

# **The Deemed Repatriation Tax – A Bridge Too Far?**

by Mark E. Berg and Fred Feingold

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In this report, Berg and Feingold summarize the relevant provisions of section 965, assess the arguments that it is unconstitutional, and outline steps that affected taxpayers should consider taking against the possibility that it will be successfully challenged.

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## I. Introduction

Congress has the broad power to impose taxes,<sup>1</sup> but that power is not without limits. For example, if a tax is not imposed on incomes within the meaning of the 16th Amendment, that tax is unconstitutional if it is a direct tax that is not apportioned among the states such that the revenues collected from each state are in proportion to its population.<sup>2</sup> Generally speaking, and as discussed in more detail below, a tax that is imposed on something other than realized income and that is imposed solely on the basis of one’s ownership of assets regardless of whether there has been any transfer or other use of that property violates the constitutional prohibition if not apportioned among the states.

While most federal taxes are clearly on the right side of this constitutional line, section 965, the widely publicized tax on a deemed repatriation of earnings of foreign corporations included in the Tax Cuts and Jobs Act,<sup>3</sup> goes much further than other, similar statutes that have previously been held to be constitutional: It taxes some shareholders on the corporation’s accumulated earnings in the absence of an actual distribution, current earnings, or any post-enactment action on the part of either the corporation or the shareholder — and in some cases even in the absence of control — thus squarely raising this constitutional issue (among others).

<sup>1</sup>U.S. Const., Art. I, section 8, cl. 1.

<sup>2</sup>U.S. Const., Art. I, section 9, cl. 4; Art. I, section 2, cl. 3; and Amend. XVI.

<sup>3</sup>Titled “An Act to Provide for Reconciliation Under Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018,” P.L. 115-97, section 14103(a) (the TCJA); see H.R. Rep. No. 115-466, at 606 (2017) (Conf. Rep.) (referring to the income inclusion under section 965 as a “deemed repatriation”).

Section 965 requires some U.S. persons that are direct or indirect shareholders of specified non-U.S. corporations to include in their income their pro rata shares of 100 percent of the previously deferred post-1986 foreign earnings of those corporations as if those amounts had been repatriated. Because of section 965, those shareholders are subject to tax currently (but may elect to pay the tax over eight years) on a portion of those amounts. For a shareholder that is a U.S. corporation, the section 965 tax is reduced by applicable foreign tax credits.<sup>4</sup> Media reports suggest that as much as \$3 trillion of previously deferred foreign earnings will be deemed to be repatriated under this provision,<sup>5</sup> which the Joint Committee on Taxation projects will yield nearly \$340 billion of tax over the next 10 years.<sup>6</sup>

The language of section 965 raises numerous difficult interpretive questions, some of which have already been addressed in published IRS guidance<sup>7</sup> and others of which are briefly noted in this report. The statute also raises serious policy questions that are beyond the scope of this discussion.

The mechanism adopted for imposing the section 965 tax is the code's income inclusion provisions for controlled foreign corporations. However, the CFC provisions on which section 965 is based do not require attribution of a CFC's income to its U.S. shareholders exceeding the CFC's current earnings, except in some circumstances in which corporate action is taken that Congress has determined to be sufficiently similar to a constructive distribution of earnings to the CFC's U.S. shareholders whose collective ownership is considered to amount to control over the foreign corporation. Section 965 is not so limited. Rather, unlike the CFC provisions, section 965 can operate to deem a distribution of earnings accumulated in prior years to U.S. persons not in control of the corporation,

regardless of whether there are any current earnings or whether there has been any action that could conceivably be characterized as a constructive distribution. As a result, section 965 raises a more fundamental question: Is the section 965 tax a direct tax on something other than incomes, thus going beyond the broad taxing power conferred on Congress by the Constitution? Given the hundreds of billions of dollars potentially at stake, we submit that this issue deserves serious consideration.

This report briefly summarizes the relevant provisions of section 965, describes the categories of taxpayers that might or might not benefit from a determination that section 965 is invalid, describes and assesses the arguments that section 965 is unconstitutional, and outlines some steps that affected taxpayers should consider taking to preserve their rights if section 965 is successfully challenged.

## II. A Brief Summary of Section 965

The mechanism for the deemed repatriation under section 965 is a current income inclusion under section 951(a)(1)(A) by some U.S. shareholders of a deferred foreign income corporation (DFIC) equal to their pro rata shares of the DFIC's accumulated post-1986 deferred foreign income (the deferred amount) on November 2, 2017, or December 31, 2017 (whichever is greater).<sup>8</sup>

For purposes of section 965, the relevant terms are defined as follows:

1. *DFIC*. A DFIC is a specified foreign corporation (SFC) that had a deferred amount on either November 2, 2017, or December 31, 2017.<sup>9</sup>
2. *SFC*. An SFC is a non-U.S. corporation that either (a) is a CFC or (b) has at least one U.S. shareholder that is a U.S. corporation and is itself neither a CFC nor a passive foreign investment company described in section 1297.<sup>10</sup>

<sup>4</sup> Section 965(a), (e)(2), (f), (g), and (h); see section 951(a).

<sup>5</sup> See, e.g., Daisuke Wakabayashi and Brian X. Chen, "Apple, After Tax Cut Windfall, Will Bring Billions Back to U.S.," *The New York Times*, Jan. 17, 2018, at A1.

<sup>6</sup> See JCT, "Estimated Budget Effects of the Conference Agreement for H.R. 1, the 'Tax Cuts and Jobs Act,'" JCX-67-17, at 6 (Dec. 18, 2017).

<sup>7</sup> Notice 2018-13, 2018-6 IRB 341; and Notice 2018-7, 2018-4 IRB 317. For an analysis of some of the remaining interpretive issues, see New York State Bar Association Tax Section, "Report on Section 965" (Feb. 6, 2018).

<sup>8</sup> Section 965(a); see H.R. Rep. No. 115-466, at 606-607.

<sup>9</sup> Section 965(d)(1).

<sup>10</sup> Section 965(e).

3. *CFC.* A CFC is a non-U.S. corporation in which one or more U.S. shareholders own more than 50 percent of the voting power or value of the stock (directly or by attribution).<sup>11</sup>

4. *U.S. shareholder.* A U.S. shareholder is any U.S. entity or individual that either owns within the meaning of section 958(a) (that is, directly or through a non-U.S. entity) or is treated as owning under the constructive ownership rules of section 958(b) shares in a corporation having 10 percent or more of the total combined voting power.<sup>12</sup>

5. *Ownership of shares.* While, as noted above, both ownership of shares within the meaning of section 958(a) and constructive ownership of shares under section 958(b) are counted in determining whether a person is a U.S. shareholder and therefore whether a non-U.S. corporation is a CFC (or, presumably by extension, an SFC), only those U.S. shareholders that own shares within the meaning of section 958(a) on the last day in the relevant year on which the corporation is a CFC (or, presumably by extension, an SFC) are subject to the income inclusion under section 965. Another TCJA provision causes this result to obtain even if B Corp. were owned by a non-U.S. person unrelated to A.<sup>13</sup>

**Example 1:** FC1, a non-U.S. corporation that is not a PFIC, has a deferred amount. A, a U.S. citizen, owns voting shares in FC1 representing 10 percent of the voting power. A is the only

shareholder of FC1 that is a U.S. person. A also owns 100 percent of the shares of B Corp., a U.S. corporation having nothing to do with FC1.

Absent the attribution rules, FC1 would not be an SFC because FC1 is not a CFC and no U.S. corporation directly owns any shares in FC1. However, the downward attribution rules in section 958(b) (by reference to section 318(a)(3)(C)), which attribute stock owned by a person “down” to a corporation in which that person owns 50 percent or more of the value of its stock, cause B Corp. to be considered as owning the shares in FC1 that are actually owned by A, which in turn causes FC1 to be considered an SFC and thus a DFIC. As a result, while B Corp., which does not own shares in FC1 within the meaning of section 958(a), would not have an income inclusion under section 965, the treatment of B Corp. as a U.S. shareholder of FC1 causes A to have an income inclusion under section 965. Another TCJA provision causes this result to obtain even if B Corp. were owned by a non-U.S. person unrelated to A.<sup>14</sup>

6. *Deferred amount.* A DFIC’s deferred amount is the earnings and profits of the DFIC accumulated in tax years beginning after December 31, 1986 (other than earnings attributable to income that is effectively connected with a U.S. trade or business or that has been in prior years, or is for the current year included in the income of the U.S. shareholders because of the preexisting provisions of section 951(a)), without diminution as a result of dividends distributed during the section 965 inclusion year other than dividends

<sup>11</sup> Section 957(a); see section 958.

<sup>12</sup> Section 951(b) (before amendment by TCJA section 14214(a)); see sections 957(c), 7701(a)(30), and 958. For tax years of foreign corporations beginning after December 31, 2017, the definition of a U.S. shareholder is also expanded to include any U.S. entity or individual that owns (directly or under applicable attribution rules) shares representing 10 percent or more of the total value of the shares. Section 951(b) (as amended by TCJA section 14214(a)). Because this expansion of the definition of a U.S. shareholder is effective only for tax years beginning after December 31, 2017, and section 965 applies to the last tax year of a DFIC beginning before January 1, 2018, this amendment to section 951(b) is not relevant to the section 965 determination.

<sup>13</sup> Sections 951(b), 958, 951(a)(1), and 965(e)(1); see section 965(e)(2) and (f) (treating an SFC that is not a CFC as if it were a CFC for purposes of the income inclusion under section 965).

<sup>14</sup> TCJA section 14213(a) amending section 958(b) to delete former section 958(b)(4), which precluded the application of the downward attribution rule to consider a U.S. person as owning stock owned by a non-U.S. person. Because this amendment is effective for the last tax year of a non-U.S. corporation beginning before January 1, 2018 (TCJA section 14213(b)), a non-U.S. corporation can be considered an SFC and thus a DFIC for purposes of section 965 solely by reason of the downward attribution of shares in the non-U.S. corporation that are owned by a non-U.S. person that also owns 50 percent or more of the value of the shares of a U.S. corporation.

distributed to another SFC, but taking into account only periods when the DFIC was an SFC.<sup>15</sup> Because the deferred amount is computed without regard to pre-1987 years and periods when the corporation was not an SFC, there are situations in which a DFIC can have a deferred amount so that its U.S. shareholders are subject to the section 965 tax without having any accumulated E&P as of the close of its last tax year that ends before January 1, 2018,<sup>16</sup> with the result that an actual distribution by such a DFIC would not be a taxable dividend in the hands of its U.S. shareholders. Moreover, the deferred amount includes (1) earnings that have been reinvested in a DFIC's active non-U.S. businesses and thus are not represented by cash or cash equivalents; (2) earnings that are represented by working capital in the form of cash or cash equivalents reasonably needed in those businesses; and (3) earnings that are represented by cash and cash equivalents exceeding the working capital reasonably needed in those businesses. The first category is subject to tax at lower rates than the second and third categories.

The deferred amount is treated as an increase in the DFIC's subpart F income as computed without regard to section 965.<sup>17</sup> Section 965 provides that the increase in the DFIC's subpart F income is to occur in "the last taxable year of a deferred foreign income corporation which

begins before January 1, 2018."<sup>18</sup> For a non-U.S. corporation that qualified as a DFIC for its last tax year that ended before January 1, 2018, it seems reasonably clear that the income inclusion by reason of section 965 occurs in the tax year of a U.S. shareholder that includes the last day of that tax year. Thus, the year of inclusion would be 2017 for a calendar-year shareholder of a DFIC that also reports on a calendar year, and 2018 for a calendar-year shareholder of a DFIC that reports on a fiscal year. However, the application of section 965 to a non-U.S. corporation that is not a DFIC for its last tax year that began before January 1, 2018, but that was a DFIC in at least one prior year is less clear.

**Example 2:** FC2, a calendar-year non-U.S. corporation that has a deferred amount at all relevant times, does not qualify as a DFIC for 2017 (its last tax year that began before January 1, 2018) because at no time during that year was it a CFC, nor did a U.S. corporation own (directly or by attribution) shares representing as much as 10 percent of the voting power. But FC2 did qualify as a DFIC from its inception through 2014, so that 2014 was the last tax year for which FC2 was a DFIC.

As applied to FC2, the quoted statutory language is ambiguous and could be read either; (1) to render section 965 inapplicable to the U.S. shareholders of FC2 because FC2 did not qualify as a DFIC for 2017; or (2) to apply section 965 to the U.S. shareholders of FC2 and to require an income inclusion in 2014, which is the last tax year that began before January 1, 2018, for which FC2 qualified as a DFIC. There are indications in the legislative history that the former interpretation was intended,<sup>19</sup> and the guidance issued so far by Treasury takes a similar view.<sup>20</sup>

<sup>15</sup> Section 965(d)(2) and (3). The deferred amount is computed without diminution by dividends distributed during the year of inclusion (other than dividends distributed to another SFC), presumably to preserve the benefit of the lower tax rate afforded by the section 965(c) deduction for the U.S. shareholders of a DFIC that made current distributions of their previously deferred foreign earnings, rather than taxing those shareholders on those distributions at the regular rates applicable to dividends (e.g., for individuals shareholders in 2017, 23.8 percent if the DFIC is a qualified foreign corporation within the meaning of section 1(h)(11) or 43.4 percent if the DFIC is not a qualified foreign corporation). Amounts included in income under the preexisting provisions of section 951(a) (i.e., subpart F income and amounts in respect of investments in U.S. property described in section 956) are not eligible for any special tax rate, although the IRS has announced that regulations will provide an ordering rule so that the section 965 inclusion will precede the calculations under section 956 and will thus in many cases preclude an inclusion by reason of section 956 in the section 965 inclusion year. See Notice 2018-7, at section 3.02(d).

<sup>16</sup> See Notice 2018-13, at section 2.01.

<sup>17</sup> Section 965(a), (e)(2), and (f); see section 951(a)(1).

<sup>18</sup> Section 965(a).

<sup>19</sup> See H.R. Rep. No. 115-466, at 606 n.1492, 613, and 618; see also section 965 heading ("Treatment of Deferred Foreign Income Upon Transition to Participation Exemption System of Taxation").

<sup>20</sup> See Notice 2018-13, at section 6 ("Section 965 is effective for the last taxable years of foreign corporations that begin before January 1, 2018, and with respect to United States shareholders, for the taxable years in which or with which such taxable years of the foreign corporations end" (emphasis added).); and section 3.05(b) ("The Treasury Department and the IRS have determined that the spot rate on December 31, 2017, is the appropriate exchange rate for purposes of translating these amounts, regardless of a specified foreign corporation's taxable year or the applicable measurement date, because it is the date [that] immediately precedes the transition to the participation exemption under section 245A.").

The section 965 tax is imposed at a reduced rate, which is effected through a deduction under section 965(c) in the amount necessary to cause the tax rate imposed on the section 965 inclusion of a U.S. shareholder that is a U.S. corporation (before taking into account FTCs) to range from 8 percent (the rate applicable to the portion of the DFIC's deferred amount that exceeds its cash and cash equivalents) to 15.5 percent (the rate applicable to the portion not exceeding its cash and cash equivalents).<sup>21</sup> Because section 965(c) provides that the deduction amount is in all cases determined taking into account the highest corporate tax rate specified in section 11 for the relevant tax year of the U.S. shareholder,<sup>22</sup> and because the reduction of the top tax rate applicable to individuals from 39.6 percent to 37 percent (a 6.6 percent reduction) is not as significant on a percentage basis as the reduction of the top corporate tax rate from 35 percent to 21 percent (a 40 percent reduction), a literal application of the language of section 965 would cause the effective section 965 tax rate to be higher than the advertised rates (8 percent to 15.5 percent) for U.S. shareholders that are not U.S.

corporations (such as U.S. citizens or resident individuals).<sup>23</sup> How much higher depends on whether the U.S. shareholder's tax year of inclusion is 2017 or 2018. One reason is that the amount of the deduction required to reduce the effective corporate rate to 8 percent or 15.5 percent is smaller in 2018 than in 2017 — years for which the highest corporate tax rates are 21 percent and 35 percent, respectively — and the resulting reduction of an individual's tax rate by reason of section 965(c) will therefore be smaller in 2018 than in 2017.

On this basis, at a minimum, the effective tax rate for calendar-year noncorporate U.S. shareholders works out to roughly 9.05 percent (noncash)<sup>24</sup> to 17.54 percent (cash)<sup>25</sup> if the section 965 inclusion occurs in 2017, and roughly 14.1 percent (noncash)<sup>26</sup> to 27.31 percent (cash)<sup>27</sup> if the section 965 inclusion occurs in 2018. Why “at a minimum?” By expressing the mechanism for reducing the tax rate on section 965 inclusions as a deduction rather than as either an exclusion from gross income or a reduced tax rate on these amounts, Congress appears to have opened the door to several seemingly anomalous results for individuals that could well increase the effective tax rates on their section 965 inclusions above even the higher rates noted above. For example, because it is not clear that the deduction under section 965(c) is taken into account in arriving at adjusted gross income,<sup>28</sup> the deduction could be both an itemized deduction as defined in section 63(d) and a miscellaneous itemized deduction as

<sup>21</sup> Because the TCJA repeals the corporate alternative minimum tax effective for tax years beginning after December 31, 2017 (TCJA section 12001), that tax will in some cases remain applicable for the section 965 inclusion year of a U.S. shareholder that is a corporation, *e.g.*, if the DFIC reports on a calendar year or if the shareholder reports on a non-calendar fiscal year that ends with or after the DFIC's non-calendar fiscal year. Because the section 965(c) deduction, while deductible in computing taxable income, is not deductible in computing E&P, and since for AMT purposes a corporation's adjusted current earnings are generally determined without deduction for items that are not deductible in computing E&P (section 56(g)(4)(C)(i)), a corporation having a section 965 inclusion could become subject to the AMT by reason of the section 965(c) deduction. Interestingly, because section 56(g)(4)(C)(vi) provides that the rule that adjusted current earnings are determined without deduction for items that are not deductible in computing E&P “shall not apply to any deduction allowable under section 965,” under a literal reading of the statute, the corporate AMT would not be implicated by the section 965(c) deduction. However, because the heading of section 56(g)(4)(C)(vi) suggests that the reference to section 965 therein is a vestigial reference to the expired provision that the TCJA replaced, it is unclear whether a court reviewing these provisions would decline to apply this favorable provision that by its terms is applicable and eliminates the corporate AMT problem on the basis that Congress erroneously failed to amend it.

<sup>22</sup> Section 965(c)(2).

<sup>23</sup> The legislative history of section 965 indicates that Congress assumed that an individual could avoid the higher-than-advertised tax rate on a section 965 inclusion by making an election under section 962 to be taxed on inclusions under section 951 (and thus under section 965) at the rates applicable to corporations. *See* H.R. Rep. No. 115-466, at 620 and n.1513. While a full analysis of this suggestion is beyond the scope of this report, suffice it to say for present purposes that the position of a noncorporate U.S. shareholder who makes a section 962 election is not equivalent to that of a U.S. shareholder that is a corporation when the DFIC makes distributions in respect of the deferred amount. *See* section 962(d).

<sup>24</sup> 39.6 percent of  $(1 - ((35 \text{ percent} - 8 \text{ percent})/35 \text{ percent})) = 9.0514$  percent.

<sup>25</sup> 39.6 percent of  $(1 - ((35 \text{ percent} - 15.5 \text{ percent})/35 \text{ percent})) = 17.5371$  percent.

<sup>26</sup> 37 percent of  $(1 - ((21 \text{ percent} - 8 \text{ percent})/21 \text{ percent})) = 14.0952$  percent.

<sup>27</sup> 37 percent of  $(1 - ((21 \text{ percent} - 15.5 \text{ percent})/21 \text{ percent})) = 27.3095$  percent.

<sup>28</sup> *See* section 62(a).

defined in section 67(b), which would have the following adverse results:

1. If the year of the section 965 inclusion is 2017, the section 965(c) deduction could be limited under section 67 (miscellaneous itemized deductions allowed only to the extent they exceed 2 percent of AGI) and then under section 68 (itemized deductions reduced by the lesser of 3 percent of AGI exceeding a threshold amount or 80 percent of the deductions), and in any event would be added back to taxable income under section 56(b)(1)(A)(i) in determining whether and to what extent the taxpayer is subject to the AMT imposed on individuals by section 55(a).
2. If the year of the section 965 inclusion is 2018, the section 965(c) deduction would simply be disallowed because of section 67(g),<sup>29</sup> which disallows all miscellaneous itemized deductions for any tax year beginning after December 31, 2017, and before January 1, 2026.

The effect of these anomalies would be to increase the effective tax rate on a section 965 inclusion by an individual well above the advertised rates of 8 percent and 15.5 percent, and well above even the higher tax rates noted above. A further adverse effect would be to increase the individual's state tax liability if he is a resident of a state, such as New York, in which an individual's federal AGI is the starting point for computing his state income tax, and a portion of the individual's federal itemized deductions is disallowed.<sup>30</sup>

<sup>29</sup> Added to the code by TCJA section 11045(a).

<sup>30</sup> While there may be a technical argument that these limitations do not apply to the section 965(c) deduction, Congress and perhaps Treasury could remove any doubt and eliminate these anomalies by clarifying that the section 965(c) deduction is taken into account in computing AGI (*i.e.*, is an above-the-line deduction). *Cf.* section 62(a) (last sentence), added by section 11011(b)(1) of the TCJA (providing that the deduction allowed by section 199A shall not be treated as an above-the-line deduction, and not so providing regarding section 965(c)).

The section 965 tax can be offset by FTCs (for a U.S. shareholder that is a corporation) to a limited extent<sup>31</sup> and may by election be paid in installments (without interest) over an eight-year period on a backloaded basis so that 40 percent of the tax is payable ratably over the first five years, 15 percent is payable in year 6, 20 percent is payable in year 7, and 25 percent is payable in year 8.<sup>32</sup> As is the case with other subpart F inclusions, a distribution to a U.S. shareholder of earnings attributable to the amounts that were included in that shareholder's income under section 965 is not again included in the shareholder's gross income.<sup>33</sup> The limitation period for assessment of the section 965 tax is six years (rather than the generally applicable three years) after the tax return for the section 965 inclusion year is filed.<sup>34</sup>

### III. Who Might Benefit From a Challenge?

Before turning to the constitutional issues raised by section 965, it is useful to consider which categories of taxpayers might benefit from a determination that section 965 is unconstitutional. Because the TCJA also includes a 100 percent dividends received deduction (DRD) for dividend distributions of foreign earnings by a non-U.S. corporation to its (10 percent) U.S. shareholders that are U.S. corporations,<sup>35</sup> such a U.S. corporation that has a section 965 inclusion and receives a distribution of its pro rata share of the DFIC's deferred amount would generally benefit from the invalidation of section 965. Assuming the DRD were not also invalidated (and there is

<sup>31</sup> Under section 965(g), the FTC otherwise allowable under section 960 to a U.S. shareholder that is a corporation is reduced by a fixed percentage that is commensurate with the reduction in the effective U.S. tax rate resulting from the deduction under section 965(c) for U.S. shareholders and DFICs that both report on the calendar year. The effect of these provisions is that the FTC will not completely eliminate a residual U.S. tax to a U.S. shareholder that is a calendar-year corporation unless the effective foreign tax rate, computed under section 986, equals 35 percent or more if the inclusion year is 2017 and 30.7 percent or more if the inclusion year is 2018. Because the inclusion under section 965 is treated as a subpart F inclusion under section 951(a), a U.S. shareholder who is an individual may make a section 962 election to be taxed at the rate applicable to a corporation regarding the inclusion required by section 965; but depending on the facts of a particular case, there may be other consequences to making that election that must be carefully considered, the discussion of which is beyond the scope of this report.

<sup>32</sup> Section 965(h).

<sup>33</sup> Section 959(a); *see* section 965(e)(2) and (f). *But see* section 962(d).

<sup>34</sup> Section 965(k).

<sup>35</sup> Section 245A(a), added by section 14101(a) of the TCJA.

little reason to think it would be) and assuming the U.S. corporation took steps (discussed below) to protect its right to a refund of any tax it paid under section 965, if section 965 were invalidated, the U.S. shareholders that are U.S. corporations would pay no tax in any year on the corporation's previously deferred earnings.

By contrast, a U.S. shareholder who is a U.S. individual who shortly after the year of the income inclusion under section 965 receives a distribution of the previously deferred amount from the non-U.S. corporation could well benefit from section 965 and therefore may be an unlikely candidate to mount a challenge to that provision.

**Example 3:** FC3, a calendar-year non-U.S. corporation that is a DFIC, has a deferred amount of \$10 million, 100 percent of which is represented by cash and cash equivalents. C, a U.S. citizen, owns voting shares in FC3 representing 10 percent of the voting power, so that C's pro rata share of FC3's deferred amount, and thus C's section 965 inclusion in 2017, is \$1 million. FC3 distributes its \$10 million deferred amount to its shareholders in 2018, including a distribution of \$1 million to C, when FC3's accumulated E&P is at least equal to \$10 million.

Under section 965, C would be subject to tax in 2017 at an effective rate of at least roughly 17.54 percent on the \$1 million inclusion<sup>36</sup> and would not be subject to any further income tax (but would possibly be subject to the 3.8 percent tax under section 1411) in 2018 on the distribution of the \$1 million.<sup>37</sup> By contrast, were section 965 to be invalidated, C would not be subject to tax in 2017 but would be subject to tax on the distribution in 2018 at either a 23.8 percent rate if FC3 were a qualified foreign corporation within the meaning

of section 1(h)(11) or a 40.8 percent rate if FC3 were not a qualified foreign corporation.<sup>38</sup>

In this case, assuming C's effective tax rate on the section 965 inclusion is limited to 17.54 percent (but not otherwise), C would be better off with the reduced tax rate under section 965 than under the law absent section 965 and thus would presumably not be interested in challenging its validity. The situation could well be different (1) if FC3 had no intention of making a distribution of the deferred amount in the foreseeable future, in which case absent section 965 the tax on an actual distribution would be deferred as under the law before the enactment of the TCJA; (2) if FC3 kept its books on a fiscal-year basis and the section 965 inclusion were in 2018 rather than 2017, in which case the effective tax rate applicable to the section 965 inclusion (that is, at least 14.1 percent to 27.31 percent, but possibly higher in light of the disallowance of miscellaneous itemized deductions) could, as noted above, be higher than the tax absent section 965; or (3) if the section 965 inclusion were in 2017 and for the reasons described above C's effective tax rate on a section 965 inclusion in 2017 were higher than 17.54 percent.

Similarly, an individual U.S. shareholder of a DFIC who has a section 965 inclusion in 2017 and intends to sell her shares in the near future might well prefer the situation under section 965, particularly given the step-up in the basis of her shares that would result under section 961(a) from the section 965 inclusion. For that shareholder, the step-up in basis would reduce the gain on the sale that would otherwise be taxable to the shareholder at the 23.8 percent rate applicable to dividends,<sup>39</sup> in exchange for which the shareholder would be subject to tax on the section 965 inclusion at the lower rates applicable in 2017, which range from roughly 9.05 percent to 17.54 percent (but the shareholder may be subject to a higher effective rate for the reasons described above).

<sup>36</sup> Under section 965(c), the deduction necessary to reduce the top tax rate applicable to corporations in 2017 under section 11 (35 percent) to 15.5 percent is \$557,143 (i.e., \$1 million \* ((35 percent - 15.5 percent)/35 percent)). C would thus be subject to income tax of \$175,371 on the section 965 inclusion (i.e., 39.6 percent of (\$1 million - \$557,143)). For reasons why the actual tax rate could be significantly higher than 17.54 percent, see *supra* text accompanying notes 28-30.

<sup>37</sup> Section 959(a); and reg. section 1.1411-10(c)(1)(i)(A)(1).

<sup>38</sup> For purposes of simplicity, this example ignores the application of section 962 and the possibility that C could drop her FC3 shares into a U.S. corporation before the distribution, and thereby benefit from the DRD under section 245A and the lower tax rate on qualified dividends under section 1(h)(11).

<sup>39</sup> See sections 1248(a) and 1(h)(11).

## IV. Potential Constitutional Infirmities

### A. Unapportioned Direct Tax Not on Incomes

As the Supreme Court confirmed as recently as 2012,<sup>40</sup> the Constitution requires that any direct tax either be apportioned among the 50 states (that is, collected from each state in proportion to its population) or be imposed on incomes within the meaning of the 16th Amendment.<sup>41</sup>

Apportioning a tax would generally require imposing it at different rates in each state, which would be a political impossibility. As a result, because the section 965 tax is not apportioned, it is unconstitutional if it is a direct tax that is not imposed on incomes.

#### 1. When is a tax a direct tax?

The Supreme Court has made it reasonably clear that at a minimum, direct taxes include taxes that are imposed on a person solely on the basis that the person (1) exists (such as capitations, or head taxes) or (2) owns real or personal property (such as ad valorem property taxes) without regard to whether there has been any transfer or other use of the property (whereas indirect taxes are imposed on transfers or other uses of a person's property).<sup>42</sup> This is why the federal government does not (and, we submit, cannot) impose real property taxes like those that municipalities commonly impose, while taxes on transactions such as the federal estate tax imposed on the transmission of assets at death, the federal gift tax imposed on lifetime transfers of assets, and the various federal excise taxes imposed on sales are considered indirect taxes and thus are exempt from the apportionment requirement.

#### 2. When is a tax not imposed on incomes?

In *Macomber*,<sup>43</sup> the seminal case on this question, the Supreme Court held that a tax on a shareholder's receipt of a common-on-common stock dividend was not a tax on incomes within the meaning of the 16th Amendment because it did not tax gain that had been "severed from the capital," but rather taxed a mere "growth or increment of value in" the shareholder's stock.<sup>44</sup> In the words of the Court in *Macomber*, "the antecedent accumulation of profits evidenced [by the stock dividend], while indicating that the shareholder is the richer because of an increase of his capital, at the same time shows he has not realized or received any income in the transaction."<sup>45</sup> This requirement that income or gain be realized in order to constitute incomes within the meaning of the 16th Amendment means, for example, that if Congress were to impose a federal wealth tax on the value of a taxpayer's property, even if that tax were computed by reference to the property's value exceeding the taxpayer's cost in the property (for example, on a deemed sale of the taxpayer's property), or a federal income tax on the deemed rental income that could have been earned on property occupied by the taxpayer, those taxes would be constitutionally suspect.<sup>46</sup> On the other hand, the tax imposed on an actual distribution by a corporation to its shareholders of the corporation's earnings, whether current or accumulated (even if accumulated before the effective date of the tax), is both an indirect tax and imposed on incomes, and therefore is constitutional.<sup>47</sup>

<sup>40</sup> *National Federation of Independent Business (NFIB) v. Sebelius*, 567 U.S. 519, 570 (2012).

<sup>41</sup> U.S. Const., Art. I, section 9, cl. 4; Art. I, section 2, cl. 3; and Amend. XVI. By contrast, indirect taxes are not subject to apportionment and need only be imposed uniformly throughout the United States. U.S. Const., Art. I, section 7, cl. 1. For a detailed discussion of the issues under both the direct tax clauses and the 16th Amendment, see Mark E. Berg, "Bar the Exit (Tax)!: Section 877A, the Constitutional Prohibition Against Unapportioned Direct Taxes and the Realization Requirement," 65 *Tax Law.* 181 (2012).

<sup>42</sup> See, e.g., *NFIB*, 567 U.S. at 570-571; *Bromley v. McCaughn*, 280 U.S. 124, 136-138 (1929); *Eisner v. Macomber*, 252 U.S. 189, 218-219 (1920); and *Knowlton v. Moore*, 178 U.S. 41, 81-83 (1900); see generally Berg, *supra* note 41, at 184-192 (collecting cases).

<sup>43</sup> *Eisner v. Macomber*, 252 U.S. 189 (1920), cited with approval in *NFIB*, 567 U.S. at 571.

<sup>44</sup> *Id.* at 206-211 (emphasis in original).

<sup>45</sup> *Id.* at 212.

<sup>46</sup> See, e.g., *Helvering v. Independent Life Insurance Co.*, 292 U.S. 371, 378-379 (1934) (a tax on deemed rental income from a building occupied by the owner would be a direct tax not imposed on incomes); Berg, *supra* note 41; and Erik M. Jensen, "The Constitutionality of a Mark-to-Market Taxing System," *Tax Notes*, June 16, 2014, p. 1299; see generally Berg, "Determining Which Taxes Are Prohibited Direct Taxes After *NFIB*," *Tax Notes*, Jan. 14, 2013, p. 205, at 211-213. But see Bruce Ackerman, "Taxation and the Constitution," 99 *Colum. L. Rev.* 1 (1999) (arguing that a federal wealth tax would be constitutional).

<sup>47</sup> *Lynch v. Hornby*, 247 U.S. 339, 343-345 (1918) (tax on post-1913 distributions of pre-1913 earnings held constitutional).

### 3. The section 965 tax.

The section 965 tax raises these issues because it is imposed on some U.S. shareholders of DFICs not because of actual transactions engaged in by those shareholders on which they in fact realized income or gain — such as selling their shares or receiving actual distributions in respect of their shares — but rather on income they are *deemed* to have realized. At first glance, it might appear that because section 965 resembles other provisions that have withstood constitutional challenge on this ground, such as subpart F<sup>48</sup> and the income attribution under the former foreign personal holding company provisions,<sup>49</sup> a constitutional challenge to section 965 would meet a similar fate — and indeed it may be that Congress chose to incorporate the mechanism under subpart F into section 965 for just that reason.<sup>50</sup> A closer look at the relevant precedent, however, suggests that the tax imposed by section 965 goes well beyond the taxes imposed by those other provisions in terms of whether the tax is a direct tax and whether it is imposed on incomes. An analysis of this issue would proceed along the following lines:

***a. Were the inclusion under section 965, like the inclusion of subpart F income under section 951(a)(1)(A), simply an attribution of the foreign corporation's current earnings to its controlling shareholders, Macomber***

*arguably would not preclude that attribution.*

To be sure, there is language in *Macomber*,<sup>51</sup> as well as legislative history from shortly after that case was decided,<sup>52</sup> that suggests that even a corporation's realized income cannot be attributed to its shareholders. But the lower courts in cases such as *Garlock*, *Estate of Whitlock*, and *Eder*<sup>53</sup> have overcome that language and upheld the attribution of a foreign corporation's current earnings to its controlling shareholders when the reason the statute was enacted was to prevent perceived abuse. The rationale for this result appears to be that because *Macomber* is concerned with *when*, rather than *to whom*, amounts are taxable,<sup>54</sup> and given the numerous authorities that permit the attribution of realized income to those in control of that income,<sup>55</sup> *Macomber* does not prevent the attribution of a corporation's current income that has clearly been realized ("severed from the capital") to its controlling shareholders. Rather, *Macomber* addresses the distinction between capital, which for this purpose includes

<sup>48</sup> *Garlock v. Commissioner*, 58 T.C. 423, 438 (1972) (subpart F inclusion by U.S. shareholders of a CFC under section 951(a)(1)(A)), *aff'd*, 489 F.2d 197 (2d Cir. 1973); *Estate of Whitlock v. Commissioner*, 59 T.C. 490, 505-510 (1972) (inclusion under section 951(a)(1)(B) to the extent of the corporation's current earnings), *aff'd on this issue*, 494 F.2d 1297 (10th Cir. 1976); *Dougherty v. Commissioner*, 60 T.C. 917, 927-930 (1973) (inclusion under section 951(a)(1)(B) exceeding the CFC's current earnings).

<sup>49</sup> *Eder v. Commissioner*, 138 F.2d 27 (2d Cir. 1943); *Alvord v. Commissioner*, 32 T.C. 1, 20 (1959), *rev'd on other grounds*, 277 F.2d 713 (4th Cir. 1960); *Rodney Inc. v. Hoey*, 53 F. Supp. 604 (S.D.N.Y. 1944); *cf. Riverfront Groves Inc. v. Commissioner*, 60 T.C. 435, 441-444 (1973) (attribution of income of a subchapter T cooperative to its patrons).

<sup>50</sup> For an excellent analysis of subpart F and the reasons for and history of its enactment, see Treasury, "The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study" (Dec. 2000). For contemporary (and competing) memoranda regarding the constitutionality of subpart F that were submitted to the House Ways and Means Committee during its consideration in 1961 of what ultimately became subpart F, see "President's 1961 Tax Recommendations: Hearings Before the H. Comm. on Ways and Means on the Tax Recommendations of the President Contained in His Message Transmitted to the Congress," 87th Cong. 311-313 (1961) (Joint Committee on Internal Revenue Taxation memorandum dated May 4, 1961, arguing that subpart F is unconstitutional); and *id.* at 313-322 (Treasury memorandum dated June 12, 1961, arguing that subpart F is constitutional) (hereinafter "Treasury memorandum").

<sup>51</sup> 252 U.S. at 218-219 ("In so far as [*Collector v. Hubbard*, 12 Wall. 1, 17 (1870)] seems to uphold the right of Congress to tax without apportionment a stockholder's interest in accumulated earnings prior to dividend declared, it must be regarded as overruled by *Pollock v. Farmers' Loan & Trust Co.*, 158 U.S. 601, 627, 628, 637. Conceding *Collector v. Hubbard* was inconsistent with the doctrine of that case, because it sustained a direct tax upon property not apportioned among the States, the Government nevertheless insists that the Sixteenth Amendment removed this obstacle, so that now the *Hubbard* case is authority for the power of Congress to levy a tax on the stockholder's share in the accumulated profits of the corporation even before division by the declaration of a dividend of any kind. Manifestly this argument must be rejected, since the Amendment applies to income only, and what is called the stockholder's share in the accumulated profits of the company is capital, not income. As we have pointed out, a stockholder has no individual share in accumulated profits, nor in any particular part of the assets of the corporation, prior to dividend declared.")

<sup>52</sup> See H.R. Rep. No. 67-350, at 10 (1921) (because of "considerable doubt . . . as to the constitutionality of the existing law" in light of *Macomber*, Congress in 1921 replaced a statute that taxed on a flow-through basis the shareholders of corporations that were formed or availed of to avoid the shareholder-level tax on dividends with the corporate-level accumulated earnings tax that was ultimately held to be constitutional in *Helvering v. National Grocery Co.*, 304 U.S. 282 (1938)).

<sup>53</sup> *Garlock*, 58 T.C. 423; *Estate of Whitlock*, 59 T.C. 490; and *Eder*, 138 F.2d 27.

<sup>54</sup> See, e.g., Henry Ordower, "Revisiting Realization: Accretion Taxation, the Constitution, *Macomber* and Mark to Market," 13 *Va. Tax Rev.* 1, 50 (1993).

<sup>55</sup> See, e.g., *Helvering v. Horst*, 311 U.S. 112 (1940); *Burnet v. Wells*, 289 U.S. 670 (1933); and *Corliss v. Bowers*, 281 U.S. 376 (1930).

income previously realized by the corporation but since added to its capital, and income, which for this purpose means currently realized income.<sup>56</sup>

*b. The inclusion under section 965, however, is not limited to a DFIC's current earnings, but rather can arise when the DFIC has accumulated earnings but no current earnings, and even when the DFIC has neither current nor accumulated earnings (for example, when the DFIC has positive aggregate earnings for the post-1986 years in which it was a SFC, and a more-than-offsetting aggregate deficit for its post-1986 years in which it was not an SFC and its pre-1987 years).*

Nor are the taxpayers that are subject to the section 965 tax necessarily part of a group of controlling U.S. shareholders. Indeed, unlike section 951(a)(1)(A), section 965 does not attribute income to controlling shareholders at all. Rather, section 965 appears to be more like the income inclusion under section 951(a)(1)(B) that is triggered by an investment of current or accumulated earnings in U.S. property as described in section 956, which, as with section 965, is designed to end the deferral of the U.S. tax on a non-U.S. corporation's foreign earnings. The legislative history of section 956 confirms that its rationale is that a CFC's investment of earnings in U.S. property is "substantially the equivalent of a dividend being paid to them,"<sup>57</sup> which a court has described as a "statutory constructive dividend doctrine."<sup>58</sup> Section 965 similarly appears to be premised on a deemed or constructive distribution (the "deemed repatriation" referred

to in the legislative history<sup>59</sup>) by the DFIC to some of its shareholders. As a result, unlike section 951(a)(1)(A), section 965 squarely raises the *Macomber* issue of whether any income has been realized and may therefore be constitutionally taxable.

*c. It is axiomatic that if this limitation on the taxing power is to have any meaning, Congress cannot arbitrarily and by fiat create the 'transaction' that causes a tax to be considered an indirect tax or the income that causes a tax to be permitted by the 16th Amendment.*

Otherwise, for example, Congress could simply deem taxpayers to have sold all their assets, impose a tax on the gain on those deemed sales, and take the view that the tax is an indirect tax on the deemed transaction and a tax on the income deemed to result. If this were possible, there would be no limits to the taxing power apart from the imagination of the legislature.<sup>60</sup> Rather, there must be some rational basis for deeming the relevant event (here, a constructive distribution) to have occurred.

Thus, the taxpayer in *Dougherty*<sup>61</sup> challenged the section 951(a)(1)(B)/956 inclusion in a case in which there were no current earnings to attribute, but only pre-enactment accumulated earnings and an investment in U.S. property in the current year. The Tax Court, in what perhaps represents the high-water mark in this area, pointed to a combination of the CFC's investment in U.S. property in the current year and the U.S. shareholders' control over the CFC as, in effect, the rational basis for the deemed distribution of pre-enactment accumulated earnings. The court acknowledged that the CFC's investment in U.S. property in the current year would not be sufficient to invoke the judicial doctrine of constructive distribution, but it stated that

<sup>56</sup> *Macomber*, 252 U.S. at 212 (referring to a corporation's "antecedent accumulation of profits" as an increase in its shareholders' capital); see also *Estate of Whitlock*, 59 T.C. at 508-509 (emphasizing *Macomber*'s focus on a corporation's accumulated (rather than current) earnings); cf. *Helvering v. Northwest Steel Rolling Mills Inc.*, 311 U.S. 46, 52-53 (1940) (surtax on the undistributed current income of a corporation is a tax on incomes even if the corporation's accumulated deficit was greater than its current income: "the tax here under consideration was imposed on profits earned during a definite period — a tax year — and therefore on profits constituting income within the meaning of the Sixteenth Amendment"); *National Grocery Co.*, 304 U.S. at 288 (dicta indicating that Congress could if it chose attribute a corporation's current income to its sole shareholder).

<sup>57</sup> S. Rep. No. 87-1881, at 87-88 (1962); see also *Dougherty*, 60 T.C. at 926 (the stated objective of these provisions is treating a CFC's increase in earnings invested in U.S. property "as if it were a dividend paid to the corporation's shareholders").

<sup>58</sup> *Dougherty*, 60 T.C. at 930.

<sup>59</sup> See *supra* note 3; see also H.R. Rep. No. 115-466, at 375 (expressing the Ways and Means Committee's belief "that it is appropriate to tax such [deferred] earnings as if they had been repatriated under present law" and that the resulting "tax on accumulated foreign earnings should apply without requiring an actual distribution of earnings").

<sup>60</sup> But see *Prescott v. Commissioner*, 561 F.2d 1287, 1293 (8th Cir. 1977) (upholding a tax on a complete liquidation deemed by Treasury regulations to have occurred), criticized in Berg, *supra* note 41, at 202-203.

<sup>61</sup> 60 T.C. 917 (1973).

Congress regarded the CFC's investment in U.S. property as "manifesting the shareholder's exercise of control over the previous income of the corporation."<sup>62</sup> One is left to wonder what the court would have done had the statute in question deemed a distribution absent even that current event.

Interestingly, the Tax Court recently had occasion to revisit *Dougherty's* deemed dividend paradigm in a different context. In *SIH Partners*,<sup>63</sup> the taxpayer, citing *Dougherty*, argued that the income inclusion by reason of section 956, which in *Dougherty* was treated as if it were a dividend, is eligible for the reduced tax rate for dividends under section 1(h)(11). The Tax Court rejected that argument on the ground that an amount treated as if it were a dividend is not a dividend for all purposes of the code.<sup>64</sup> Given that the treatment of the section 956 inclusion as a dividend was the basis on which the court in *Dougherty* had found that provision to be constitutional, the court's recent decision in *SIH Partners* could be said to undermine the constitutional underpinnings of *Dougherty* and thus of section 956.

By contrast, the IRS has announced that under regulations to be issued, the calculations under section 965 will be made and the section 965 inclusions will be taken into account before any amounts are determined under section 956 for the section 965 inclusion year.<sup>65</sup> Because this ordering rule will in many cases cause a CFC's current and accumulated earnings to become previously taxed income described in section 959(a) before section 956 is applied, it will have the effect of providing favorable treatment to any deemed dividends in that year by reason of section 956 — similar to the favorable treatment that section 965 provides for actual distributions by a CFC in the year in which there is a section 965 inclusion (that is, those actual distributions are disregarded for

purposes of section 965 and therefore do not prevent the amount distributed from being eligible for the lower tax rate generally afforded by the section 965(c) deduction).<sup>66</sup>

*d. Whatever one thinks of the Tax Court's decision in Dougherty, section 965 ventures well beyond the limits of that case, deeming a distribution to occur without there being any actual event in the current year, however tangentially related to the deeming of a dividend, that could be said to provide a rational basis therefor.*

Arguably, Congress has gone a bridge too far with section 965, and has enacted the rare tax statute that (1) imposes a tax on a shareholder solely by reason of that shareholder's ownership of shares on an amount (the deferred accumulated earnings) that has not been severed from the ownership of the shares and therefore could not constitute incomes within the meaning of the 16th Amendment and (2) imposes that tax in the absence of any overt action either on the part of the DFIC or the shareholder that could cause the tax imposed by virtue of section 965 to be characterized as a permissible indirect tax.

*e. In the absence of any overt action that triggers the tax, the question is whether Congress may point to the perceived abuse from the continued retention by non-U.S. corporations of their deferred earnings as a rational basis for deeming a distribution to be made to the controlling shareholders that arguably could have caused a distribution to occur, and if so whether there is any limitation on Congress's determination of the degree of control necessary for that action to be deemed to occur.*

As noted above, section 965 may apply to a situation in which shares representing as little as 10 percent of the voting power of the shares of the DFIC are owned (or deemed to be owned) by a U.S. corporation. But even assuming the DFIC were a CFC, control by U.S. shareholders (even

<sup>62</sup> *Id.* at 930.

<sup>63</sup> *SIH Partners LLP v. Commissioner*, 150 T.C. No. 3 (Jan. 18, 2018).

<sup>64</sup> *Id.*, citing *Rodriguez v. Commissioner*, 722 F.3d 306 (5th Cir. 2013).

<sup>65</sup> See Notice 2018-7, at section 3.02(d).

<sup>66</sup> See *supra* note 15; and sections 965(d)(2)(B) and 951(a)(1)(B); cf. section 989(b) (treating an inclusion under section 951(a)(1)(B) "as an actual distribution made on the last day of the taxable year for which such amount was so included" for purposes of foreign currency translation).

coupled with perceived abuse) by itself has not been considered a sufficient rational basis for a deemed distribution of accumulated profits (as opposed to the attribution of current income), any more than a taxpayer's control over other property owned by the taxpayer can be considered a sufficient rational basis for a deemed sale of that property.<sup>67</sup>

***f. While NFIB might appear to be to the contrary, on a closer reading that case appears to be distinguishable.***

In *NFIB*,<sup>68</sup> the Supreme Court determined that the “shared responsibility payment” imposed by Congress in 2010 for failing to obtain health insurance,<sup>69</sup> which the Court found to be an exercise of Congress’s taxing power, is not a direct tax because it is not a capitation imposed “without regard to property, profession, or *any other circumstance*” and is “plainly not a tax on the ownership of land or personal property.”<sup>70</sup> To be sure, the section 965 tax, like the shared responsibility payment in *NFIB*, is imposed in the absence of any action. Arguably, however, *NFIB* can be distinguished on the ground that unlike the shared responsibility payment in that case — which the Court found not to be a direct tax because it is not imposed merely because the taxpayer owns property — the section 965 tax is imposed solely because a U.S. shareholder owns shares in a corporation, without regard to whether there has been a transfer or other use of

that property by the taxpayer, or even whether the shareholder or the corporation has any current income (and, as has been noted, in some circumstances without regard to whether the corporation even has accumulated income). As a result, the section 965 tax would appear to be a direct tax on the general ownership of property — that is, the shares of the DFIC.<sup>71</sup>

***g. Thus, in the absence of an actual event after the effective date of section 965 that could provide a rational basis for a legislative determination that there was a deemed distribution and thus that the tax is either an indirect tax or imposed on incomes, section 965 would appear to be vulnerable to a constitutional challenge on its face (that is, even as applied to controlling shareholders) on the same grounds as the statute that was found to be unconstitutional in Macomber.***

***h. At the very least, even if section 965 were to survive the above facial challenge, section 965 appears to be on shaky constitutional grounds as applied to several situations.***

For example, (1) the corporation is not a CFC and is a DFIC only because it has a U.S. shareholder that owns shares representing as little as 10 percent of the voting power, so that a group of U.S. persons in control of the corporation cannot rationally be said to exist; (2) the DFIC has no current or accumulated earnings, and therefore an actual distribution by the DFIC

<sup>67</sup> While doubt has been expressed concerning the constitutionality of the deemed-sale exit tax on expatriates and others under section 877A (Berg, *supra* note 41), at least in the case of section 877A one can point to action taken by (or peculiar circumstances regarding) the owner of the property deemed to have been sold, *i.e.*, her voluntary expatriation or even an involuntary loss of status as a permanent long-term U.S. resident. We note that thus far, no court has addressed whether any such action could be considered a sufficient basis to classify a tax imposed on the portion of the value of property exceeding its cost basis as a permissible indirect tax.

<sup>68</sup> 567 U.S. at 570-571. Despite the views of some commentators who have suggested that both the prohibition on unapportioned direct taxes and *Macomber* are dead letters (see, *e.g.*, Ackerman, *supra* note 46; and Calvin H. Johnson, “Apportionment of Direct Taxes: The Foul-Up in the Core of the Constitution,” 7 *Wm. & Mary Bill Rts. J.* 1 (1998)), the Court in *NFIB* reaffirmed that unapportioned direct taxes are unconstitutional, cited *Macomber* with approval, and acknowledged that *Macomber* has continuing relevance regarding the constitutional principles discussed herein.

<sup>69</sup> Section 5000A(b), added to the code by section 1501(b) of the Patient Protection and Affordable Care Act of 2010, P.L. 111-148. It was effectively repealed by section 11081 of the TCJA.

<sup>70</sup> *NFIB*, 567 U.S. at 571 (citations and internal quotation marks omitted; emphasis in original).

<sup>71</sup> See Berg, *supra* note 46; see also *Murphy v. IRS*, 460 F.3d 79 (D.C. Cir. 2006) (a tax on compensatory damages for emotional distress and loss of reputation is not a tax on incomes within the meaning of the 16th Amendment and therefore is unconstitutional), *vacated*, 493 F.3d 170 (D.C. Cir. 2007) (accepting the government’s argument, made for the first time in its motion for reconsideration, that the tax is imposed on a transaction and thus is not a direct tax). Interestingly, the Supreme Court’s other holding in *NFIB* — that the individual health insurance mandate exceeded Congress’s power under the commerce clause because it is a regulation of inactivity — would appear to preclude an additional argument in defense of section 965 along the lines of the argument that Treasury made in 1961 that even if subpart F exceeded Congress’s taxing power, it was a valid exercise of Congress’s power to regulate commerce with foreign nations. See Treasury memorandum, *supra* note 50, at 318-321.

would not have been taxable to its U.S. shareholders as a dividend;<sup>72</sup> or (3) the DFIC has invested 100 percent of its current and accumulated earnings in its non-U.S. business, so that even if accumulating earnings for a ‘bad’ purpose could be said to be the type of ‘abuse’ that creates a rational basis for deeming a dividend, that basis would not be applicable.

Similarly, consider the case of a taxpayer that is a U.S. shareholder of a DFIC in the last tax year of the DFIC that began before January 1, 2018, but acquired the shares in the DFIC shortly before the time of the section 965 inclusion and thus was not a shareholder of the DFIC in prior years.

**Example 4:** FC4, a calendar-year non-U.S. corporation, has been an SFC throughout its existence. FC4 has a deferred amount of \$10 million, 100 percent of which is attributable to its earnings for the period of January 1, 1987, through October 31, 2017, and it has no E&P for the period of November 1, 2017, to December 31, 2017. D Corp., a U.S. corporation, purchases 10 percent of the single class of shares in FC4 on November 1, 2017, for \$1 million from a person having no basis in the shares.

If FC4 were a CFC, FC4 would appear to have no deferred amount, and D Corp. would appear to have no section 965 inclusion, because all of FC4’s earnings would, if distributed, be excluded from the deferred amount by reason of section 965(d)(2).<sup>73</sup> Moreover, even in the case of a DFIC that is not a CFC, it is certainly possible to read the language of section 965 to provide that D Corp. has no income inclusion thereunder because none

of FC4’s deferred amount represents earnings from periods when D Corp. was a shareholder of FC4 (much less in control of FC4), and therefore D Corp. did not defer U.S. tax on any earnings of a non-U.S. corporation.<sup>74</sup>

But suppose FC4 were not a CFC and section 965 were nonetheless to be interpreted to require an income inclusion in 2017 by D Corp. of \$1 million, being D Corp.’s 10 percent share of FC4’s deferred amount of \$10 million, as determined after D Corp. purchased shares in FC4 but without regard to how much of FC4’s deferred amount represents earnings in years when D Corp. was a shareholder. Such an interpretation could well give rise to a challenge to section 965 as applied to D Corp. on both the grounds discussed above (because D Corp. is being taxed not on its income or even FC4’s income, but rather on capital (that is, shares in FC4) it purchased after FC4 had the earnings that gave rise to the deferred amount) and due process/equal protection grounds (because D Corp., not having been a shareholder of FC4 when the income was earned, is being taxed on someone else’s income).<sup>75</sup>

## B. The Equal Protection Clause

The equal protection clause of the 14th Amendment<sup>76</sup> does not by its terms apply to Congress; but the Fifth Amendment’s due process clause,<sup>77</sup> which is applicable to federal laws passed by Congress, has been found to have an equal protection component.<sup>78</sup> As applied to economic regulations such as tax laws that do not involve fundamental rights or suspect classifications, such as those based on race, the

<sup>72</sup>Similarly, although section 951A, added to the code by section 14201(a) of the TCJA, is an income attribution statute and thus does not raise issues in this regard of the same magnitude as those raised by section 965, there can be circumstances in which a U.S. shareholder of a CFC has an income inclusion under section 951A when the CFC has no current (or even accumulated) E&P, so that an actual distribution by the CFC would not be taxed as a dividend in the hands of the U.S. shareholder. See section 951A(c)(2)(A) and (B)(ii). As applied in these situations, section 951A is arguably an unapportioned direct tax on something other than incomes and therefore unconstitutional.

<sup>73</sup>See section 965(d)(2) (the deferred amount excludes earnings that if distributed would be excluded from the gross income of a U.S. shareholder of a CFC under section 959, and under regulations this will also be applied for shareholders who are not U.S. shareholders as if they were); Notice 2018-7 at section 3.02(c) (the regulations described in section 965(d)(2) will be issued); section 959(e) (amounts included in the gross income of a selling shareholder as a dividend by reason of section 1248(a) will be treated as an amount included in gross income of that person under section 951(a)(1)(A)); section 959(a) (amounts included in gross income under section 951(a) will not, when distributed, be again included in gross income).

<sup>74</sup>See section 965(d)(1) (“The term ‘deferred foreign income corporation’ means, with respect to any United States shareholder, any specified foreign corporation of such shareholder which has accumulated post-1986 deferred foreign income (as of [the measuring date]) greater than zero” (emphasis added).); see also section 965(f) (determining a taxpayer’s pro rata share of a DFIC’s section 965 inclusion amount “under rules similar to the rules of section 951(a)(2)”; cf. *Marsman v. Commissioner*, 205 F.2d 335 (4th Cir. 1953) (declining to interpret the former foreign personal holding company provisions in a manner that would apply the tax to an individual on earnings derived before she became a U.S. resident); *Gutierrez v. Commissioner*, 53 T.C. 394 (1969) (same), *aff’d mem.* (D.C. Cir. 1971).

<sup>75</sup>U.S. Const., Amend. V; see, e.g., *Hoepfer v. Tax Commission of Wisconsin*, 284 U.S. 206 (1931) (taxation of one person on another’s income violates the due process and equal protection clauses).

<sup>76</sup>U.S. Const., Amend. XIV.

<sup>77</sup>U.S. Const., Amend. V.

<sup>78</sup>See, e.g., *Bolling v. Sharpe*, 347 U.S. 497 (1954).

courts have upheld classifications for which there is a rational basis.<sup>79</sup> Under this standard, a great deal of deference is given to tax statutes, upholding them as long as “there is a plausible policy reason for the classification, the legislative facts on which the classification is apparently based rationally may have been considered to be true by the governmental decisionmaker, and the relationship of the classification to its goal is not so attenuated as to render the distinction arbitrary or irrational.”<sup>80</sup>

Section 965 makes some classifications that appear to fail even under this deferential standard.

**Example 5:** E, a U.S. citizen, owns 10 percent of the voting stock of FC5, a non-U.S. corporation. F Corp., a U.S. corporation that is unrelated to E, owns another 10 percent of the voting stock of FC5. G, also a U.S. citizen, owns 10 percent of the voting stock of FC6, another non-U.S. corporation. No U.S. corporation owns, directly or by attribution, any shares in FC6. FC5 and FC6 both have deferred amounts, and neither one is a CFC or a PFIC.

FC5 is a DFIC because F Corp., a U.S. corporation, owns 10 percent or more of its voting stock, while FC6 is not a DFIC because no U.S. corporation owns or is deemed to own 10 percent of the voting stock of FC6. As a result, E is subject to section 965 tax while G is not, with the only difference between these two U.S. citizens being that E happens to have a co-shareholder that is a U.S. corporation while G does not. Because it is difficult to imagine a rational basis for this distinction between E and G, section 965 as applied to E would appear to be vulnerable to challenge on equal protection grounds.

Similarly susceptible to challenge on this ground is the distinction that section 965 draws between shareholders who own 10 percent or more of the voting stock of a foreign corporation and those who own less than 10 percent, as well as the distinction between an individual shareholder

who has a co-shareholder that is a U.S. corporation that owns 10 percent or more of the voting stock and an individual shareholder who has a co-shareholder that is a U.S. corporation that owns less than 10 percent of the voting stock.

## V. Protective Measures

If a taxpayer wishes to challenge the validity of a tax (or its applicability to the taxpayer for any other reason), the alternative methods for doing so are (1) not paying the tax and, when and if the IRS issues a statutory notice of deficiency,<sup>81</sup> challenging the deficiency in the Tax Court by filing a timely petition (generally within 90 days of the date of the mailing of the notice of deficiency);<sup>82</sup> or (2) paying the tax, filing a timely administrative claim for refund (generally by the later of three years after the return is filed or two years after the tax is paid) and, if the refund claim is denied, bringing a timely refund action in the Court of Federal Claims or the relevant district court (generally no earlier than six months after filing an administrative claim for refund and no later than two years after the date of the mailing of any notice of disallowance of the refund claim).<sup>83</sup>

Significantly, under the so-called full-payment rule, to bring a refund action, a taxpayer generally must pay the full amount of the tax, even in situations in which the tax is payable in installments.<sup>84</sup> Since the time limit for filing a refund claim generally expires on the later of three years after filing the relevant return or two years after paying the tax, a taxpayer that elects under section 965 to pay the section 965 tax on a backloaded basis over an eight-year period and that in fact pays the tax on that schedule may be precluded from claiming a refund of any section 965 tax paid more than two years before the final installment is paid.

**Example 6:** FC7, a calendar-year non-U.S. corporation, has a deferred amount of

<sup>79</sup> See, e.g., *Armour v. Indianapolis*, 566 U.S. 673, 680-681 (2012); and *New Orleans v. Dukes*, 427 U.S. 297, 303 (1976).

<sup>80</sup> *Nordlinger v. Hahn*, 505 U.S. 1, 11 (1992) (citations omitted); see also *Allegheny Pittsburgh Coal Co. v. Commission of Webster County*, 488 U.S. 336, 344 (1989) (no equal protection violation so long as the classification is “neither capricious nor arbitrary, and rests upon some reasonable consideration of difference or policy”).

<sup>81</sup> The limitations period for which is six years from the date the tax return for the section 965 inclusion year is filed, rather than the generally applicable three years. Section 965(k).

<sup>82</sup> Sections 6213(a) and 6503(a)(1).

<sup>83</sup> Sections 6511(a), 6532(a)(1), and 7422(a).

<sup>84</sup> *Flora v. United States*, 362 U.S. 145 (1960); see section 7422(j) (statutory exception to the full-payment rule for estate tax paid in installments under section 6166).

\$57,021,840, 100 percent of which is represented by cash and cash equivalents. FC7 is a DFIC. H, a U.S. citizen, owns voting shares in FC7 representing 10 percent of the voting power, so that H's pro rata share of FC7's deferred amount — and thus H's section 965 inclusion in 2017 — is \$5,702,184, the tax on which is \$1 million.<sup>85</sup> H reports the section 965 inclusion on H's 2017 tax return, elects under section 965(h) to pay the section 965 tax in installments, and accordingly pays the tax as follows:

Date	Amount
April 15, 2018	\$80,000
April 15, 2019	\$80,000
April 15, 2020	\$80,000
April 15, 2021	\$80,000
April 15, 2022	\$80,000
April 15, 2023	\$150,000
April 15, 2024	\$200,000
April 15, 2025	\$250,000
Total	\$1 million

Under the full-payment rule, H would be precluded from filing a claim for refund of the section 965 tax until April 15, 2025, when the last installment of that tax is paid. Moreover, any such claim for refund would be timely only as to the amounts paid during the two-year period before filing the claim.<sup>86</sup> Thus, if the last payment is made on April 15, 2025, a refund claim filed on that date could cover only the payments made on April 15, 2024, and April 15, 2025 (whereas if the last payment were made and the refund claim were filed a day earlier — on April 14, 2025 — the refund claim could cover the last three payments made, representing 60 percent of the tax).

As a result, a taxpayer that is contemplating a challenge to section 965 is in a procedural bind: If the taxpayer elects to pay the tax in installments, the benefits of the interest-free deferral of the tax

must be weighed against the resulting preclusion of that taxpayer from claiming a refund for what could well be a substantial portion of the tax. Thus, a taxpayer that wishes to challenge section 965 should consider not electing to pay the tax in installments, but rather either not paying section 965 tax on the basis of constitutionality (in which case consideration should be given to disclosing this position on the tax return as a means of avoiding penalties),<sup>87</sup> or paying the section 965 tax in full upfront and filing a timely claim for refund. As an alternative, a taxpayer that elects to pay the tax in installments can at any time prepay the balance of the tax and at that time file a claim for refund, in which case the refund claim could include all taxes paid within two years of the date of the refund claim.

Significantly, since it seems inevitable that someone will challenge section 965 on the grounds described above, even a taxpayer that has no intention to challenge section 965 would be well advised to consider taking protective steps, including filing a protective claim for refund, to protect the taxpayer's right to a refund in the event section 965 is successfully challenged.

## VI. Conclusion

Much has been written in the press about corporate America being in favor of the reduced 21 percent corporate tax rates generally and the even lower tax rates that could apply to foreign earnings by reason of sections 951A, 250, and 245A, which could collectively reduce the U.S. corporate tax on foreign earnings other than subpart F income to 10.5 percent (and in some circumstances even lower). With these benefits in mind, the one-time "hit" to corporate earnings occasioned in no small part by the imposition of the section 965 deemed repatriation tax may be a price to which corporate America is resigned. But should it be? These other benefits are not dependent on whether section 965 is determined to be valid if challenged. And while one cannot predict with certainty that a challenge to section 965 would be successful — particularly given the general reluctance of courts to strike down taxing statutes on constitutional grounds — the

<sup>85</sup> See *supra* notes 25 and 36. But see *supra* text accompanying notes 28-30 for a discussion of why the effective tax rate may be higher than 17.54 percent.

<sup>86</sup> See section 6511(a).

<sup>87</sup> See section 6662(d)(2)(B)(ii).

authorities strongly suggest that unlike section 956, the application of section 965 to a corporation's accumulated profits may well be found to be invalid.

Indeed, there are substantial arguments that can be made to support the position that unlike the application of the subpart F provisions generally and section 956 in particular, section 965 is unconstitutional, at least as applied to some types of U.S. shareholders (such as noncontrolling shareholders of a DFIC that is not a CFC, and shareholders of a DFIC that has a deferred amount but either has no current or accumulated E&P or with respect to a particular U.S. shareholder has no post-1986 E&P accumulated during the period such person was a shareholder<sup>88</sup>).

As noted previously, while corporations may generally view the deemed repatriation tax as a fair price to pay for the reduction in the corporate tax rates (although one may question whether they have done their sums correctly), given the diverse circumstances of taxpayers, no doubt at least some will feel differently. As a result, the likelihood that someone will question the validity of section 965 should not be discounted. Should such a challenge occur, the constitutional limitations on the taxing power discussed above would be put in issue. If section 965 were to be upheld, would anything be left of the explicit constitutional prohibition against unapportioned direct taxes, and if not, what might that portend for other explicit constitutional limitations on governmental power that some might consider to be equally anachronistic? In any event, taxpayers to whom section 965 ostensibly applies would be well advised to consider these arguments and to take steps to protect their rights (and the rights of their shareholders) to a refund in the event section 965 is successfully challenged. ■

<sup>88</sup> See *supra* notes 73-75 and accompanying text.

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