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How Notice 2018-13 Frames Foreign Earnings Transition Tax

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On Jan. 19, the U.S. Department of the Treasury and the Internal Revenue Service issued Notice 2018-13 — Additional Guidance Under Section 965 and Guidance Under Sections 863 and 6038 in Connection with the Repeal of Section 958(b)(4). As its title implies, Notice 2018-13 elaborates on the first published guidance addressing the Tax Cuts and Jobs Act's new §965 deemed repatriation provision, which was issued on Dec. 29, 2017, as Notice 2018-07 (the prior notice). Notice 2018-13 also describes the IRS and Treasury's intent to issue updated Form 5471 instructions, which will introduce an important (and much needed) limitation to the filing requirements following the repeal of §958(b)(4).

Section 965 and the Prior Notice

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New §965, enacted on Dec. 22, 2017, as part of the new tax reform legislation, has a two-part mechanism.

First, it piggybacks on subpart F to deem a gross income inclusion under §951(a)(1)(A) for U.S. shareholders of "deferred foreign income corporations" (DFICs). This inclusion is structured as an increase in the subpart F income of a DFIC, for its last taxable year beginning before Jan. 1, 2018 (the inclusion year), equal to the greater of the DFIC's "accumulated post-1986 deferred foreign income" (generally, accumulated untaxed post-1986 earnings and profits (E&P)) determined on Nov. 2, 2017, and Dec. 31, 2017 (the measurement dates). This amount is reduced by any aggregate post-1986 E&P deficits, measured as of Nov. 2, 2017, of "E&P deficit foreign corporations" (EDFCs) allocated to the U.S. shareholder.

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Second, it allows a U.S. shareholder with a §965(a) inclusion a deduction based on two measurements: the U.S. shareholder's "aggregate foreign cash position amount" (resulting in the inclusion being taxed at a 15.5 percent rate) and the aggregate E&P held in forms other than cash or equivalents, as defined (resulting in the inclusion being taxed at an 8 percent rate).

Unfortunately, the statutory text of §965 leaves many open questions regarding how a U.S. shareholder's §965 inclusion amount is computed, as well as the scope of any anti-avoidance rules authorized under §965(o)(2). The prior notice responds to the first concern

by expressing the government's intent to issue regulations addressing a host of §965 computational issues. These issues, in part, include preventing unintended distortions of the "accumulated post-1986 deferred foreign income" and "aggregate foreign cash position amount" attributable to related-party transactions, transactions occurring between the measurement dates and complications associated with fiscal tax year DFICs. The prior notice also addresses how §965 inclusions are coordinated with the §959 previously taxed income (PTI) rules and certain related issues.

New Guidance Concerning the Application of §965

Notice 2018-13 builds on the prior notice by detailing the government's intent to issue regulations addressing additional §965 computational issues.

First, Notice 2018-13 describes regulations that will clarify that a foreign corporation which is a DFIC may not also be an EDFC (even if it otherwise satisfies the EDFC definition). This means that a "specified foreign corporation" (SFC) of a U.S. shareholder (a foreign corporation that may be classified as either a DFIC or EDFC with respect to a U.S. shareholder) that has an accumulated post-1986 E&P deficit as of Nov. 2, 2017 (the EDFC testing date), is a DFIC and not an EDFC if such SFC has positive post-1986 accumulated deferred foreign income as of Dec. 31, 2017. The new regulations will clarify that an SFC with accumulated post-1986 E&P greater than zero may be neither a DFIC or EDFC. For example, if an SFC has accumulated post-1986 E&P greater than zero consisting of a positive E&P amount, all of which would be PTI if distributed and a lesser E&P deficit amount not attributable to PTI if distributed, the SFC is not classified as a DFIC or an EDFC because, unlike accumulated post-1986 E&P, accumulated post-1986 deferred foreign income does not include PTI. The implication of this rule is important because only the E&P deficits of EDFCs may be used by U.S. shareholders to offset the accumulated post-1986 deferred foreign income of its DFICs.

Notice 2018-13 also describes forthcoming regulations permitting U.S. shareholders to make an election to compute the accumulated post-1986 E&P of an SFC using an October month-end simplifying convention. Specifically, U.S. shareholders will be permitted to elect an "alternative method" of computing positive or negative aggregate post-1986 E&P as of Nov. 2, 2017, by computing such E&P amount as of Oct. 31, 2017, and adding two additional days' worth of E&P based on a per day E&P calculation determined as if the SFC's taxable year including Oct. 31, 2017, ended on such date and assuming the SFC earned E&P during the two-day period following Oct. 31, 2017, at the same rate at which it earned E&P during the year ending Oct. 31, 2017. Special rules are also provided for applying the alternative method to SFCs that have 52-53 week taxable years. Notice 2018-13 recognizes that the alternative method will be helpful for taxpayers in avoiding the challenge of computing E&P in the middle of a month.

Notice 2018-13 signals that regulations will be issued under §965 addressing the calculation of a U.S. shareholder's pro rata share of an EDFC's E&P deficit where there are multiple classes of stock. Such regulations will provide that a specified E&P deficit of such an EDFC is "is allocated first among the shareholders of the corporation's common stock and in proportion to the value of the common stock held by such shareholders," presumably as a percentage of the value of the corporation's entire equity capital. See Reg. Sec. 1.951-1(e), cited by the notice. Consistent with the conference report to the tax reform legislation, regulations will also specify that an E&P deficit includes a "hovering deficit" (as defined in §1.367(b)-7(d)(2)(i)).

For purposes of computing "net accounts receivable" (or "accounts receivable" less "accounts payable") included in the "aggregate foreign cash position amount," Notice 2018-13 signals that future regulations

will generally limit the definition of "accounts receivable" and "accounts payable" to include only ordinary course of business financings. Notice 2018-13 also sets forth that regulations will treat a demand loan (or a loan that must be repaid within one year of such demand) as a short-term obligation included in the aggregate foreign cash position amount.

Additionally, Notice 2018-13 details that forthcoming regulations will address the application of §965 with respect to SFCs that use a functional currency other than the U.S. dollar. For purposes of computing the §965 inclusion amount, the regulations will apply the spot rate as of Dec. 31, 2017, to translate the foreign-currency-denominated accumulated post-1986 E&P into U.S. dollars, regardless of an SFC's taxable year or the applicable measurement date. Forthcoming regulations will also address how to compute the accumulated post-1986 E&P of an SFC that changes its functional currency between the two measurement dates, and will further provide that foreign currency gain or loss on any subsequent distribution of PTI attributable to a §965 inclusion will be determined based on the movement in the exchange rate between Dec. 31, 2017, and the date of the PTI distribution. The future regulations will finally require that foreign-currency-denominated "cash positions" be converted into U.S. dollars at the spot rate on the relevant cash measurement date for determining the U.S. shareholder's "aggregate foreign cash position amount."

The prior notice announced that future regulations will provide that if a U.S. shareholder receives distributions from a DFIC during an inclusion year that are attributable to PTI, the amount of gain recognized by the U.S. shareholder with respect to the stock of the DFIC under §961(b)(2) will be reduced (but not below zero) by the §965 inclusion amount (the "gain-reduction rule"). Notice 2018-13 states that future regulations will also address the application of the gain-reduction rule to distributions received from a DFIC through a chain of ownership described in §958(a). These regulations will reduce the amount of gain recognized by a U.S. shareholder under §961(b)(2) or §961(c) (distribution of PTI in excess of a shareholder's basis in foreign corporation stock) by the §965 inclusion amount for distributions through a chain of ownership described under §958(a) from a DFIC during the inclusion year. This expansion of the gain-reduction rule provides additional comfort for U.S. shareholders desiring to pull cash out of SFCs prior to the end of the tax year of a §965 inclusion without triggering an additional corporate entity-level gain.

Elimination of Form 5471 Filing Obligation for Certain Constructive Owners

The filing obligations for Form 5471 ("Information Return of U.S. Persons With Respect To Certain Foreign Corporations") took on a more expansive reach following the repeal of §958(b)(4). Notice 2018-13 provides much needed administrative relief to taxpayers through the introduction of an exception to the filing requirements for Form 5471 with respect to certain constructive owners of CFCs.

Due to the repeal of §958(b)(4), the stock of a foreign corporation that is owned by a foreign person is now attributed to a U.S. person owned by the second foreign person under §318(a)(3) for purposes of determining whether the U.S. person is a U.S. shareholder of the first foreign corporation and whether the first foreign corporation is a CFC. As a result, foreign corporations that were not previously characterized as CFCs may now be characterized as CFCs for purposes of triggering a Form 5471 filing obligation even though such foreign corporations do not have any direct or indirect U.S. owners. (Note that the repeal of §958(b)(4) did not modify the subpart F inclusion rules. A U.S. shareholder's pro rata share of a CFC's subpart F income and any §956 amount continue to be determined based on direct and indirect ownership of the subject CFC under §958(a), which does not take into account downward attribution.)

Notice 2018-13 states the IRS intends to amend the instructions for Form 5471 to provide an exception to the filing obligation for any U.S. person that is a U.S. shareholder with respect to a CFC, provided no U.S. shareholder owns stock in such CFC within the meaning of §958(a), and the foreign corporation is a CFC solely because such U.S. person is considered to own the stock of the foreign corporation owned by a foreign person under § 318(a)(3). Notice 2018-13 states that until the instructions to Form 5471 are modified, taxpayers may rely on the exception outlined in the notice for the last taxable year of foreign corporations beginning before Jan. 1, 2018, and each subsequent year, and for the taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

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