

## Additional Guidance Under Section 965 and Guidance Under Sections 863 and 6038 in Connection with the Repeal of Section 958(b)(4)

Notice 2018-13

### SECTION 1. OVERVIEW

This notice announces that the Department of the Treasury (“Treasury Department”) and the Internal Revenue Service (“IRS”) intend to issue regulations for determining amounts included in gross income by a United States shareholder under section 951(a)(1) by reason of section 965 of the Internal Revenue Code (“Code”) as amended by “An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018,” P.L. 115-97 (the “Act”), which was enacted on December 22, 2017. See Notice 2018-07, 2018-4 I.R.B. 317, for prior guidance issued under section 965. In addition, this notice provides guidance in connection with the repeal of section 958(b)(4) by the Act.

Section 2 of this notice provides background on section 965 and the repeal of section 958(b)(4) by the Act. Section 3 of this notice describes regulations that the Treasury Department and the IRS intend to issue with respect to section 965. Section 4 of this notice describes a modification that the Treasury Department and the IRS intend to make with respect to regulations under section 965 that were described in section 3.03 of Notice 2018-07. Section 5 of this notice provides guidance under section 863 in connection with the repeal of section 958(b)(4) by the Act and announces the IRS’s

intention to update the Instructions for Form 5471 as a result of such repeal. Section 6 of this notice describes the effective dates of the regulations and other guidance described in this notice. Section 7 of this notice requests comments and provides contact information.

## SECTION 2. BACKGROUND

### *.01 Treatment of Accumulated Post-1986 Deferred Foreign Income as Subpart F Income*

Section 965(a) provides that for the last taxable year of a deferred foreign income corporation (“DFIC”) that begins before January 1, 2018 (such year of the DFIC, the “inclusion year”), the subpart F income of the corporation (as otherwise determined for such taxable year under section 952) shall be increased by the greater of (1) the accumulated post-1986 deferred foreign income of such corporation determined as of November 2, 2017, or (2) the accumulated post-1986 deferred foreign income of such corporation determined as of December 31, 2017 (each such date, a “measurement date,” and the greater of the accumulated post-1986 deferred foreign income of the corporation as of the measurement dates, the “section 965(a) earnings amount”).

The section 965(a) earnings amount is not subject to the rules or limitations in section 952 and is not limited by the accumulated earnings and profits of the DFIC as of the close of the inclusion year.

*.02 Determination of United States Shareholder's Section 951(a)(1) Inclusion By Reason of Section 965*

Section 965(b)(1) provides that, if a taxpayer is a United States shareholder with respect to at least one DFIC and at least one E&P deficit foreign corporation, then the portion of the section 965(a) earnings amount which would otherwise be taken into account under section 951(a)(1) by a United States shareholder with respect to each DFIC is reduced by the amount of such United States shareholder's aggregate foreign E&P deficit that is allocated to such DFIC. The portion of the section 965(a) earnings amount that is taken into account under section 951(a)(1) by a United States shareholder, taking into account the reduction described in the preceding sentence, is referred to in this notice as the "section 965(a) inclusion amount."<sup>1</sup>

*.03 Allocation of Aggregate Foreign E&P Deficit and Definition of E&P Deficit Foreign Corporation*

The aggregate foreign E&P deficit of any United States shareholder is allocated to each DFIC of the United States shareholder in an amount that bears the same proportion to such aggregate as (A) such United States shareholder's pro rata share of the section 965(a) earnings amount of each such DFIC bears to (B) the aggregate of

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<sup>1</sup> In contrast to Notice 2018-07, this notice uses the term "section 965(a) inclusion amount" to refer to an amount included in the gross income of the United States shareholder with respect to a DFIC, rather than an amount of the DFIC.

such United States shareholder's pro rata shares of the section 965(a) earnings amounts of all DFICs of such United States shareholder. Section 965(b)(2). The term "aggregate foreign E&P deficit" means, with respect to any United States shareholder, the lesser of (I) the aggregate of such shareholder's pro rata shares of the specified E&P deficits of the E&P deficit foreign corporations of such shareholder or (II) the aggregate of such shareholder's pro rata shares of the section 965(a) earnings amounts of all DFICs of such shareholder. Section 965(b)(3)(A)(i).

The term "E&P deficit foreign corporation" means, with respect to any taxpayer, any specified foreign corporation with respect to which such taxpayer is a United States shareholder, if, as of November 2, 2017, (i) such specified foreign corporation has a deficit in post-1986 earnings and profits, (ii) such corporation was a specified foreign corporation, and (iii) such taxpayer was a United States shareholder of such corporation. Section 965(b)(3)(B). The term "specified E&P deficit" means, with respect to an E&P deficit foreign corporation, the amount of such corporation's deficit in post-1986 earnings and profits as of November 2, 2017. See section 965(b)(3)(C). A specified foreign corporation that is a DFIC cannot also be an E&P deficit foreign corporation. See H.R. Rep. No. 115-466, at 618 (2017) (Conf. Rep.) ("Deferred earnings of a U.S. shareholder are reduced (but not below zero) by the shareholder's

share of deficits as of November 2, 2017, from a specified foreign corporation that is not a [DFIC] . . .”).

*.04 Application of the Participation Exemption*

Section 965(c)(1) provides that there shall be allowed as a deduction for the taxable year of a United States shareholder in which a section 965(a) inclusion amount is included in the gross income of such United States shareholder an amount equal to the sum of (A) the United States shareholder’s 8 percent rate equivalent percentage (as defined in section 965(c)(2)(A)) of the excess (if any) of (i) the section 965(a) inclusion amount, over (ii) the amount of such United States shareholder’s aggregate foreign cash position, plus (B) the United States shareholder’s 15.5 percent rate equivalent percentage (as defined in section 965(c)(2)(B)) of so much of such United States shareholder’s aggregate foreign cash position as does not exceed the section 965(a) inclusion amount.

Section 965(c)(3)(A) provides that the term “aggregate foreign cash position” means, with respect to any United States shareholder, the greater of (i) the aggregate of such United States shareholder’s pro rata share of the cash position of each specified foreign corporation of such United States shareholder determined as of the close of the inclusion year, or (ii) one half of the sum of (I) the aggregate described in clause (i) determined as of the close of the last taxable year of each such specified foreign

corporation that ends before November 2, 2017, plus (II) the aggregate described in clause (i) determined as of the close of the taxable year of each such specified foreign corporation which precedes the taxable year referred to in subclause (I). Each date referred to in the preceding sentence is referred to in this notice as a “cash measurement date.”

The cash position of any specified foreign corporation is the sum of (i) cash held by such corporation, (ii) the net accounts receivable of such corporation, and (iii) the fair market value of the following assets held by such corporation: (I) personal property which is of a type that is actively traded and for which there is an established financial market; (II) commercial paper, certificates of deposit, the securities of the Federal government and of any State or foreign government; (III) any foreign currency; (IV) any obligation with a term of less than one year (“short-term obligation”); and (V) any asset which the Secretary identifies as being economically equivalent to any asset described in section 965(c)(3)(B). Section 965(c)(3)(B). For purposes of section 965(c)(3), the term “net accounts receivable” means, with respect to any specified foreign corporation, the excess (if any) of (i) such corporation’s accounts receivable, over (ii) such corporation’s accounts payable (determined consistent with the rules of section 461). Section 965(c)(3)(C).

*.05 Definition of DFIC and Accumulated Post-1986 Deferred Foreign Income*

For purposes of section 965, a DFIC is, with respect to any United States shareholder, any specified foreign corporation of such United States shareholder that has accumulated post-1986 deferred foreign income (as of a measurement date) greater than zero. Section 965(d)(1). The term “accumulated post-1986 deferred foreign income” means the post-1986 earnings and profits of the specified foreign corporation except to the extent such earnings and profits (A) are attributable to income of the specified foreign corporation that is effectively connected with the conduct of a trade or business within the United States and subject to tax under chapter 1 (“effectively connected income”), or (B) in the case of a controlled foreign corporation (“CFC”), if distributed, would be excluded from the gross income of a United States shareholder under section 959 (“previously taxed income”). Section 965(d)(2).

Section 965(d)(3) provides that the term “post-1986 earnings and profits” means the earnings and profits of the foreign corporation (computed in accordance with sections 964(a) and 986, and by only taking into account periods when the foreign corporation was a specified foreign corporation) accumulated in taxable years beginning after December 31, 1986, and determined (A) as of the measurement date that is applicable with respect to such foreign corporation, and (B) without diminution by reason of dividends distributed during the inclusion year other than dividends distributed to another specified foreign corporation.

*.06 Specified Foreign Corporation*

Section 965(e)(1) provides that the term “specified foreign corporation” means (A) any CFC and (B) any foreign corporation with respect to which one or more domestic corporations is a United States shareholder (10-percent corporation). For purposes of sections 951 and 961, a 10-percent corporation is treated as a CFC solely for purposes of taking into account the subpart F income of such corporation under section 965(a). Section 965(e)(2). However, if a passive foreign investment company (as defined in section 1297) with respect to the shareholder is not a CFC, then such corporation is not a specified foreign corporation. Section 965(e)(3).

*.07 Determination of Pro Rata Share*

Section 965(f)(1) provides that the determination of any United States shareholder’s pro rata share of any amount with respect to any specified foreign corporation shall be determined under rules similar to the rules of section 951(a)(2) by treating such amount in the same manner as subpart F income (and by treating such specified foreign corporation as a CFC).

*.08 Repeal of Section 958(b)(4)*

Section 958 provides rules for determining stock ownership of a foreign corporation for purposes of sections 951 through 965. Section 958(b) provides, in relevant part, that section 318(a) (relating to the constructive ownership of stock)



applies, subject to certain modifications, to the extent that the effect is to treat any United States person as a United States shareholder within the meaning of section 951(b) or to treat a foreign corporation as a CFC under section 957. Effective for the last taxable year of foreign corporations beginning before January 1, 2018, and each subsequent year of such foreign corporations, and for the taxable years of United States shareholders in which or with which such taxable years of foreign corporations end, the Act repeals section 958(b)(4). As in effect prior to repeal, section 958(b)(4) provided that subparagraphs (A), (B), and (C) of section 318(a)(3) were not to be applied so as to consider a United States person as owning stock which is owned by a person who is not a United States person. The subparagraphs of section 318(a)(3) generally attribute stock owned by a person to a partnership, estate, trust, or corporation in which such person has an interest (so-called “downward attribution”). For example, stock of a corporation owned by a person that owns 50 percent or more in value of the stock of another corporation is treated as owned by such other corporation. See section 318(a)(3)(C).

### SECTION 3. REGULATIONS TO BE ISSUED ADDRESSING THE APPLICATION OF SECTION 965

#### *.01 Determination of Status of a Specified Foreign Corporation as a DFIC or an E&P Deficit Foreign Corporation*

The Treasury Department and the IRS intend to issue regulations providing that, for purposes of determining the status of a specified foreign corporation as a DFIC or an E&P deficit foreign corporation, it must first be determined whether the specified foreign corporation is a DFIC. If the specified foreign corporation meets the definition of a DFIC, it is classified solely as a DFIC and not also as an E&P deficit foreign corporation, even if such specified foreign corporation otherwise satisfies the requirements of section 965(b)(3)(B). If a specified foreign corporation does not meet the definition of a DFIC, the United States shareholder must then determine whether it is an E&P deficit foreign corporation. In some cases, as illustrated in Example 2, a specified foreign corporation may be classified as neither a DFIC nor an E&P deficit foreign corporation, despite having post-1986 earnings and profits greater than zero or a deficit in accumulated post-1986 deferred foreign income.

Example 1. (i) Facts. USP, a domestic corporation, owns all of the stock of FS, a foreign corporation. As of November 2, 2017, FS has a deficit in post-1986 earnings and profits of 150u. As of December 31, 2017, FS has 200u of post-1986 earnings and profits. FS does not have previously taxed income or effectively connected income for any taxable year.

(ii) Analysis. Because FS, a specified foreign corporation, does not have previously taxed income or effectively connected income for any taxable year, FS's accumulated post-1986 deferred foreign income is equal to its post-1986 earnings and profits. Because FS has accumulated post-1986 deferred foreign income as of December 31, 2017, FS is a DFIC. See section 965(d)(1). Accordingly, FS is not an E&P deficit foreign corporation.

Example 2. (i) Facts. USP, a domestic corporation, owns all of the stock of FS, a foreign corporation. As of both November 2, 2017, and December 31, 2017, FS has 100u of previously taxed income described in section 959(c)(2) and a deficit of 90u in earnings and profits described in section 959(c)(3), all of which were accumulated in taxable years beginning after December 31, 1986, while FS was a specified foreign corporation. Accordingly, as of both November 2, 2017, and December 31, 2017, FS has 10u of post-1986 earnings and profits.

(ii) Analysis. (A) Determination of status as a DFIC. For purposes of determining whether FS is a DFIC, a determination must be made whether FS has accumulated post-1986 deferred foreign income greater than zero as of either November 2, 2017, or December 31, 2017. Under section 965(d)(2), FS's accumulated post-1986 deferred foreign income is its post-1986 earnings and profits, except to the extent such earnings are effectively connected income or previously taxed income. Disregarding FS's 100u of previously taxed income, FS has a 90u deficit in accumulated post-1986 deferred foreign income as of both November 2, 2017, and December 31, 2017. Accordingly, FS does not have accumulated post-1986 deferred foreign income greater than zero as of either measurement date and therefore FS is not a DFIC.

(B) Determination of status as an E&P deficit foreign corporation. For purposes of determining whether FS is an E&P deficit foreign corporation, a determination must be made whether FS has a deficit in post-1986 earnings and profits as of November 2, 2017. As described in paragraph (i) of this Example 2, FS has 10u of post-1986 earnings and profits as of both November 2, 2017, and December 31, 2017. As a result, FS does not have a deficit in post-1986 earnings and profits as of November 2, 2017, and therefore FS is not an E&P deficit foreign corporation. Accordingly, FS is neither a DFIC nor an E&P deficit foreign corporation.

#### *.02 Alternative Method for Calculating Post-1986 Earnings and Profits*

The Act provides that the earnings and profits of a specified foreign corporation must be determined as of two measurement dates and “in accordance with sections 964(a) and 986.” See section 965(a) and (d)(3). Consistent with this requirement, the Treasury Department and the IRS have determined that, for purposes of measuring the

post-1986 earnings and profits of a specified foreign corporation as of a measurement date, the extent to which an item of income, deduction, gain, or loss is taken into account as of such measurement date must generally be determined under principles applicable to the calculation of earnings and profits, including the application of sections 312 and 964.

For purposes of determining whether a specified foreign corporation is a DFIC and for purposes of determining a DFIC's section 965(a) earnings amount, the actual post-1986 earnings and profits of the specified foreign corporation must be determined as of the close of both November 2, 2017, and December 31, 2017. In addition, for purposes of determining whether a specified foreign corporation is an E&P deficit foreign corporation and for purposes of determining the amount of the specified E&P deficit of an E&P deficit foreign corporation, the actual post-1986 earnings and profits (including a deficit) of the specified foreign corporation must be determined as the close of November 2, 2017.

However, the Treasury Department and the IRS recognize that it may be impractical for taxpayers to determine the post-1986 earnings and profits of a specified foreign corporation as of a measurement date that does not fall on the last day of a month. Therefore, the Treasury Department and the IRS intend to issue regulations providing that an election may be made to determine a specified foreign corporation's

post-1986 earnings and profits as of a measurement date based on the amount of post-1986 earnings and profits (including a deficit) as of another date as provided in this section 3.02 (the “alternative method”). If an election to use the alternative method is made, the amount of the post-1986 earnings and profits (including a deficit) of a specified foreign corporation (other than a specified foreign corporation with a 52-53-week taxable year described in §1.441-2(a)(1)) as of November 2, 2017, will equal the sum of (1) the corporation’s post-1986 earnings and profits as of October 31, 2017, and (2) the corporation’s annualized earnings and profits amount. For this purpose, the term “annualized earnings and profits amount” means, with respect to a specified foreign corporation, the amount equal to the product of two (the number of days after October 31, 2017, and on or before the measurement date on November 2, 2017) multiplied by the daily earnings amount of the specified foreign corporation. The term “daily earnings amount” means, with respect to a specified foreign corporation, the post-1986 earnings and profits (including a deficit) of the specified foreign corporation as of the close of October 31, 2017, that were earned (or incurred) during the specified foreign corporation’s taxable year that includes October 31, 2017, divided by the number of days that have elapsed in such taxable year as of the close of October 31, 2017. A specified foreign corporation that does not have a 52-53-week taxable year described in

§1.441-2(a)(1) may not determine its post-1986 earnings and profits under the alternative method with respect to the measurement date on December 31, 2017.

In the case of a specified foreign corporation that has a 52-53-week taxable year described in §1.441-2(a)(1), an election may be made to use the alternative method to determine its post-1986 earnings and profits as of both measurement dates based on the amount of post-1986 earnings and profits (including a deficit) as of the closest end of a fiscal month to each measurement date consistent with the principles of the preceding paragraph. For example, if the closest end of a fiscal month of a specified foreign corporation that has a 52-53-week taxable year occurs after an applicable measurement date, the annualized earnings amount will be subtracted from (rather than added to) the post-1986 earnings and profits of the specific foreign corporation as of such fiscal month end. For a specified foreign corporation with a 52-53-week taxable year, in order to use the alternative method for any measurement date, the election must be made for both measurement dates.

The IRS intends to issue forms, publications, regulations, or other guidance that will specify the manner and timing of an election to use the alternative method.

Example. (i) Facts. FS, a foreign corporation, has a calendar year taxable year and as of October 31, 2017, FS has post-1986 earnings and profits of 10,000u, 3,040u of which were earned during the taxable year that includes October 31, 2017. An election is made for FS to determine its post-1986 earnings and profits under the alternative method.

(ii) Analysis. As of the close of October 31, 2017, 304 days have elapsed in the taxable year of FS that includes October 31, 2017. Therefore, FS's daily earnings amount is 10u (3,040u divided by 304), and FS's annualized earnings and profits amount is 20u (10u multiplied by 2). Accordingly, FS's post-1986 earnings and profits as of November 2, 2017, are 10,020u (its post-1986 earnings and profits as of October 31, 2017 (10,000u), plus its annualized earnings and profits amount (20u)).

### *.03 Treatment of Deficits*

#### (a) Allocation of Deficits to Different Classes of Stock

For purposes of determining the amount of a United States shareholder's aggregate foreign E&P deficit, the aggregate of such shareholder's pro rata shares of the specified E&P deficits of the E&P deficit foreign corporations of such shareholder must be determined. Section 965(f)(1) provides that, in determining a United States shareholder's pro rata share of "any amount with respect to any specified foreign corporation," rules similar to section 951(a)(2) shall be applied. Section 1.951-1(e) provides guidance with respect to allocating subpart F income among multiple classes of stock but does not address deficits.

The Treasury Department and the IRS intend to issue regulations providing that, for purposes of determining a United States shareholder's pro rata share of the specified E&P deficit of an E&P deficit foreign corporation that has multiple classes of stock outstanding, the specified E&P deficit 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.

(b) Treatment of Hovering Deficits

The Conference Report accompanying the Act provides that “the amount of post-1986 earnings and profits of a specified foreign corporation is the amount of positive earnings and profits accumulated as of the measurement date reduced by any deficit in earnings and profits of the specified foreign corporation as of the measurement date, without regard to the limitation category of the earnings or deficit.” H.R. Rep. No. 115-466, at 618. The Conference Report clarifies that, for this purpose, the term “deficit” includes a hovering deficit (as defined in §1.367(b)-7(d)(2)(i)), with the following example:

For example, assume that a foreign corporation organized after December 31, 1986 has \$100 of accumulated earnings and profits as of November 2, 2017, and December 31, 2017 . . . which consist of \$120 general limitation earnings and profits and a \$20 passive limitation deficit, the foreign corporation's post-1986 earnings and profits would be \$100, even if the \$20 passive limitation deficit was a hovering deficit.

Id. at 619. Consistent with the Conference Report, the Treasury Department and the IRS intend to issue regulations clarifying that all deficits related to post-1986 earnings and profits, including hovering deficits, are taken into account for purposes of determining the post-1986 earnings and profits (including a deficit) of a specified foreign corporation.



#### *.04 Determination of Aggregate Foreign Cash Position*

##### (a) Definitions for Determining Net Accounts Receivable

Section 965(c)(3)(C) does not define the term “accounts receivable” for purposes of the term “net accounts receivable.” The Treasury Department and the IRS intend to issue regulations providing that, for purposes of section 965(c)(3)(C), the term “accounts receivable” means receivables described in section 1221(a)(4), and the term “accounts payable” means payables arising from the purchase of property described in section 1221(a)(1) or 1221(a)(8) or the receipt of services from vendors or suppliers. Receivables that are treated as accounts receivable within the meaning of section 965(c)(3)(C)(i) will not also be treated as short-term obligations.

##### (b) Treatment of Demand Obligations

Section 965(c)(3)(B) provides that the “cash position” of a specified foreign corporation includes the fair market value of any short-term obligation. The Treasury Department and the IRS intend to issue regulations providing that, for purposes of determining a specified foreign corporation’s cash position, a loan that must be repaid on the demand of the lender (or that must be repaid within one year of such demand) will be treated as a short-term obligation, regardless of the stated term of the instrument.

#### *.05 Translation Rules*

(a) Comparison of Accumulated Post-1986 Deferred Foreign Income as of the Measurement Dates

Generally, determinations made under subtitle A of the Code must be made in a taxpayer's functional currency. See section 985(a). For purposes of determining the tax under subtitle A of the Code of any shareholder of a foreign corporation, the earnings and profits of such corporation must be determined in the corporation's functional currency. See section 986(b)(1). Accordingly, the Treasury Department and the IRS intend to issue regulations providing that, for purposes of determining the section 965(a) earnings amount of a specified foreign corporation, the accumulated post-1986 deferred foreign income of the specified foreign corporation as of each of the measurement dates must be compared in the functional currency of the specified foreign corporation. If the functional currency of a specified foreign corporation changes between the two measurement dates, the comparison must be made in the functional currency of the specified foreign corporation as of December 31, 2017, by translating the specified foreign corporation's earnings and profits as of November 2, 2017, into the new functional currency using the spot rate on November 2, 2017. For purposes of this notice, the term "spot rate" has the meaning described in §1.988-1(d).

(b) Determination of the Amount of Inclusion Under Section 951(a)(1) by Reason of Section 965

In the case of any United States person, the earnings and profits determined under section 986(b)(1) when distributed, deemed distributed, or otherwise taken into account are translated into U.S. dollars using the appropriate exchange rate for purposes of determining the tax on such earnings under subtitle A of the Code. See section 986(b)(2). Generally, except as provided in regulations, section 989(b) sets forth the appropriate exchange rate. In the case of an actual distribution of earnings and profits or an actual or deemed sale or exchange of stock in a foreign corporation treated as a dividend under section 1248, the appropriate exchange rate is the spot rate on the date such distribution or deemed dividend is included into income. Section 989(b)(1) and (2). In the case of subpart F income included in income by a United States shareholder under section 951(a)(1)(A), the appropriate exchange rate is the average exchange rate for the taxable year of the foreign corporation. Section 989(b)(3). Any amounts included in income under section 951(a)(1)(B) (inclusions under section 956) are treated for this purpose as distributions made on the last day of the taxable year for which such amounts were so included, and accordingly translated at the spot rate on the last day of such taxable year. Section 989(b).

In order to calculate the section 965(a) inclusion amount of a United States shareholder with respect to a DFIC, the United States shareholder's pro rata shares of the section 965(a) earnings amounts of its DFICs and the specified E&P deficits of its

E&P deficit foreign corporations must be translated into U.S. dollars. 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 on which a specified foreign corporation's post-1986 earnings and profits becomes fixed and immediately precedes the transition to the participation exemption under section 245A. Furthermore, a single spot rate on December 31, 2017, is more administrable for the IRS and less burdensome for taxpayers than the yearly average approach of section 989(b)(3) because under the yearly average approach, certain amounts required for the determination of the section 965(a) inclusion amount of a United States shareholder (for example, the United States shareholder's aggregate foreign E&P deficit) would not be determinable until the last closing of an inclusion year of a specified foreign corporation of the United States shareholder.

Accordingly, the Treasury Department and the IRS intend to issue regulations providing that the appropriate exchange rate under section 989(b) for translating the section 965(a) earnings amount will be the spot rate on December 31, 2017. The regulations will also provide that the spot rate on December 31, 2017, will apply for purposes of translating other amounts necessary for the application of section 965(b), including (1) translating a section 965(a) earnings amount into U.S. dollars in computing

amounts described in section 965(b)(2)(A) and (B), (2) translating a specified E&P deficit into U.S. dollars in order to determine a United States shareholder's aggregate foreign E&P deficit under section 965(b)(3)(A), (3) translating a section 965(a) inclusion amount with respect to a DFIC (if such amount was reduced by an aggregate foreign E&P deficit under section 965(b)(1)) back into the functional currency of the DFIC for purposes of determining the previously taxed income of the DFIC, and (4) translating the portion of the U.S. dollar-denominated aggregate foreign E&P deficit allocated to a DFIC under section 965(b)(2) into the functional currency of the DFIC for purposes of determining its previously taxed income under section 965(b)(4)(A).

The regulations will also provide that, for purposes of section 986(c), foreign currency gain or loss with respect to distributions of previously taxed income described in section 959(c)(2) by reason of section 965 will be determined based on movements in the exchange rate between December 31, 2017, and the date on which such previously taxed earnings and profits are actually distributed.

Example. (i) Facts. As of November 2, 2017, and December 31, 2017, USP, a domestic corporation, owns all of the stock of CFC1, an E&P deficit foreign corporation with the "u" as its functional currency; CFC2, an E&P deficit foreign corporation with the "v" as its functional currency; CFC3, a DFIC with the "y" as its functional currency; and CFC4, a DFIC with the "z" as its functional currency. USP, CFC1, CFC2, CFC3, and CFC4 each have a calendar year taxable year. As of December 31, 2017,  $1u=\$1$ ,  $.75v=\$1$ ,  $.50y=\$1$ , and  $.25z=\$1$ . CFC1 has a specified E&P deficit of 100u, CFC2 has a specified E&P deficit of 120v, CFC3 has a section 965(a) earnings amount of 50y, and CFC4 has a section 965(a) earnings amount of 75z.

(ii) Analysis. (A) For purposes of applying section 965(b), the section 965(a) earnings amount of each of CFC3 and CFC4 translated into U.S. dollars at the spot rate on December 31, 2017, is \$100 (50y at .50y=\$1) and \$300 (75z at .25z=\$1), respectively. Furthermore, USP's pro rata share of the section 965(a) earnings amounts, as translated, is \$100 and \$300, respectively, or 100% of each section 965(a) earnings amount.

(B) For purposes of applying section 965(b), the specified E&P deficit of each of CFC1 and CFC2 translated into U.S. dollars at the spot rate on December 31, 2017, is \$100 (100u at 1u=\$1) and \$160 (120v at .75v=\$1), respectively. Furthermore USP's pro rata share of each specified E&P deficit, as translated, is \$100 and \$160, respectively, or 100% of each specified E&P deficit. Therefore, USP's aggregate foreign E&P deficit is \$260.

(C) For purposes of applying section 965(b), USP's aggregate foreign E&P deficit of \$260 is allocated \$65 to reduce the amount that USP would otherwise take into account under section 951(a)(1) by reason of section 965 with respect to CFC3 ( $\$260 \times (\$100/\$400)$ ) and allocated \$195 to reduce the amount that USP would otherwise take into account under section 951(a)(1) by reason of section 965 with respect to CFC4 ( $\$260 \times (\$300/400)$ ). After reduction under section 965(b)(1), the section 965(a) inclusion amount of USP with respect to CFC3 is \$35 ( $\$100 - \$65$ ) and the section 965(a) inclusion amount of USP with respect to CFC4 is \$105 ( $\$300 - \$195$ ). The previously taxed income of CFC3 and CFC4 resulting from the section 965(a) inclusion amounts included in gross income by USP, translated into the respective functional currencies of CFC3 and CFC4 at the spot rate on December 31, 2017, are 17.5y ( $\$35$  at .50y=\$1) and 26.25z ( $\$105$  at .25z=\$1), respectively.

(D) For purposes of determining the previously taxed income of each of CFC3 and CFC4 under section 965(b)(4)(A) as a result of the reduction to USP's section 965(a) inclusion amounts with respect to CFC3 and CFC4, the amounts of the aggregate foreign E&P deficit of USP are allocated to each of CFC3 and CFC4 under section 965(b)(2), which translated into the respective functional currencies of CFC3 and CFC4 at the spot rate on December 31, 2017, are 32.5y ( $\$65$  at .50y=\$1) and 48.75z ( $\$195$  at .25z=\$1), respectively.

(c) Determination of Cash Positions as of Cash Measurement Dates

The Treasury Department and the IRS intend to issue regulations providing that the cash position of a specified foreign corporation with respect to any cash measurement date must be expressed in U.S. dollars. Therefore, the amount of a United States shareholder's aggregate foreign cash position will be the greater of the U.S. dollar-denominated aggregate amounts on each cash measurement date described in section 965(c)(3)(A).

In determining the cash position attributable to net accounts receivable, the amount of accounts receivables and accounts payables (in each case, if not otherwise denominated in U.S. dollars) must be translated into U.S. dollars at the spot rate on the relevant cash measurement date. The fair market value of assets described in section 965(c)(3)(B)(iii) must also be determined in U.S. dollars on the relevant cash measurement date. For example, in the case of foreign currency, the fair market value will equal the currency amount translated at the spot rate on the relevant cash measurement date.

#### **SECTION 4. MODIFICATION TO RULE DESCRIBED IN SECTION 3.03 OF NOTICE 2018-07 RELATING TO DISTRIBUTIONS OF PREVIOUSLY TAXED INCOME**

Section 3.03 of Notice 2018-07 announced that the Treasury Department and the IRS intend to issue regulations providing that if a United States shareholder receives distributions from a DFIC during the inclusion year that are attributable to previously

taxed income described in section 959(c)(2) by reason of section 965(a), the amount of gain recognized by the United States 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(a) inclusion amount (the “gain-reduction rule”). Notice 2018-07 does not expressly apply the gain-reduction rule to distributions to a United States shareholder from an entity (an “upper-tier entity”) that is not a DFIC (for instance, an E&P deficit foreign corporation) that has received distributions from a DFIC (a “lower-tier DFIC”) attributable to previously taxed income described in section 959(c)(2) by reason of section 965(a). Moreover, Notice 2018-07 could be interpreted to provide that even when the upper-tier entity is a DFIC, the amount of gain recognized by the United States shareholder that is reduced by reason of the gain-reduction rule is limited solely to the section 965(a) inclusion amount of the United States shareholder with respect to the upper-tier entity, rather than also including the section 965(a) inclusion amount with respect to the lower-tier DFIC from which such upper-tier entity has received distributions attributable to previously taxed income described in section 959(c)(2) by reason of section 965(a).

The Treasury Department and the IRS intend to issue regulations that provide that the gain-reduction rule also applies to distributions received from a DFIC through a chain of ownership described in section 958(a). Specifically, regulations will provide that if a United States shareholder receives distributions through a chain of ownership



described under section 958(a) from a DFIC during the inclusion year that are attributable to previously taxed income described in section 959(c)(2) by reason of section 965(a), the amount of gain recognized under section 961(b)(2) by the United States shareholder with respect to the stock or property of any entity in the ownership chain described in section 958(a) through which the distribution is made will be reduced (but not below zero) by the section 965(a) inclusion amount of the United States shareholder with respect to such DFIC. The gain-reduction rule will apply similarly to reduce the amount of gain that would otherwise be recognized under section 961(c) by any controlled foreign corporation in the ownership chain described in section 958(a) through which the distribution is made to a United States shareholder for purposes of determining the amount included under section 951(a)(1) in the gross income of the United States shareholder.

Example. (i) Facts. USP, a domestic corporation, owns all of the stock of CFC1, a specified foreign corporation that has no post-1986 earnings and profits (or deficit), and CFC1 owns all the stock of CFC2, a DFIC. USP is a calendar year taxpayer. CFC1 and CFC2 have inclusion years that end on November 30, 2018. The functional currency of CFC1 and CFC2 is the U.S. dollar. USP's adjusted basis in the stock of CFC1 is zero, and CFC1's adjusted basis in the stock of CFC2 is zero. On January 1, 2018, CFC2 distributes \$100 to CFC1, and CFC1 distributes \$100 to USP. USP has a section 965(a) inclusion amount of \$100 with respect to CFC2. CFC2 has no other earnings and profits described in section 959(c)(1) or (2), other than earnings and profits described in section 959(c)(2) by reason of section 965(a).

(ii) Analysis. USP receives a distribution from CFC2, a lower-tier DFIC, through a chain of ownership described in section 958(a) during the inclusion year of CFC2 that

is attributable to \$100 of previously taxed income described in section 959(c)(2) by reason of section 965(a). The amount of gain that USP would otherwise recognize with respect to the stock of CFC1 under section 961(b)(2) and the amount of gain that CFC1 would otherwise recognize with respect to the stock of CFC2 under section 961(c) for purposes of determining CFC1's subpart F income is reduced (but not below zero) in each case by \$100, USP's section 965(a) inclusion amount with respect to CFC2.

## SECTION 5. GUIDANCE IN CONNECTION WITH THE REPEAL OF SECTION 958(b)(4)

### *.01 Application of Section 863*

Section 863 and the regulations thereunder provide special rules for determining the source of certain items of gross income, including gross income from space and ocean activities and international communications income. Section 863(d) provides that, except as provided in regulations, any income derived from a space or ocean activity ("space and ocean income") by a United States person is sourced in the United States (such income, "U.S. source income") and that any space and ocean income derived by a foreign person is sourced outside the United States (such income, "foreign source income"). Regulations under section 863(d) include an exception from the statutory provision regarding space and ocean income derived by a foreign person if the foreign person is a CFC. Specifically, space and ocean income derived by a CFC is treated as U.S. source income, except to the extent that the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in a foreign country. See §1.863-8(b)(2)(ii).

In the case of any United States person, 50 percent of any international communications income (as defined in section 863(e)(2)) is treated as U.S. source income and 50 percent of such income is treated as foreign source income. Section 863(e)(1)(A). Subject to certain exceptions, including exceptions set forth in regulations, international communications income derived by a foreign person is treated as foreign source income. Regulations under section 863(e) provide that international communications income derived by a CFC is treated as one-half U.S. source and one-half foreign source. See §1.863-9(b)(2)(ii).

As a result of the repeal of section 958(b)(4) by the Act, stock of a foreign corporation owned by a foreign person can be attributed to a United States person under section 318(a)(3) for purposes of determining whether such United States person is a United States shareholder of the foreign corporation and, therefore, whether the foreign corporation is a CFC. In other words, as a result of the repeal of section 958(b)(4), section 958(b) now provides for “downward attribution” from a foreign person to a United States person in circumstances in which section 958(b), before the Act, did not so provide. As a result, foreign corporations that were not previously treated as CFCs may be treated as CFCs.

The Treasury Department and the IRS have determined that, in light of the change to the constructive ownership rules in section 958(b), further study is necessary

to determine whether it is appropriate for the source of income described in section 863(d) and (e) to be determined by reference to the status of the recipient as a CFC. Accordingly, for purposes of applying §§1.863-8 and 1.863-9, taxpayers may determine whether a foreign corporation is a CFC without regard to the repeal of section 958(b)(4) pending further guidance (which will be prospective, as described in section 6 of this notice).

*.02 Elimination of Form 5471 Filing Obligation for Certain Constructive Owners*

Pursuant to section 6038(a)(4), the IRS may require any United States person treated as a United States shareholder of a CFC to file an information return on Form 5471, "Information Return of U.S. Persons with Respect to Certain Foreign Corporations," with respect to its ownership in such CFC. For this purpose, a United States shareholder is defined in section 951(b), and the United States shareholder's ownership in a CFC is determined based on direct and indirect ownership under section 958(a) and constructive ownership under section 958(b). Under the Instructions for Form 5471 (Rev. Dec. 2017), a United States shareholder who owns stock in a CFC for an uninterrupted period of 30 or more days during the CFC's tax year and owned the stock on the last day of that year is a Category 5 Filer and must file Form 5471.

As discussed in section 5.01 of this notice, as a result of the Act, section 958(b) now provides for "downward attribution" from a foreign person under section 318(a)(3)

to a United States person in circumstances in which section 958(b), before the Act, did not so provide. A United States shareholder's pro rata share of a CFC's subpart F income and the amount determined under section 956 that a United States shareholder is required to include in gross income, however, continue to be determined based on direct and indirect ownership of the CFC under section 958(a), which does not take into account such downward attribution.

The IRS intends to amend the Instructions for Form 5471 to provide an exception from Category 5 filing for a United States person that is a United States shareholder with respect to a CFC if no United States shareholder (including such United States person) owns, within the meaning of section 958(a), stock in such CFC, and the foreign corporation is a CFC solely because such United States person is considered to own the stock of the CFC owned by a foreign person under section 318(a)(3).

## SECTION 6. EFFECTIVE DATES

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. The Treasury Department and the IRS intend to provide that the regulations described in sections 3 and 4 of this notice are effective beginning the first taxable year of a foreign corporation (and with respect to United States shareholders, the taxable years in

which or with which such taxable years of the foreign corporations end) to which section 965 applies. Before the issuance of the regulations described in this notice, taxpayers may rely on the rules described in sections 3 and 4 of this notice.

The repeal of section 958(b)(4) is effective for the last taxable year of foreign corporations beginning before January 1, 2018, and each subsequent year of such foreign corporations and for the taxable years of United States shareholders in which or with which such taxable years of foreign corporations end. Taxpayers may rely on section 5.01 of this notice with respect to the last taxable year of foreign corporations beginning before January 1, 2018, and for the taxable years of United States shareholders in which or with which such taxable years of foreign corporations end, pending the issuance of further guidance (the application of which will be prospective). Before the change to instructions described in section 5.02 of this notice, taxpayers may also rely on the exception described in section 5.02 of this notice for the last taxable year of foreign corporations beginning before January 1, 2018, and each subsequent year of such foreign corporations and for the taxable years of United States shareholders in which or with which such taxable years of foreign corporations end.

#### SECTION 7. REQUEST FOR COMMENTS AND CONTACT INFORMATION

The Treasury Department and the IRS request comments on the rules described in this notice. The Treasury Department and the IRS expect to issue additional

guidance under section 965, and the Treasury Department and the IRS request comments on what additional guidance should be issued to assist taxpayers in applying section 965. In addition, comments are requested as to whether, in light of the repeal of section 958(b)(4), it would be appropriate for the Treasury Department and the IRS to reconsider the provisions of any form, publication, regulation, or other guidance that reference CFCs, and if so, what revisions may be appropriate.

Written comments may be submitted to the Office of Associate Chief Counsel (International), Attention: Leni C. Perkins, Internal Revenue Service, IR-4549, 1111 Constitution Avenue, NW, Washington, DC 20224. Alternatively, taxpayers may submit comments electronically to [Notice.comments@irs.counsel.treas.gov](mailto:Notice.comments@irs.counsel.treas.gov). Comments will be available for public inspection and copying.

The principal author of this notice is Ms. Perkins of the Office of Associate Chief Counsel (International). For further information regarding this notice, contact Ms. Perkins at (202) 317-6934 (not a toll free call).