estate’s UBIA of qualified property will be allocated among the trust or estate and its beneficiaries in the same proportions as is the DNI of the trust or estate. This is the case regardless of how any depreciation or depletion deductions resulting from the same property may be allocated under section 643(c) among the trust or estate and its beneficiaries for purposes other than section 199A.
This result is inappropriate and inconsistent with the purpose of section 199A. Therefore, § 1.199A–6(d)(3)(vii) provides that a trust formed or funded with a principal purpose of receiving a deduction under section 199A will not be respected for purposes of determining the threshold amount under section 199A.

In the August Proposed Regulations, the Treasury Department and the IRS requested comments with respect to whether taxable recipients of annuity and unitrust interests in charitable remainder trusts and taxable beneficiaries of other split-interest trusts may be eligible for the section 199A deduction to the extent that the amounts received by such recipients include amounts that may give rise to the deduction. The request for such comments indicated that such comments should include explanations of how amounts that may give rise to the section 199A deduction would be identified and reported in the various classes of income of the trusts received by such recipients and how the excise tax rules in section 664(c) would apply to such amounts.

A. Charitable Remainder Trust
Beneficiary’s Eligibility for the Deduction

A few commenters suggested that a charitable remainder trust under section 664 should be allowed to calculate the deduction at the trust level and that the charitable remainder trust should be treated as a single taxpayer for purposes of the thresholds for taxable income, W–2 wages, and UBIA of qualified property.

Several commenters recommended that, if unrelated business taxable income (UBTI) is qualified business income, the section 199A deduction should be allowed before the UBTI excise tax is imposed. However, other commenters disagreed. Another commenter stated that the section 199A deduction should not be allowed when calculating UBTI because it is not a deduction directly connected with carrying on the trade or business and is allowable only for purposes of chapter 1, while the excise tax on UBTI is imposed under chapter 42 (that is, it is not an income tax). Another commenter said the UBTI excise tax under section 664(c) should not affect QBI because that tax is charged to principal.

One commenter recommended that QBI should be allocated to the ordinary income tier. Another recommended that QBI should be the bottom of the first tier (last to be distributed) and section 199A items should be reported on the Schedule K–1 when QBI is deemed distributed. Another commenter stated that a charitable remainder trust has no taxable income and no DNI, so the allocation of QBI, W–2 wages, and UBIA of qualified property should be allocated to beneficiaries based on the percentage of distributions from the ordinary income tier, with QBI allocated to the charitable remainder trust remaining a tier one item. Another commenter stated that QBI cannot be a separate tier because it is a deduction, rather than a rate difference.

The Treasury Department and the IRS believe that, because a charitable remainder trust described in section 664 is not subject to income tax, and because the excise tax imposed by section 664(c) is treated as imposed under chapter 42, the trust does not either have or calculate a section 199A deduction and the threshold amount described in section 199A(e)(2) does not apply to the trust. Furthermore, application of section 199A to effectively reduce the 100 percent rate of tax imposed by section 664(c) on any UBTI would be inconsistent with the intent of section 664(c) to deter trusts from making investments that generate significant UBTI. However, any taxable recipient of a unitrust or annuity amount from the trust must determine and apply the recipient’s own threshold amount for purposes of section 199A, taking into account any ordinary or unitrust amounts received from the trust. Therefore, a taxable recipient of a unitrust or annuity amount from a charitable remainder trust may take into account QBI, qualified REIT dividends, and qualified PTP income for purposes of determining the recipient’s section 199A deduction and the threshold amount described in section 199A(e)(2) based on the rate of tax (not taking into account section 199A) have been exhausted. The unitrust or annuity recipient will be treated as receiving a proportionate amount of any QBI, qualified REIT dividends, and qualified PTP income that is distributed along with other income in the same class within the ordinary income category subject to a higher rate of tax (not taking into account section 199A).

The Treasury Department and the IRS requested comments with respect to whether any special rules were necessary with respect to split-interest trusts. One commenter suggested that additional rules may be necessary for split-interest trusts other than charitable remainder trusts. After considering the comment and studying other split-interest
trusts in more depth after the publication of the August Proposed Regulations, the Treasury Department and the IRS have determined that special rules for other split-interest trusts, such as non-grantor charitable lead trusts or pooled income funds, are not necessary because such trusts are taxable under part I, subchapter J, chapter 1 of the Code, except subpart E. Such split-interest trusts would apply the rules for non-grantor trusts and estates set forth in § 1.199A–6(d)(3) to determine any applicable section 199A deduction for the trust or its taxable beneficiaries.

C. Separate Shares

Although no comments were received with respect the application of the threshold amount to separate shares, the Treasury Department and the IRS believe that clarification with respect to this issue may be necessary. These proposed regulations provide that, in the case of a trust described in section 663(c) with substantially separate and independent shares for multiple beneficiaries, such separate shares will not be treated as separate trusts for purposes of applying the threshold amount. Instead, the trust will be treated as a single trust for purposes of determining whether the taxable income of the trust exceeds the threshold amount. The purpose of the separate share rule in section 663(c) is to treat distributions of trust DNI to trust beneficiaries as independent taxable events solely for purposes of applying sections 661 and 662 with respect to each beneficiary’s separate share. The rule determines each beneficiary’s share of DNI based on the amount of DNI from that beneficiary’s separate share, rather than as a percentage of the trust’s DNI.

Nevertheless, under the separate share rule, if a trust retains any portion of DNI, the trust will be subject to tax as a single trust with respect to the retained DNI. Only trusts with retained DNI will be eligible for the section 199A deduction, because a trust will be allocated QBI, qualified REIT dividends, and qualified PTP income only in proportion to the amount of DNI retained by the trust for the taxable year. For this reason, a trust, regardless of the number of separate shares it has for its beneficiaries under the separate share rule of section 663(c), will be treated as a single trust for purposes of applying the threshold amount under section 199A. To the extent that a taxable beneficiary of a trust receives a distribution of DNI from the beneficiary’s separate share of the trust which includes section 199A items, the beneficiary would apply its own threshold amount to those section 199A items in computing its section 199A deduction in accordance with the rules of § 1.199A–6(d).

Availability of IRS Documents


Proposed Effective/Applicability Date

Section 7805(b)(1)(A) and (B) of the Code generally provide that no temporary, proposed, or final regulation relating to the internal revenue laws may apply to any taxable period ending before the earliest of (A) the date on which such regulation is filed with the Federal Register, or (B) in the case of a final regulation, the date on which a proposed or temporary regulation to which the final regulation relates was filed with the Federal Register.

The amendments to §§ 1.199A–3 and 1.199A–6 set forth in this notice of proposed rulemaking generally are proposed to apply to taxable years ending after the date of publication of a Treasury decision adopting these rules as final regulations in the Federal Register. However, taxpayers may rely on the rules in the amendments to §§ 1.199A–3 and 1.199A–6 set forth in this notice of proposed rulemaking, in their entirety, until the date a Treasury decision adopting these regulations as final regulations is published in the Federal Register.

Special Analyses

I. Regulatory Planning and Review – Economic Analysis

Executive Orders 13563 and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing rules, and of promoting flexibility.

The proposed regulations have been designated by the Office of Management and Budget’s (“OMB”) Office of Information and Regulatory Affairs (“OIRA”) as subject to review under Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and OMB regarding review of tax regulations. It has been determined that the proposed rulemaking is economically significant under section 1(c) of the Memorandum of Agreement and thereby subject to review. Accordingly, the proposed regulations have been reviewed by OMB.

A. Overview

Congress enacted section 199A to provide taxpayers other than corporations a deduction of up to 20 percent of QBI from domestic businesses plus up to 20 percent of their combined qualified REIT dividends and qualified PTP income. As stated in the Explanation of Provisions, these regulations are necessary to provide taxpayers with computational, definitional, and anti-avoidance guidance regarding the application of section 199A. These proposed regulations contain amendments to § 1.199A–3, providing further guidance to taxpayers for purposes of calculating the section 199A deduction. They provide clarity for taxpayers in determining their eligibility for the deduction and the amount of the allowed deduction. Among other benefits, this clarity helps ensure that taxpayers all calculate the deduction in a similar manner, which encourages decision-making that is economically efficient contingent on the provisions of the overall Code.

B. Baseline

The analysis in this section compares the proposed regulation to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of these regulations.
C. Economic Analysis of the Proposed Amendments to § 1.199A–3

1. Background

Because the section 199A deduction has not previously been available, §§ 1.199A–1 through 1.199A–6 provide greater specificity for a large number of the relevant terms and necessary calculations taxpayers are currently required to apply under the statute. However, one subject not covered by the August 2018 Proposed Regulations is the treatment of REIT dividends received by RICs. Because RICs are taxed as C corporations, they are ineligible for the section 199A deduction under the statute, which generally does not apply to C corporations. However, the statute also directs the Secretary to prescribe such regulations as are necessary to carry out the purposes of section 199A, including regulations for its application in the case of tiered entities. Thus these proposed regulations establish rules under which a RIC that earns qualified REIT dividends may pay section 199A dividends to its shareholders.

An alternative approach the Treasury Department and the IRS could have taken would be to remain silent on this issue. For reasons given below, the Treasury Department and the IRS concluded such an approach would likely give rise to less economically efficient decisions than the approach taken in these proposed regulations.

2. Anticipated benefits of the Proposed Amendments to § 1.199A–3

The Treasury Department and the IRS expect that the definitions and guidance provided in the proposed amendments to § 1.199A–3 will implement the section 199A deduction in an economically efficient manner. An economically efficient tax system generally aims to treat income derived from similar economic decisions similarly in order to reduce incentives to make choices based on tax rather than market incentives. In absence of these proposed regulations, the section 199A statute would not accomplish this in the case of REIT dividends. Under the statute and the section 199A final regulations, individuals who directly hold ownership interests in a REIT would generally qualify for the section 199A deduction on their qualified REIT dividends. However, individuals who are shareholders of a RIC that has an ownership interest in a REIT would not receive any benefit from section 199A on REIT dividends received by the RIC, even if the RIC pays dividends to the individual. Thus, in the absence of these supplemental proposed regulations, a market distortion is introduced by section 199A whereby direct ownership of REITs is tax-advantaged relative to indirect ownership of REITs through RICs.

These proposed regulations remove this distortion. The proposed amendments to § 1.199A–3 establish rules under which a RIC that earns qualified REIT dividends may pay section 199A dividends to its shareholders, such that the effective tax treatment of qualified REIT dividends is similar under the proposed regulations regardless of whether a taxpayer invests in a REIT directly or through a RIC.

3. Anticipated costs of the Proposed Amendments to § 1.199A–3

The Treasury Department and the IRS do not anticipate any meaningful economic distortions to be induced by the proposed amendments to § 1.199A–3 because the proposed amendments seek to continue to provide similar tax treatment to REIT income regardless of whether it is held directly or through a RIC. Prior to TCJA, the tax treatment was similar, but TCJA made REIT dividends eligible for the section 199A deduction, and the section 199A final regulations did not address this uncertainty. This proposed amendment ensures that REIT income earned through a RIC is also eligible for the same deduction. RICs are financial intermediaries, and, as a general rule, economic distortion is minimized to the extent that the tax consequences of investment through an intermediary correspond to the tax consequences of direct investment. The Treasury Department and the IRS request comments regarding any anticipated economic costs. Changes to the collective paperwork burden arising from this and other sections of these regulations are discussed in section D, Anticipated impacts on administrative and compliance costs, of this analysis.

D. Anticipated impacts on administrative and compliance costs

The proposed regulations add to the compliance costs of RICs and intermediaries such as brokerage firms that hold RIC shares. In order for a RIC’s shareholders to benefit from the section 199A deduction on qualified REIT dividends earned by the RIC, the proposed regulations require the RIC to compute and report section 199A dividends to its shareholders. Though many RICs keep detailed records of their investment portfolios, this action nonetheless creates non-trivial administrative costs for any RICs and intermediaries that wish to provide section 199A dividends to their shareholders. These costs and the associated impacted tax forms are described in the Paperwork Reduction Act section of this proposed amendment.

E. Executive Order 13771

These regulations have been designated as regulatory under E.O. 13771.

II. Paperwork Reduction Act

The collection of information required by this proposed regulation is in proposed § 1.199A–3. The collection of information in proposed § 1.199A–3 is required for RICs that choose to report information regarding qualified REIT dividends to their shareholders. It is necessary to report the information to the IRS and relevant taxpayers in order to ensure that taxpayers properly report in accordance with the rules of the proposed regulations the correct amount of deduction under section 199A. The collection of information in proposed § 1.199A–3 is satisfied by providing information about section 199A dividends as Form 1099-DIV and its instructions may prescribe.

For purpose of the PRA, the reporting burden associated with § 1.199A–3 will be reflected in the IRS Form 14029, Paperwork Reduction Act Submission, associated with Form 1099-DIV (OMB control number 1545–0110). The burden associated with the information collection in the proposed regulations represents 1,567 million hours and $149 million ($2018) annually to comply with the in-
Information collection requirement in the proposed regulations. The burden hours estimate was derived from IRS’s legacy burden model and is discussed in further detail on 1545-0110. The hourly rate is derived from RAAS’s Business Taxpayer Burden model that relates time and out-of-pocket costs of business tax preparation, derived from survey data, to assets and receipts of affected taxpayers along with other relevant variables, and converted by the Treasury Department to 2017. The Treasury Department and the IRS request comments on all aspects of information collection burdens related to the proposed regulations. In addition, when available, drafts of the applicable IRS forms are posted for comment at https://www.irs.gov/pub/irs-pdf/f1099div.pdf.

III. Regulatory Flexibility Act

It is hereby certified that the collections of information in proposed § 1.199A–3 will not have a significant economic impact on a substantial number of small entities.

The collection in proposed § 1.199A–3 applies only to RICs that pay section 199A dividends. As described above, Congress created RICs to give small investors access to the professional management and asset diversification that are available only with very large investment portfolios. To insure appropriate non-tax regulation of these substantial investment portfolios, subchapter M of chapter I of subtitle A the Code requires that such RICs must be eligible for registration, and must actually be registered, with the Securities and Exchange Commission under the Investment Company Act of 1940. There are some small businesses that are publicly traded, but most publicly traded businesses are not small entities as defined by the Regulatory Flexibility Act. Thus, the Treasury Department and the IRS have determined that the collection of information in this notice of proposed rulemaking will not have a significant economic impact. Accordingly, the Treasury Department and the IRS invite comments from interested members of the public on both the number of entities affected and the economic impact on small entities.

Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearing

The Treasury Department and the IRS request comments on all aspects of the proposed rules.

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the “Addresses” heading. All comments will be available at www.regulations.gov or upon request. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the Federal Register.

Drafting Information

The principal authors of these regulations are Michael Y. Chin and Steven Harrison, Office of the Associate Chief Counsel (Financial Institutions and Products) and Robert Alinsky, Vishal R. Amin, Margaret Burow, and Frank J. Fisher, Office of the Associate Chief Counsel (Pass-throughs and Special Industries). However, other personnel from the Treasury Department and the IRS participated in their development.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citations for part 1 are revised by amending sectional authorities for §§ 1.199A–3 and 1.199A–6 to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.199A–3 also issued under 26 U.S.C. 199A(c)(4)(C) and (f)(4).

* * * *

Section 1.199A–6 also issued under 26 U.S.C. 199A(f)(1)(B) and (f)(4).

* * * *

Par. 2. Section 1.199A–0 is amended by:

1. Adding entries for § 1.199A–3(b)(1)(iv)(A) and (B).

2. Adding entries for § 1.199A–3(d), (d)(1) and (2), (d)(2)(i) through (iii), (d)(2)(ii)(A) and (B), (d)(3), (d)(3)(i) through (v), (d)(4), (d)(4)(i) and (ii), and (d)(5) and (6).

3. Adding entries for § 1.199A–6(d)(3)(iii) and (v).

The additions read as follows:

§ 1.199A–0 Table of contents.

* * * *

§ 1.199A–3 Qualified business income, qualified REIT dividends, and qualified PTP income.

* * * *

(b) * *

(1) * *

(iv) * *

(A) In general.

(B) Attributes of disallowed loss determined in year loss is incurred.

* * * *

(d) Section 199A dividends paid by a regulated investment company.

(1) In general.

(2) Definition of section 199A dividend.

(i) In general.

(ii) Reduction in the case of excess reported amounts.

(iii) Allocation of excess reported amount.

(A) In general.

(B) Special rule for noncalendar-year RICs.

(3) Definitions.

(i) Reported section 199A dividend amount.

(ii) Excess reported amount.

(iii) Aggregate reported amount.

(iv) Post-December reported amount.
(v) Qualified REIT dividend income.
(4) Treatment of section 199A dividends by shareholders.
   (i) In general.
   (ii) Holding period.
(5) Example.
(6) Applicability date.

§ 1.199A–6 Relevant pass-through entities (RPEs), publicly traded partnerships (PTPs), trusts, and estates.

§ 1.199A–3 Qualified business income, qualified REIT dividends, and qualified PTP income.

§ 1.199A–3 Qualified business income, qualified REIT dividends, and qualified PTP income.

Par. 3. Section 1.199A–3 is amended by revising paragraph (b)(1)(iv) and adding paragraph (d) to read as follows:

§ 1.199A–3 Qualified business income, qualified REIT dividends, and qualified PTP income.

(b) * * *
(1) * * *
(iv) Previously disallowed losses—(A) In general. Previously disallowed losses or deductions (including losses disallowed under sections 465, 469, 704(d), and 1366(d)) disallowed in the taxable year generally are taken into account for purposes of computing QBI to the extent the disallowed loss or deduction is otherwise allowed by section 199A and this section. These losses shall be used, for purposes of section 199A and these regulations, in order from the oldest to the most recent on a first-in, first-out (FIFO) basis and shall be treated as losses from a separate trade or business. To the extent such losses relate to a PTP, they must be treated as a loss from a separate PTP in the taxable year the losses are taken into account. However, losses or deductions that were disallowed, suspended, limited, or carried over from taxable years ending before January 1, 2018 (including under sections 465, 469, 704(d), and 1366(d)), are not taken into account in a later taxable year for purposes of computing QBI.

(B) Attributes of disallowed loss determined in year loss is incurred. Whether a disallowed loss or deduction is attributable to a trade or business, and otherwise meets the requirements of this section, is determined in the year the loss is incurred. Whether a disallowed loss or deduction is attributable to a specified service trade or business (including whether an individual has taxable income under the threshold amount, within the phase-in range, or in excess of the phase-in range) also is determined in the year the loss is incurred. To the extent a loss is partially disallowed, QBI in the year of disallowance must be reduced proportionately.

(d) Section 199A dividends paid by a regulated investment company—(1) In general. If section 852(b) applies to a regulated investment company (RIC) for a taxable year, the RIC may pay section 199A dividends, as defined in this paragraph (d).

(2) Definition of section 199A dividend—(i) In general. Except as provided in paragraph (d)(2)(ii) of this section, a section 199A dividend is any dividend or part of such a dividend that a RIC pays to its shareholders and reports as a section 199A dividend in written statements furnished to its shareholders.

(ii) Reduction in the case of excess reported amounts. If the aggregate reported amount with respect to the RIC for any taxable year exceeds the RIC’s qualified REIT dividend income for the taxable year, then a section 199A dividend is equal to—

(A) The reported section 199A dividend amount, reduced by;

(B) The excess reported amount that is allocable to that reported section 199A dividend amount.

(iii) Allocation of excess reported amount—(A) In general. Except as provided in paragraph (d)(2)(iii)(B) of this section, the excess reported amount (if any) that is allocable to the reported section 199A dividend amount is that portion of the excess reported amount that bears the same ratio to the excess reported amount as the reported section 199A dividend amount bears to the aggregate reported amount.

(B) Special rule for noncalendar-year RICs. In the case of any taxable year that does not begin and end in the same calendar year, if the post-December reported amount equals or exceeds the excess reported amount for that taxable year, paragraph (d)(2)(iii)(A) of this section is applied by substituting “post-December reported amount” for “aggregate reported amount,” and no excess reported amount is allocated to any dividend paid on or before December 31 of that taxable year.

(3) Definitions. For purposes of paragraph (d) of this section—

(i) Reported section 199A dividend amount. The term reported section 199A dividend amount means the amount of a dividend distribution reported to the RIC’s shareholders under paragraph (d)(2)(i) of this section as a section 199A dividend.

(ii) Excess reported amount. The term excess reported amount means the excess of the aggregate reported amount over the RIC’s qualified REIT dividend income for the taxable year.

(iii) Aggregate reported amount. The term aggregate reported amount means the aggregate amount of dividends reported by the RIC under paragraph (d)(2)(i) of this section as section 199A dividends for the taxable year (including section 199A dividends paid after the close of the taxable year and described in section 855).

(iv) Post-December reported amount. The term post-December reported amount means the aggregate reported amount determined by taking into account only dividends paid after December 31 of the taxable year.

(v) Qualified REIT dividend income. The term qualified REIT dividend income means, with respect to a taxable year of a RIC, the excess of the amount of qualified REIT dividends, as defined in § 1.199A–3(c)(2), includible in the RIC’s taxable income for the taxable year over the amount of the RIC’s deductions that are properly allocable to such income.

(4) Treatment of section 199A dividends by shareholders—(i) In general. For purposes of section 199A and the regulations under section 199A, a section 199A dividend is treated by a taxpayer that receives the section 199A dividend as a qualified REIT dividend.

(ii) Holding period. Paragraph (d)(4)(i) does not apply to any dividend received with respect to a share of RIC stock—

(A) That is held by the shareholder for 45 days or less (taking into account the
principles of section 246(c)(3) and (4)) during the 91-day period beginning on the date which is 45 days before the date on which the share becomes ex-dividend with respect to such dividend; or

(B) To the extent that the shareholder is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

(5) Example. The following example illustrates the provisions of this paragraph (d).

(i) Example. (A) X is a corporation that has elected to be a RIC. For its taxable year ending March 31, 2019, X has $25,000 of net long-term capital gain, $60,000 of qualified dividend income, $25,000 of taxable interest income, $15,000 of net short-term capital gain, and $25,000 of qualified REIT dividends. X has $15,000 of deductible expenses, of which $3,000 is allocable to the qualified REIT dividends. On December 31, 2018, X pays a single dividend of $100,000 on December 31, and reports $20,000 of the dividend as a section 199A dividend in written statements to its shareholders. On March 31, 2019, X pays a dividend of $35,000, and reports $5,000 of the dividend as a section 199A dividend in written statements to its shareholders.

(B) X’s qualified REIT dividend income under paragraph (d)(3)(v) of this section is $22,000, which is the excess of X’s $25,000 of qualified REIT dividends over $3,000 in allocable expenses. The reported section 199A dividend amounts for the December 31, 2018, and March 31, 2019, distributions are $20,000 and $5,000, respectively. For the taxable year ending March 31, 2019, the aggregate reported amount of section 199A dividends is $25,000, and the excess reported amount under paragraph (d)(3)(ii) of this section is $3,000. Because X is a non-calendar-year RIC and the post-December reported amount of $5,000 exceeds the excess reported amount of $3,000, the entire excess reported amount is allocated under paragraphs (d)(2)(iii)(A) and (B) of this section to the reported section 199A dividend amount for the March 31, 2019, distribution. No portion of the excess reported amount is allocated to the reported section 199A dividend amount for the December 31, 2018, distribution. Thus, the section 199A dividend on March 31, 2019, is $2,000, which is the reported section 199A dividend amount of $5,000 reduced by the $3,000 of allocable excess reported amount. The section 199A dividend on December 31, 2018, is the $20,000 that X reports as a section 199A dividend.

(ii) In the case of a trust described in section 663(c) with substantially separate and independent shares for multiple beneficiaries, such trust will be treated as a single trust for purposes of determining whether the taxable income of the trust exceeds the threshold amount.

(v) Charitable remainder trusts. A charitable remainder trust described in section 664 is not entitled to and does not calculate a section 199A deduction and the threshold amount described in section 199A(e)(2) does not apply to the trust. However, any taxable recipient of a unitrust or annuity amount from the trust must determine and apply the recipient’s own threshold amount for purposes of section 199A taking into account any annuity or unitrust amounts received from the trust. A recipient of a unitrust or annuity amount from a trust may take into account QBI, qualified REIT dividends, or qualified PTP income for purposes of determining whether the trust is treated as a single trust for purposes of § 1.664–1(d).

(ii) Separate shares. In the case of a trust described in section 663(c) with substantially separate and independent shares for multiple beneficiaries, such trust will be treated as a single trust for purposes of determining whether the taxable income of the trust exceeds the threshold amount.

Par. 4. Section 1.199A–6 is amended by adding paragraphs (d)(3)(iii) and (v) to read as follows:

§ 1.199A–6 Relevant passthrough entities (RPEs), publicly traded partnerships (PTPs), trusts, and estates.

(3) Separate shares...

(v) Charitable remainder trusts. A charitable remainder trust described in section 664 is not entitled to and does not calculate a section 199A deduction and the threshold amount described in section 199A(e)(2) does not apply to the trust. However, any taxable recipient of a unitrust or annuity amount from the trust must determine and apply the recipient’s own threshold amount for purposes of section 199A taking into account any annuity or unitrust amounts received from the trust. A recipient of a unitrust or annuity amount from a trust may take into account QBI, qualified REIT dividends, or qualified PTP income for purposes of determining whether the trust is treated as a single trust for purposes of § 1.664–1(d).

Example. Assume that A purchases 100 shares of the stock of X, a RIC, on February 25, 2019. On March 31, 2019, of which $5,000 of which $5,000 is reported as a section 199A dividend for A’s 2018 taxable year. If A meets the holding period requirements under paragraph 1.199A–6(d)(2)(iii)(A) and (B) of this section to the reported section 199A dividend amounts for the December 31, 2018, distribution. No portion of the excess reported amount is allocated under paragraphs 1.199A–6(d)(3)(ii) of this section is $3,000. Because A is a non-calendar-year RIC and the post-December reported amount of $5,000 exceeds the excess reported amount of $3,000, the entire excess reported amount is allocated under paragraphs 1.199A–6(d)(2)(iii)(A) and (B) of this section to the reported section 199A dividend amount for the March 31, 2019, distribution. No portion of the excess reported amount is allocated to the reported section 199A dividend amount for the December 31, 2018, distribution. Thus, the section 199A dividend on March 31, 2019, is $2,000, which is the reported section 199A dividend amount of $5,000 reduced by the $3,000 of allocable excess reported amount. The section 199A dividend on December 31, 2018, is the $20,000 that X reports as a section 199A dividend.

(C) Shareholder A, a United States person, receives a dividend from X of $100 on December 31, 2018, of which $20 is reported as a section 199A dividend. If A meets the holding period requirements in paragraph 1.199A–6(d)(4)(i) of this section with respect to the stock of X, A treats $20 of the dividend from X as a qualified REIT dividend for purposes of section 199A for A’s 2018 taxable year.

(D) A receives a dividend from X of $35 on March 31, 2019, of which $5 is reported as a section 199A dividend. If A meets the holding period requirements in paragraph 1.199A–6(d)(4)(i) of this section
Reissuance of State or Local Bonds

REG–141739–08

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed amendments to 26 CFR part 1 under sections 150 and 1001 of the Code (Proposed Regulations).

1. In General

In general, under section 103, interest received by the holders of certain bonds issued by State and local governments is exempt from Federal income tax. To qualify for the tax exemption, a bond issued by a State or local government must satisfy various eligibility requirements under sections 141 through 150 at the time of issuance of the bond. If the issuer and holder agree after issuance to modify the terms of a tax-exempt bond significantly, the original bond may be treated as having been retired and exchanged for a newly issued, modified bond. Similarly, if the issuer or its agent acquires and resells the bond, the bond may be treated as having been retired upon acquisition and replaced upon resale with a newly issued bond.

The term “reissuance” commonly refers to the effect of a transaction in which a new debt instrument replaces an old debt instrument as a result of retirement of the old debt instrument pursuant to such an exchange or extinguishment. In the case of a reissuance, the reissued bond must be tested for qualification under sections 103 and 141 through 150. The reissuance of an issue of tax-exempt bonds may result in various negative consequences to the issuer, such as changes in yield for purposes of the arbitrage investment yield restrictions under section 148(a), acceleration of arbitrage rebate payment obligations under section 148(f), and change-in-law risk.

2. Tender Option Bonds

Tender option bonds and variable rate demand bonds (collectively, tender option bonds) have special features that present reissuance questions. Specifically, tender option bonds have original terms that provide for a tender option interest rate mode, as described in this paragraph. Issuers of tax-exempt bonds often preauthorize several different interest rate modes in the bond documents and retain an option to switch interest rate modes under parameters set forth in the bond documents. During a tender option mode, tender option bonds have short-term interest rates that are reset periodically at various short-term intervals (typically, every seven days) based on the current market rate necessary to remarket the bonds at par. In connection with each resetting of the interest rate, the holder of a tender option bond has a right or requirement to tender the bond back to the issuer or its agent for purchase at par. Tender option bonds also may have interest rate mode conversion options that permit the issuer or conduit borrower to change the interest rate mode on the bonds from a tender option mode to another short-term interest rate mode or to a fixed interest rate to maturity. At the time of a conversion to another interest rate mode, the holder of a tender option bond typically has the right or requirement to tender the bond for purchase at par.

Tender option bonds generally have third-party liquidity facilities from banks or other liquidity providers to ensure that there is sufficient cash to repurchase the bonds upon a holder’s tender, and they also commonly have credit enhancement from bond insurers or other third-party guarantors. Upon a holder’s exercise of its tender rights in connection with either a resetting of the interest rate during a tender option mode or a conversion to another interest rate mode, a remarketing agent or a liquidity provider typically will acquire the bonds subject to the tender and resell the bonds either to the same bondholders or to others willing to purchase such bonds.

3. Existing Guidance

To address reissuance questions related to tax-exempt bonds, on December 27, 1988, the IRS published Notice 88–130, 1988–2 CB 543, which provides rules for determining when a tax-exempt bond is retired for purposes of sections 103 and 141 through 150. Notice 88–130 provides in part that a tax-exempt bond is retired when there is a change to the terms of the bond that results in a disposition of the bond for purposes of section 1001. In addition, Notice 88–130 provides special
rules for retirement of certain tender option bonds that meet a definition of the term “qualified tender bond.”

On June 26, 1996, the Department of the Treasury (Treasury Department) and the IRS published final regulations under § 1.1001–3 (1996 Final Regulations) in the Federal Register (61 FR 32926). These regulations provide rules for determining whether a modification of the terms of a debt instrument, including a tax-exempt bond, results in an exchange for purposes of section 1001. In recognition of a need to coordinate the interaction of the prior guidance in Notice 88–130 with the subsequent final regulations under § 1.1001–3 for particular tax-exempt bond purposes, the Treasury Department and the IRS stated their intention to issue regulations under section 150 on this subject in the Federal Register (61 FR 32930).

On April 14, 2008, the IRS published Notice 2008–41, 2008–1 CB 742. Like Notice 88–130, Notice 2008–41 provides rules for determining when a tax-exempt bond is retired for purposes of sections 103 and 141 through 150 and includes special rules for qualified tender bonds. While the retirement standards provided in these two notices are similar, Notice 2008–41 was intended to coordinate the retirement standards for tax-exempt bond purposes with the 1996 Final Regulations on modifications of debt instruments under § 1.1001–3 and to be more administrable than Notice 88–130. In order to preserve flexibility and to limit potential unintended consequences during the 2008 financial crisis, Notice 2008–41 permitted issuers to apply either notice. Generally, under Notice 2008–41, a tax-exempt bond is retired when a significant modification to the terms of the bond occurs under § 1.1001–3, the bond is acquired by or on behalf of its issuer, or the bond is otherwise redeemed or retired. The notice clarifies that, for purposes of these retirement standards, the purchase of a tax-exempt bond by a third-party guarantor or third-party liquidity facility provider pursuant to the terms of the guarantee or liquidity facility is not treated as a purchase or other acquisition by or on behalf of a governmental issuer. Although these general rules apply to a qualified tender bond, Notice 2008–41 also provides that certain features of qualified tender bonds will not result in a retirement. In Notice 2008–41, the Treasury Department and the IRS reiterated their intention to provide guidance on the retirement of tax-exempt bonds in regulations under section 150.

The Proposed Regulations provide rules for determining when tax-exempt bonds are treated as retired for purposes of sections 103 and 141 through 150. The Proposed Regulations also amend § 1.1001–3(a)(2) to conform that section to the special rules in the Proposed Regulations for retirement of qualified tender bonds.

Explanation of Provisions

1. Section 1.150–3: Retirement of Tax-Exempt Bonds

A. General Rules for Retirement of a Tax-Exempt Bond

The Proposed Regulations generally provide retirement standards that apply to tax-exempt bonds for purposes of sections 103 and 141 through 150. These retirement standards follow the guidance in Notice 2008–41 with technical refinements. The Proposed Regulations provide that a tax-exempt bond is retired if a significant modification to the terms of the bond occurs under § 1.1001–3, if the issuer or an agent acting on its behalf acquires the bond in a manner that liquidates or extinguishes the bondholder’s investment in the bond, or if the bond is otherwise redeemed (for example, redeemed at maturity).

For this purpose, the Proposed Regulations define the term “issuer” to mean the State or local governmental unit that actually issues the bonds and any related party (as defined in § 1.150–1(b)) to that actual issuer. In the case of a governmental unit, the applicable related party definition under § 1.150–1(b) applies a controlled group test under § 1.150–1(e) to determine related party status, based generally on all of the facts and circumstances. This controlled group test includes special rules which specifically treat control over the governing board of a governmental unit and control over use of funds or assets of a governmental unit as giving rise to controlled group status.

By focusing on the actual issuer rather than on a conduit borrower, this definition of issuer maintains and respects the essential legal construct necessary for issuance of many tax-exempt bonds, such as qualified private activity bonds under section 141(e), that the actual issuer be treated as the obligor in conduit financings. Thus, under the Proposed Regulations, the acquisition of a tax-exempt bond by a conduit borrower that is not a related party to the actual issuer does not result in the retirement of that bond.

The Proposed Regulations also prescribe certain consequences for a bond that is retired pursuant to a deemed exchange under § 1.1001–3 or following the acquisition of the bond by the issuer or the issuer’s agent. In the former case, the bond is treated as a new bond issued at the time of the modification as determined under § 1.1001–3. In the latter case, if the issuer resells the bond, the bond is treated as a new bond issued at the time of resale. If the issuer does not resell the acquired bond, the acquired bond is simply retired. In either case in which a retired bond is treated as a newly issued bond, the issuer must consider whether the new bond refunds the retired bond. For this purpose, the rules regarding the definition of a refunding issue under § 1.150–1(d) apply. For example, if the issuer of the bond retired pursuant to § 1.1001–3 is the same as the issuer (or a related party to the issuer) of the newly issued bond, the newly issued bond will be part of a current refunding issue that refunds the retired bond.

B. Exceptions to Retirement of a Tax-Exempt Bond

The Proposed Regulations provide three exceptions that limit retirements resulting from the operation of the general rules. Two of these exceptions are intended to prevent the special features of tender option bonds from resulting in a retirement. A third exception applies to all tax-exempt bonds.

The first two exceptions in the Proposed Regulations apply to qualified tender bonds, a defined term that is essentially a tender option bond meeting certain requirements. Specifically, a qualified tender bond is a tax-exempt bond that, pur-
suant to the terms of its governing con-
tact, bears interest during each interest rate mode at a fixed rate, a qualified floating rate under § 1.1275–5, or an objective rate that is permitted for a tax-exempt bond under § 1.1275–5(c)(5). Furthermore, interest on a qualified tender bond must be unconditionally payable at periodic intervals of no more than a year. Finally, a qualified tender bond may not have a stated maturity date later than 40 years after its issue date and must include a qualified tender right. This definition is similar to the definition of qualified tender bond provided in Notice 2008–41.

The Proposed Regulations define a qualified tender right required for a qualified tender bond in terms of the mechanics by which the tender right operates. The Proposed Regulations define a qualified tender right to include either a tender right that arises periodically during a tender option mode or a tender right that arises upon the exercise of the issuer’s option under the original terms of the bond to change the interest rate mode.

A qualified tender bond has two features that otherwise could result in retirement of the bond under the general rules for retirement in the Proposed Regulations. First, when accompanied by a qualified tender right, an exercise of the issuer’s option to change the interest rate mode might, in some circumstances, qualify as a modification under the rule in § 1.1001–3(c)(2)(iii) for alterations that might result from the exercise of an option. Thus, absent the exception in the Proposed Regulations, a qualified tender right might result in a modification that, if significant, would cause the qualified tender bond to be retired. To address this circumstance, the Proposed Regulations provide an exception that avoids retirement by dis-regarding a qualified tender right for purposes of determining whether a significant modification of a qualified tender bond under § 1.1001–3 results in retirement of the bond. Consequently, the issuer’s option to change the interest rate mode typically would qualify as a unilateral option and the change of interest rate mode resulting from exercise of that option would not be a modification of the qualified tender bond.

The second feature of a qualified tender bond that could result in retirement of the bond under the general rules for retirement in the Proposed Regulations is the financing structure feature that may require the issuer or its agent to acquire the bond upon exercise of the qualified tender right. To address this circumstance, the Proposed Regulations provide another exception under which an acquisition of a qualified tender bond pursuant to the exercise of a qualified tender right will not result in retirement, provided that neither the issuer nor its agent holds the bond for longer than 90 days. This 90-day period is intended to provide the issuer or its marketing agent with sufficient time to resell a tendered bond to a new holder.

The Proposed Regulations also provide an exception to the general rules of retirement for all tax-exempt bonds. This exception, carried forward from Notice 2008–41, provides that acquisition of a tax-exempt bond by a guarantor or liquidity facility provider acting as the issuer’s agent does not result in retirement of the bond if the acquisition is pursuant to the terms of the guarantee or liquidity facility and the guarantor or liquidity facility provider is not a related party (as defined in § 1.150–1(b)) to the issuer.

2. Applicability Dates

The rules in § 1.150–3 of the Proposed Regulations are proposed to apply to events and actions taken with respect to bonds that occur on or after the date that is 90 days after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register. Issuers may apply these regulations to events and actions taken with respect to bonds that occur before that date. The Treasury Department and the IRS expect that the final regulations will obsolete Notice 88–130 and Notice 2008–41.

Special Analyses

This regulation is not subject to review under section 6(b) of Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Department of the Treasury and the Office of Management and Budget regarding review of tax regulations. Because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small entities.

Comments and Requests for Public Hearing

Before the Proposed Regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the ADDRESSES heading. The Treasury Department and the IRS request comments on all aspects of the proposed rules. All comments will be available at www.regulations.gov or upon request. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the Federal Register.

Drafting Information

The principal authors of these regulations are Spence Hanemann of the Office of Associate Chief Counsel (Financial Institutions and Products) and Vicky Tsilas, formerly of the Office of Associate Chief Counsel (Financial Institutions and Products). However, other personnel from the Treasury Department and the IRS participated in their development.

Availability of IRS Documents

The IRS notices cited in this preamble are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at www.irs.gov.

* * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:
§ 1.150–3 Retirement standards for state and local bonds.

(a) General purpose and scope. This section provides rules to determine when a tax-exempt bond is retired for purposes of sections 103 and 141 through 150.

(b) General rules for retirement of a tax-exempt bond. Except as otherwise provided in paragraph (c) of this section, a tax-exempt bond is retired when:

(1) A significant modification of the bond occurs under § 1.1001–3;

(2) The issuer or its agent acquires the bond in a manner that liquidates or extinguishes the bondholder’s investment in the bond; or

(3) The bond is otherwise redeemed (for example, redeemed at maturity).

(c) Exceptions to retirement of a tax-exempt bond—(1) Qualified tender right does not result in a modification. In applying § 1.1001–3 to a qualified tender bond for purposes of paragraph (b)(1) of this section, both the existence and exercise of a qualified tender right are disregarded. Thus, a change in the interest rate mode made in connection with the exercise of a qualified tender right generally is not a modification because the change occurs by operation of the terms of the bond and the holder’s resulting right to put the bond to the issuer or its agent does not prevent the issuer’s option from being a unilateral option.

(2) Acquisition pursuant to a qualified tender right. Acquisition of a qualified tender bond by the issuer or its agent does not result in retirement of the bond under paragraph (b)(2) of this section if the acquisition is pursuant to the operation of a qualified tender right and neither the issuer nor its agent continues to hold the bond after the close of the 90-day period beginning on the date of the tender.

(3) Acquisition of a tax-exempt bond by a guarantor or liquidity facility provider. Acquisition of a tax-exempt bond by a guarantor or liquidity facility provider acting on the issuer’s behalf does not result in retirement of the bond under paragraph (b)(2) of this section if the acquisition is pursuant to the terms of the guarantee or liquidity facility and the guarantor or liquidity facility provider is not a related party (as defined in § 1.150–1(b)) to the issuer.

(d) Effect of retirement. If a bond is retired pursuant to paragraph (b)(1) of this section (that is, in a transaction treated as an exchange of the bond for a bond with modified terms), the bond is treated as a new bond issued at the time of the modification as determined under § 1.1001–3. If the issuer or its agent resells a bond retired pursuant to paragraph (b)(2) of this section, the bond is treated as a new bond issued on the date of resale. In both cases, the rules of § 1.150–1(d) apply to determine if the new bond is part of a refunding issue.

(e) Definitions. For purposes of this section, the following definitions apply:

(1) Issuer means the State or local governmental unit (as defined in § 1.103–1) that actually issues the tax-exempt bond and any related party (as defined in § 1.150–1(b)) to the actual issuer (as distinguished, for example, from a conduit borrower that is not a related party to the actual issuer).

(2) Qualified tender bond means a tax-exempt bond that, pursuant to the terms of its governing contract, has all of the features described in this paragraph (e)(2). During each authorized interest rate mode, the bond bears interest at a fixed interest rate, a qualified floating rate under § 1.1275–5(b), or an objective rate for a tax-exempt bond under § 1.1275–5(c)(5). Interest on the bond is unconditionally payable at periodic intervals of no more than one year. The bond has a stated maturity date that is not later than 40 years after the issue date of the bond. The bond includes a qualified tender right.

(3) Qualified tender right means a right or obligation of a holder of the bond to tender the bond for purchase as described in this paragraph (e)(3). The purchaser under the tender may be the issuer, its agent, or another party. The tender right is available on at least one date before the stated maturity date. For each such tender, the purchase price of the bond is equal to par (plus any accrued interest). Following each such tender, the issuer or its marketing agent either redeems the bond or uses reasonable best efforts to resell the bond within the 90-day period beginning on the date of the tender. Upon any such resale, the purchase price of the bond is equal to par (plus any accrued interest).

(f) Applicability date. This section applies to events and actions taken with respect to bonds that occur on or after the date that is 90 days after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register.

Par. 3. Section 1.1001–3 is amended by:

1. Revising paragraph (a)(2).

2. Revising the paragraph (h) subject heading.

3. Revising the first sentence of paragraph (h)(1).

4. Revising the paragraph (h)(2) subject heading.

5. Adding paragraph (h)(3).

The revisions and addition read as follows:

§ 1.1001–3 Modifications of debt instruments.

(a) * * *

(2) Qualified tender bonds. For special rules governing whether tax-exempt bonds that are qualified tender bonds are retired for purposes of sections 103 and 141 through 150, see § 1.150–3. * * * * *

(h) Applicability date. * * *

(1) * * * Except as otherwise provided in paragraphs (h)(2) and (3) of this section, this section applies to alterations of the terms of a debt instrument on or after September 24, 1996. * * * * *

(2) Alteration or modification results in an instrument or property right that is not debt. * * * *

(3) Qualified tender bonds. Paragraph (a)(2) of this section applies to events and actions taken with respect to qualified tender bonds that occur on or after the date that is 90 days after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register.

Kirsten Wielobob
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on December 28, 2018, 8:45 a.m., and published in the issue of the Federal Register for December 31, 2018, 83 F.R. 67701)
Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as “rulings”) that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with modified, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with amplified and clarified, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, modified and superseded describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspected is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
CI—City.
COOP—Cooperative.
C.D.—Court Decision.
C.Y.—County.
D—Decedent.
DC— Dummy Corporation.
DE—Donee.
Del. Order —Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.

EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FX—Foreign corporation.
G.C.M.—Chief Counsel’s Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.

PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
T.F.E.—Transferer.
T.F.R.—Transferor.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
X—Corporation.
Y—Corporation.
Z—Corporation.
Numerical Finding List¹

Bulletin 2019–9

Action on Decision:
2019-1, 2019-08 I.R.B. 569

Announcements:
2019-1, 2019-06 I.R.B. 566

Notices:
2019-01, 2019-02 I.R.B. 275
2019-02, 2019-02 I.R.B. 281
2019-03, 2019-03 I.R.B. 350
2019-05, 2019-02 I.R.B. 283
2019-06, 2019-03 I.R.B. 353
2019-08, 2019-03 I.R.B. 354
2019-09, 2019-04 I.R.B. 403
2019-11, 2019-05 I.R.B. 430
2019-13, 2019-08 I.R.B. 580

Proposed Regulations:
REG-104259-18, 2019-02 I.R.B. 300
REG-104352-18, 2019-03 I.R.B. 357
REG-106089-18, 2019-05 I.R.B. 431
REG-134652-18, 2019-09 I.R.B. 747
REG-141739-08, 2019-09 I.R.B. 757

Revenue Procedures:
2019-1, 2019-01 I.R.B. 1
2019-4, 2019-01 I.R.B. 146
2019-6, 2019-02 I.R.B. 284
2019-8, 2019-03 I.R.B. 347
2019-9, 2019-02 I.R.B. 293
2019-11, 2019-09 I.R.B. 742
2019-12, 2019-04 I.R.B. 401
2019-13, 2019-09 I.R.B. 744

Revenue Rulings:
2019-03, 2019-02 I.R.B. 272

Treasury Decisions:
9845, 2019-08 I.R.B. 570
9846, 2019-09 I.R.B. 583
9847, 2019-09 I.R.B. 670

¹A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2018–27 through 2018–52 is in Internal Revenue Bulletin 2018–52, dated December 27, 2018.
Finding List of Current Actions on Previously Published Items

Bulletin 2019–9

¹A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2018–27 through 2018–52 is in Internal Revenue Bulletin 2018–52, dated December 27, 2018.
We Welcome Comments About the Internal Revenue Bulletin

If you have comments concerning the format or production of the Internal Revenue Bulletin or suggestions for improving it, we would be pleased to hear from you. You can email us your suggestions or comments through the IRS Internet Home Page (www.irs.gov) or write to the Internal Revenue Service, Publishing Division, IRB Publishing Program Desk, 1111 Constitution Ave. NW, IR-6230 Washington, DC 20224.