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IRS Provides Guidance on Tax Reform’s New § 965 Deemed Repatriation Provision

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It answers some questions but leaves many issues unresolved.

On December 29, the US Internal Revenue Service (IRS) issued Notice 2018-07—*Guidance under Section 965* (the Notice)—indicating its intent to issue regulations for determining amounts included in gross income by a US shareholder under § 951(a)(1) by reason of the tax reform’s new § 965 deemed repatriation provision, enacted December 22.

New § 965 has a two-part mechanism. First, it piggybacks on subpart F to deem a gross income inclusion under § 951(a)(1)(A) for US 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 January 1, 2018 (the inclusion year), equal to the greater of the DFIC’s “accumulated post-1986 deferred foreign income” determined on November 2, 2017 and December 31, 2017 (the measurement dates). This amount is reduced by any aggregate E&P deficits allocated to the DFIC. Second, it allows a US shareholder with a § 965(a) inclusion a deduction based on two measurements: the US 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 eight percent rate).

Section 3 of the Notice describes regulations to be issued under § 965. It has five subsections, described below.

Section 3.01—Determining the Aggregate Foreign Cash Position

In cases where a taxpayer is a US shareholder in multiple DFICs that have differing taxable years, there may be more than one year of the US shareholder in which gross income inclusions under § 951(a)(1)(A) must be taken into account as a result of § 965. For example, for a calendar-year US shareholder in multiple DFICs, some (but not all) of which have elected under § 898(c)(2) to have a

taxable year ending on November 30, the inclusion year with respect to the calendar year DFICs would be the calendar year 2017, while the inclusion year with respect to the November 30 DFICs would be the fiscal year ending November 30, 2018. The result under § 951(a)(2)(1)(A) would be that the US shareholder would have gross income inclusions arising from § 965 both in 2017 and in 2018 (the US shareholder inclusion years).

The Notice acknowledges that, in the case of a US shareholder with more than one US shareholder inclusion year, the statutory definition of the aggregate foreign cash position (which determines the amount of the § 965 inclusion that is taxed at the 15.5 percent rate rather than at the eight percent rate) could result in inappropriately counting the same foreign cash for each US shareholder inclusion year.

As a relief measure, the Notice announces the intention to issue regulations to avoid such double counting of cash. Specifically, the regulations announced in the Notice will provide that, in determining the aggregate foreign cash position for the first US shareholder inclusion year, the amount taken into account is the lesser of the US shareholder's aggregate foreign cash position or the aggregate of the § 965(a) inclusions taken into account by the US shareholder for that year. For a subsequent US shareholder inclusion year, the amount as determined under the statutory prescription will be reduced by the amount taken into account in any preceding US shareholder inclusion year.

The announced relief will also address another problem in the statutory definition of aggregate foreign cash position that arises in that situation—specifically, that the information necessary to determine the aggregate foreign cash position with respect to a US shareholder for its first US shareholder inclusion year (say, calendar year 2017) depends on (among other things) the cash position of all the specified foreign corporations (SFCs) in which it is a US shareholder as of the end of each SFC's inclusion year (which may be December 31, 2017 or November 30, 2018). Not all the information may be available to the US shareholder when it has to file its tax return for its year ending December 31, 2017.

To address this problem, the regulations will provide that, to the extent that the determination of the aggregate foreign cash position depends on the cash position of any SFCs of the US shareholder as of the end of a SFC taxable year that comes after the due date (including extensions) of the US shareholder's tax return for the US shareholder's inclusion year, the US shareholder may assume that the cash position of such SFCs at the end of such years is zero. The Notice references future guidance regarding the appropriate method to adjust for the difference between the actual year end cash position of a SFC and the assumed zero amount in accordance with the Notice modifications described above.

Related Party Accounts and Loans

In determining the cash position of a SFC, § 965(c)(3)(D) mandates that certain cash equivalents, such as accounts receivable or loans with a term of less than a year, should not be counted if the US shareholder has already taken the same amount into account with respect to another SFC. The provision deals with the double counting of a loan or account receivable held by one SFC and cash held by another SFC which may be held to repay the loan or account. The Notice extends the concept underlying the provision by announcing that all receivables or payables between SFCs will be disregarded to the extent of the common ownership by a US shareholder. Thus, for example, an intercompany receivable held by one SFC will not be taken into account regardless of the cash position of the counterparty SFC if both are wholly owned by the same US shareholder.

Derivative Financial Instruments

The Notice also announces the US Treasury's intent to exercise its regulatory authority to identify assets as economically equivalent to those specified in the statute as cash equivalents by including derivative financial instruments (such as notional principal contracts, options, forwards, futures, short positions in commodities or securities, or similar financial instruments) other than those that are a "bona fide hedging transaction" for purposes of subpart F. Treasury and the IRS are considering whether future guidance should exclude from the definition of a cash position financial instruments that are not actively traded or that do not reference a cash-equivalent asset.
With respect to derivative financial instruments that are bona fide hedging transactions used to hedge a cash-equivalent asset, the amount taken into account in relation to the cash-equivalent asset in computing the cash position will include the value of the hedge (positive or negative).

Section 3.02—Determining Accumulated Post-1986 Deferred Foreign Income

Section 3.02 of the Notice addresses four aspects in the determination of accumulated post-1986 deferred foreign income. The first concerns adjustments to post-1986 E&P in connection with payments between SFCs between the November 2, 2017 and December 31, 2017 E&P measurement dates. Citing the *Conference Report*, the Notice signals intent to issue regulations addressing the possibility of double-counting or double non-counting in computing post-1986 E&P arising from amounts that are paid or incurred between related SFCs between the measurement dates and that would otherwise reduce post-1986 E&P on the latter such date. The issue can arise because the § 965(a) earnings amount (the amount that gives rise to the subpart F inclusion) depends on the greater of the accumulated post-1986 deferred foreign income on the two measurement dates. The Notice gives two examples in which—under regulations—adjustments will be made to inter-SFC, inter-measurement date payments to, in essence, ignore the payments to arrive at aggregate § 965(a) earnings. A third example shows that the regulations won't adjust aggregate § 965(a) earnings of foreign corporations to the extent they get inter-measurement date payments from unrelated parties. The fourth and final example is a variant of the third, adding an inter-SFC, inter-measurement date payment, and concluding that an adjustment will be made.

The second aspect concerns the "dividend reduction rule" in § 965(d)(3)(B), under which post-1986 E&P of a SFC are reduced to reflect dividends distributed during the corporation's inclusion year to another SFC. The dividend reduction rule addresses potential double-counting of the distributing SFC's E&P in calculating the § 965(a) inclusion amounts with respect to the distributing and distributee SFCs. The Notice posits a situation in which a portion of an inter-SFC distribution reduces post-1986 E&P of a distributing SFC by an amount exceeding the increase of the post-1986 E&P of the distributee SFC, and notes that such reduction wouldn't relieve double-counting and so would be inconsistent with the purpose of the rule. The Notice says this could arise, for example, under an E&P reduction under § 312(a)(3)—e.g., in an inter-SFC distribution of property whose adjusted basis exceeds its fair market value. The Notice signals issuance of regulations clarifying that the amount by which the post-1986 E&P of a SFC is reduced under § 965(d)(3)(B) because of a distribution made to a SFC in the inclusion year may not exceed the amount by which the post-1986 E&P of the distributee corporation is increased as a result of the distribution.

The first and second aspects of § 3.02 of the Notice address concerns over double counting and double non-counting of earnings, but don't address IRS authority under § 965(o)(2) to issue anti-abuse regulations or other guidance to prevent avoidance of the purposes of § 965 through a reduction in E&P, whether in the inclusion year or earlier.

The third aspect of section 3.02 addresses determining accumulated post-1986 deferred foreign income in the case of a controlled foreign corporation (CFC) with non-US shareholders on a measurement date. Regulations will provide that the CFC's accumulated post-1986 deferred foreign income will be reduced—following the principles of Rev. Rul. 82-16—by amounts that would be described in § 965(d)(2)(B) (i.e., previously tax income (PTI)) if such shareholders were US shareholders. The Notice gives an example illustrating this reduction.

The fourth aspect concerns coordination between §§ 959 and 965 in the inclusion year. This guidance will help taxpayers hoping to repatriate § 965 PTI during the inclusion year. Regulations will describe a five-step method for determining subpart F inclusions, including § 965(a) inclusions, the effect of distributions of PTI under § 959, and § 956 inclusions under § 951(a)(1)(B): (1) a DFIC's subpart F income and the US shareholder's § 951(a)(1)(A) inclusion are determined first, ignoring § 965(a); (2) the § 959 treatment of pre-January 1, 2018 distributions from a DFIC to another SFC is determined; (3) the DFIC's § 965(a) inclusion amount and the US shareholder's corresponding § 951(a)(1)(A) amount are determined; (4) the treatment of all distributions—other than those described in (2)—is determined under § 959; and (5) any § 956 amount is determined for the DFIC and the US shareholder, and the US shareholder's § 951(a)(1)(B) inclusion is taken into account. The Notice gives an example applying this. A relevant open question for steps (2) and (4) is determining the ordering of § 965(a) PTI and non-§ 965(a) PTI in any distribution of PTI. The Notice says future regulations will address this.

Section 3.03—Application of § 961 to Amounts Treated As Subpart F Income Under § 965

Section 3.03 of the Notice provides welcome relief from a possible application of currently effective regulations that could have resulted in tax at the top 35 percent corporate income tax rate under prior law of earnings repatriated by the DFIC during its inclusion year. This relief is important since taxpayers will usually need to have the DFIC distribute cash to finance payment of the § 965 transition tax.

An example illustrates the issue. Assume that the taxpayer US parent (USP) has a basis of zero in its stock in its wholly-owned DFIC (FS). Both USP and FS have a taxable year that ends December 31. FS's "§ 965(a) earnings amount" (the amount potentially subject to § 965(a)) is 100. Assume that FS actually distributes 100 to USP on December 15, 2017.

By reason of § 965's application, § 951(a) requires USP to include, for its taxable year ending December 31, 2017, FS's § 965(a) earnings amount of 100. Depending on FS's cash position, such amount would be subject to tax at a rate between eight percent and 15.5 percent. Section 961(a) and the regulations thereunder would increase USP's basis in FS's shares (to 100) by the amount of the inclusion on the last day of FS's taxable year, December 31, 2017. Section 959(a) would exclude the 100 distributed on December 15, 2017 from USP's gross income.

Section 961(b)(1), which the new legislation did not change, provides that, under regulations issued by the Treasury, the basis of stock in a CFC with respect to which a US shareholder receives an amount excluded from gross income under § 959 is reduced by the amount excluded. Section 961(b)(2) provides that, to the extent an amount so excluded exceeds the US shareholder's basis in the CFC's shares, the amount is treated as gain from the sale or exchange of property. Regulations (Treas. Reg. § 1.961-2(c)) provide that basis is to be reduced for such purpose "as of the time" the US shareholder receives the excluded amount.

At the time of the December 15, 2017 distribution, USP has a zero basis in its FS shares. Accordingly, a very plausible reading of the regulations is that, as a result of the distribution, for its year ending December 31, 2017, USP recognizes under § 961(b)(2) gain from the sale or exchange of property of 100, taxed at the prevailing corporate tax rate under prior law (up to 35 percent). Note that, although the illustration is extreme, similar situations could arise whenever FS's distribution during the inclusion year exceeds USP's basis in its FS shares. This may well be the situation with a distribution from a long-owned CFC that has significant deferred earnings subject to the deemed repatriation but in whose shares USP has minimal basis.

Presumably in order to alleviate this problem, the Notice provides that Treasury will issue regulations providing that the amount of the gain recognized under § 961(b)(2) (in the example, 100) will be reduced (but not below zero) by the § 965(a) inclusion amount (in the example, also 100). As a consequence, in the example USP would not recognize any gain under § 961(b)(2).

The Treasury's method to address this issue is interesting. Under proposed regulations, the downward basis adjustment under § 961(b)(1) occurs on the same day (the last day of the CFC's taxable year) as the upward basis adjustment under § 961(a). If the Notice had adopted this approach or any other approach making the upward and downward basis adjustments on the same day, issues under § 961(b)(2) would not have arisen since (at least in the example) the adjustments are equal. In this connection, one issue arising from the approach the Treasury adopted is whether basis is still increased by 100 under § 961(a) on December 31, 2017, even though USP has not suffered any tax detriment under § 961(b)(2).

Section 3.04—Treatment of Affiliated Group Making a Consolidated Return for Purposes of § 965

Section 3.04 provides that, "solely with respect to the calculation of the amount included in gross income by a consolidated group . . . under section 951(a)(1)(A) by reason of section 965(a)," all of the members of the consolidated group "that are treated as United States shareholders of one or more specified foreign corporations [corporations whose earnings are subject to § 965] will be treated as a single United States shareholder."

The purpose of this provision is not entirely clear. Perhaps it has something to do with effecting deficits. In § 965(b), the statute itself provides for a reduction of the amount included by a US shareholder in gross income under § 951(a) by reason of § 965(a). The reduction equals the US shareholder's share of an earnings and profits deficit (E&P deficit) as of November 2, 2017 of any specified foreign corporation in which the US shareholder was a shareholder on that date. It is possible that, even after the application of § 965(b) to each member of a consolidated group on a single-company basis, one or more members will have a potential § 965(a) inclusion even though one or more other members will have a share of an E&P deficit. Effectively treating such members as a single shareholder for this purpose, § 965(b)(5) provides for the netting of such a potential inclusion by such share of an E&P deficit. Perhaps § 3.04 is simply intended to advise taxpayers that regulations fleshing out this concept will be forthcoming.

Section 3.04 provides as its only example that:

"all members of a consolidated group that are United States shareholders will be treated as a single United States shareholder for purposes of determining the aggregate foreign cash position of the consolidated group and for purposes of taking such aggregate foreign cash position into account under § 965(c)(1)."

The example is odd since under the statute the “aggregate foreign cash position” is relevant only for the purpose of determining the amount of the deductionfrom gross income allowed to the US shareholder under § 965(c) and thus the tax rate to which the § 965(a) inclusion, taking into account the deduction, will be subject. As indicated, § 3.04 applies by its terms “solely with respect to the calculation of the amount included in gross income under section 951(a)(1)(A) by reason of section 965(a),” not the amount of the deduction under § 965(c).

If the intent is to say something about the aggregate cash position, perhaps the point is that the statute (in § 965(c)(3)) provides that the aggregate cash position, with respect to a particular US shareholder in a specified corporation, is the greater of two cash measurements and that, where more than one US shareholder in a consolidated group has a cash position under either or both measurements, one needs to select one of the two measurements (presumably the measurement that results in the greater amount) to apply uniformly.

For example, in the case of a calendar year SFC, a US shareholder’s cash position is the greater of (i) the shareholder’s pro rata share of the foreign corporation’s cash position as of December 31, 2017 and (ii) the average of such shares of the foreign corporation’s cash position as of December 31, 2016 and December 31, 2015. Assume that an SFC (FS) has a cash position of 200 on each of December 31, 2015 and December 31, 2016 and of 500 on December 31, 2017. Assume that A and B, both members of the same consolidated group, each own 50 percent of FS on December 31, 2015 and December 31, 2016. On January 1, 2017, B sells its interest in FS to a person that is not a group member but A retains its interest throughout 2017. The combined average of A’s and B’s shares of FS’s cash position as of December 31, 2015 and December 2016 is 200. The combined shares—attributable to A only since B no longer owns any shares—as of December 31, 2017 is 250. Perhaps the Notice is saying that, for purposes of determining the aggregate deductions under § 965(c) allowable to all group members, the group’s share of FS’s cash position is the greater of these amounts, 250, as determined using the December 31, 2017 measurement alternative.

Section 3.05—Determination of Foreign Currency Gain or Loss Under § 986(c)

Section 986(c) provides that foreign currency gain or loss with respect to amounts excluded from gross income under § 959 attributable to movements in exchange rates between the times of deemed (under § 951(a)) and actual distribution to the US shareholder are to be treated as ordinary income or loss from the same source as the associated income inclusion. Consistent with the C*onference Report* to the legislation, § 3.05 of the Notice provides that Treasury will issue regulations providing that any gain or loss otherwise recognized under this provision with respect to amounts excluded from gross income under § 959 attributable to a § 951(a) inclusion consisting of a § 965(a) earnings amount will be diminished in the same proportion as the § 965(c) deduction reduced the gross § 951(a) inclusion consisting of the § 965(a) earnings amount.

Prior law did not allow a US shareholder a deduction (comparable to the § 965(c) deduction) specifically allocable to an amount of gross amount included under § 951(a). The Notice therefore states that the adjustments to the § 986(c)’s application “must be made so as to apply solely” with respect to amounts attributable to § 965(a) earnings. Regulations will have to be developed, for example, to distinguish between distributions excluded under § 959 that are attributable to prior inclusions of § 965(a) earnings and other types of subpart F income such as foreign base company income. The Notice does not indicate how the regulations will make such distinctions other than that they will “provide ordering rules.”

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