

IRS, Treasury Issue Guidance on Section 965 Deemed Repatriation Rules, Signal Important Form 5471 Exception

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Notice 2018-13 details the government's intent to issue regulations addressing additional Section 965 computational issues. The new regulations will clarify, among other things, that US shareholders will be permitted to elect an "alternative method" of computing positive or negative aggregate post-1986 earnings and profits as of November 2, 2017. Notice 2018-13 also states that the IRS intends to amend the instructions to Form 5471 so as to provide an exception to the filing obligation for any US person that is a US shareholder with respect to a controlled foreign corporation, only as a result of "downward attribution" of stock ownership in the CFC.

The US Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) 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), on January 19. As its title implies, Notice 2018-13 elaborates on the first published guidance addressing the tax reform's new Section 965 deemed repatriation provision, which was issued on December 29, 2017, as Notice 2018-07 (the Prior Notice) (discussed in an earlier Morgan Lewis [LawFlash](#)). Notice 2018-13 also describes Treasury's and the IRS'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 Section 958(b)(4).

Section 965 and the Prior Notice

New Section 965, enacted on December 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 Section 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" (generally, accumulated untaxed post-1986 earnings and profits (E&P)) determined on November 2, 2017, and December 31, 2017 (the measurement dates). This amount is reduced by any aggregate post-1986 E&P deficits, measured as of November 2, 2017, of "E&P deficit foreign corporations" (EDFCs) allocated to the US shareholder.

Second, it allows a US shareholder with a Section 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% rate) and the aggregate E&P held in forms other than cash or cash equivalents, as defined (resulting in the inclusion being taxed at an 8% rate).

Unfortunately, the statutory text of Section 965 leaves many open questions regarding how a US shareholder's Section 965 inclusion amount is computed, as well as on the scope of any anti-avoidance rules authorized under Section 965(o)(2). The Prior Notice responds to the first concern by expressing the government's intent to issue regulations addressing a host of Section 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 Section 965 inclusions are coordinated with the Section 959 previously taxed income (PTI) rules and certain related issues.

New Guidance Concerning the Application of Section 965

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

First, Notice 2018-13 describes regulations that will clarify that a foreign corporation that 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 US shareholder (a foreign corporation that may be classified as either a DFIC or an EDFC with respect to a US shareholder) that has an accumulated post-1986 E&P deficit as of November 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 December 31, 2017.

The new regulations will clarify that an SFC with accumulated post-1986 E&P greater than zero may be *neither* a DFIC nor an 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 is PTI and a lesser E&P deficit, 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 US shareholders to offset the accumulated post-1986 deferred foreign income of their DFICs.

Notice 2018-13 also describes forthcoming regulations permitting US shareholders to make an election to compute the accumulated post-1986 E&P of an SFC using an October month-end simplifying convention. Specifically, US shareholders will be permitted to elect an "alternative method" of computing positive or negative aggregate post-1986 E&P as of November 2, 2017, by computing such E&P amount as of October 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 October 31, 2017, ended on such date and assuming the SFC earned E&P (or incurred a deficit) during the two-day period following October 31, 2017, at the same rate at which it earned E&P (or incurred a deficit) during the year ending October 31, 2017. Special rules are also provided for applying the alternative method to SFCs that have 52- to 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 Section 965 addressing the calculation of

a US shareholder's pro rata share of an EDFC's E&P deficit where there are multiple classes of stock. Such regulations will provide that the specified E&P deficit of such an EDFC "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 Treas. Reg. § 1.951-1(e). Consistent with the conference report accompanying HR 1, regulations will also specify that an E&P deficit includes a "hovering deficit" (as defined in Treas. Reg. § 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 definitions 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 Section 965 with respect to SFCs that use a functional currency other than the US dollar. For purposes of computing the Section 965 inclusion amount, the regulations will apply the spot rate as of December 31, 2017, to translate the foreign-currency-denominated accumulated post-1986 E&P into US 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 Section 965 inclusion will be determined based on the movement in the exchange rate between December 31, 2017, and the date of the PTI distribution. The future regulations will finally require that foreign-currency-denominated "cash positions" be converted into US dollars at the spot rate on the relevant cash measurement date for determining the US shareholder's "aggregate foreign cash position amount."

The Prior Notice announced that future regulations will provide that if a US shareholder receives distributions from a DFIC that are attributable to PTI during an inclusion year, the amount of gain recognized by the US shareholder with respect to the stock of the DFIC under Section 961(b)(2) will be reduced (but not below zero) by the Section 965 inclusion amount (i.e., 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 Section 958(a). These regulations will reduce the amount of gain recognized by a US shareholder under Section 961(b)(2) or Section 961(c) (distribution of PTI in excess of a shareholder's basis in foreign corporation stock) by the Section 965 inclusion amount for distributions through a chain of ownership described under Section 958(a) from a DFIC during the inclusion year. This expansion of the gain-reduction rule provides additional comfort for US shareholders desiring to pull cash out of SFCs prior to the end of the tax year of a Section 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 US Persons with Respect to Certain Foreign Corporations, took on a more expansive reach following the repeal of Section 958(b)(4). Notice 2018-13 provides much needed administrative relief to taxpayers by introducing an exception to the filing requirements for Form 5471 with respect to certain constructive owners of controlled foreign corporations (CFCs).

Due to the repeal of Section 958(b)(4), the stock of a foreign corporation that is owned by a foreign person is now attributed to a US person owned by the foreign person under Section 318(a)(3) for purposes of determining whether the US person is a US shareholder of the foreign corporation and whether the 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 US owners. (Note that the repeal of Section 958(b)(4) did not modify the subpart F inclusion rules. A US shareholder's pro rata share of a CFC's subpart F income and any Section 956 amount continue to be determined based on direct and indirect ownership of the subject CFC under Section 958(a), which does not take into account downward attribution.)

Notice 2018-13 states that the IRS intends to amend the instructions for Form 5471 to provide an exception to the filing obligation for any US person that is a US shareholder with respect to a CFC, provided no US shareholder owns stock in such CFC within the meaning of Section 958(a) and the foreign corporation is a CFC solely because such US person is considered to own the stock of the foreign corporation owned by a foreign person under Section 318(a)(3).

Until the instructions to Form 5471 are modified, Notice 2018-13 states that taxpayers may rely on the exception outlined in the notice for the last taxable year of foreign corporations beginning before January 1, 2018, and each subsequent year, and for the taxable years of US shareholders in which such taxable years of foreign corporations end.

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