

Guidance under Section 965

Notice 2018-07

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. Section 2 of this notice provides background on section 965. Section 3 of this notice describes regulations that the Treasury Department and the IRS intend to issue. Section 4 of this notice describes the effective dates of those regulations. Section 5 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”). Furthermore, under section 965(b)(1), 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 a DFIC is reduced by the amount of such United States shareholder’s aggregate foreign E&P deficit which is allocated to such DFIC under section 965(b)(2). The section 965(a) earnings amount reduced as described in the preceding sentence is referred to in this notice as the “section 965(a) inclusion amount.” Neither the section 965(a) earnings amount nor the section 965(a) inclusion amount is subject to the rules or limitations in section 952 or limited by the accumulated earnings and profits of the DFIC on the date of the inclusion.

.02 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 (“actively traded property”); (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). Also, for purposes of section 965(c), 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).

Section 965(c)(3)(D) provides that net accounts receivable, actively traded property, and short-term obligations shall not be taken into account by a United States shareholder in determining its aggregate foreign cash position to the extent that such United States shareholder demonstrates to the satisfaction of the Secretary that such amount is so taken into account by such United States shareholder with respect to another specified foreign corporation.

Section 965(c)(3)(F) provides that if the Secretary determines that a principal purpose of any transaction was to reduce the aggregate foreign cash position taken into account under section 965(c), such transaction shall be disregarded for purposes of section 965(c).

.03 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)(2) further provides that, to the extent provided in regulations or other guidance prescribed by the Secretary, in the case of any CFC that has shareholders that are not United States shareholders, accumulated post-1986 deferred foreign income shall be appropriately reduced by amounts which would be previously taxed income if such shareholders were United States shareholders.

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. Accordingly, under section 965(d)(3)(B), dividends paid by a specified foreign corporation in the inclusion year before a measurement date generally reduce the post-1986 earnings and profits of the corporation as determined on such measurement date, except for dividends paid to a person other than a specified foreign corporation (for example, a United States shareholder).

.04 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).

.05 Determinations 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).

.06 Regulations or Other Guidance

Section 965(o) provides that the Secretary shall prescribe such regulations or other guidance as may be necessary or appropriate to carry out the provisions of section 965, including regulations or other guidance to provide appropriate basis adjustments, and

regulations or other guidance to prevent the avoidance of the purposes of this section, including through a reduction in earnings and profits, through changes in entity classification or accounting methods, or otherwise.

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

.01 Determination of Aggregate Foreign Cash Position

(a) Allocation Between Multiple Inclusion Years

The Treasury Department and the IRS are aware that in cases where specified foreign corporations have inclusion years that end in or with different taxable years of the same United States shareholder, section 965 could result in double-counting such shareholder's aggregate foreign cash position for purposes of determining the shareholder's deduction under section 965(c). For example, assume USP, a calendar year taxpayer, wholly owns CFC1, which has an inclusion year ending December 31, 2017, and CFC2, which has an inclusion year ending November 30, 2018. In addition, assume that USP's pro rata share of the cash position of each of CFC1 and CFC2 on all relevant cash measurement dates is \$100, with the result that USP's aggregate foreign cash position is \$200. Under section 965(c), the amount allowed as a deduction in the taxable year of a United States shareholder for which the United States shareholder takes a section 965(a) inclusion amount into gross income is based on the aggregate foreign cash position of the United States shareholder. One interpretation of section 965(c) could result in the 15.5 percent rate equivalent percentage applying to as much as \$400 of the aggregate section 965(a) inclusion amounts of CFC1 and CFC2 taken into account by USP, because USP's aggregate foreign cash position for its 2017 taxable year (in which CFC1's section 965(a) inclusion amount is taken into account) is \$200 and its aggregate foreign cash

position for its 2018 taxable year (in which CFC2's section 965(a) inclusion amount is taken into account) is also \$200.

The Treasury Department and the IRS intend to issue regulations providing that in the case of a United States shareholder that has a section 965(a) inclusion amount in more than one taxable year, the aggregate foreign cash position taken into account in the first taxable year will equal the lesser of the United States shareholder's aggregate foreign cash position or the aggregate of the section 965(a) inclusion amounts taken into account by the United States shareholder in that taxable year. Furthermore, the amount of the United States shareholder's aggregate foreign cash position taken into account in any succeeding taxable year will be its aggregate foreign cash position reduced by the amount of its aggregate foreign cash position taken into account in any preceding taxable year.

Example. (i) Facts. USP, a domestic corporation, owns all of the stock of CFC1, a foreign corporation, which owns all of the stock of CFC2, also a foreign corporation. USP is a calendar year taxpayer. CFC1's inclusion year ends December 31, 2017, and CFC2's inclusion year ends November 30, 2018. The cash position of each of CFC1 and CFC2 on all relevant cash measurement dates is \$200, with the result that USP has an aggregate foreign cash position of \$400. For its 2017 taxable year, USP takes into account CFC1's section 965(a) inclusion amount of \$300, and for its 2018 taxable year, USP takes into account CFC2's section 965(a) inclusion amount of \$300.

(ii) Analysis. USP's aggregate foreign cash position taken into account in 2017 is \$300, the lesser of USP's aggregate foreign cash position (\$400) or the section 965(a) inclusion amount (\$300) that USP takes into account in 2017. The amount of USP's aggregate foreign cash position taken into account in 2018 is \$100, USP's aggregate foreign cash position (\$400) reduced by the amount of its aggregate foreign cash position taken into account in 2017 (\$300).

In addition, in cases in which, for example, a calendar year United States shareholder owns specified foreign corporations with inclusion years that end in or with different taxable years of the United States shareholder, at least one specified foreign corporation of such United States shareholder will have a final cash measurement date in 2017 (for example, December 31, 2017) and at least one other such specified foreign corporation will have a final cash

measurement date in 2018 (for example, November 30, 2018). The Treasury Department and the IRS are aware that a United States shareholder in this situation may not be able to determine its aggregate foreign cash position for purposes of calculating its deduction under section 965(c) for its 2017 taxable year by the date that its return for such taxable year must be filed (including extensions).

For purposes of determining the aggregate foreign cash position of a United States shareholder for a taxable year in which it takes into account a section 965(a) inclusion amount, future regulations will provide that the United States shareholder can assume that its pro rata share of the cash position of any specified foreign corporation with an inclusion year ending after the date the return for such taxable year of such United States shareholder is timely filed (including extensions, if any) will be zero as of the cash measurement date with which the inclusion year ends. If a United States shareholder's pro rata share of the cash position of a specified foreign corporation was treated as zero pursuant to the preceding sentence, and the amount described in section 965(c)(3)(A)(i) in fact exceeds the amount described in section 965(c)(3)(A)(ii) with respect to such United States shareholder, the United States shareholder must make appropriate adjustments to reflect that the 15.5 percent rate equivalent percentage applies to a greater amount of the aggregate section 965(a) inclusion amounts taken into account. The Treasury Department and the IRS expect to issue future guidance regarding the appropriate method for making such an adjustment.

Example. (i) Facts. USP, a domestic corporation, owns all of the stock of CFC1, a foreign corporation, which owns all of the stock of CFC2, also a foreign corporation. USP is a calendar year taxpayer. CFC1's inclusion year ends December 31, 2017, and CFC2's inclusion year ends November 30, 2018. The cash position of CFC1 on each of December 31, 2015, December 31, 2016, and December 31, 2017, is \$100. The cash position of CFC2 on each of November 30, 2015, and November 30, 2016, is \$200. CFC1 has a section 965(a) inclusion amount.

(ii) Analysis. In determining its aggregate foreign cash position for its 2017 taxable year, USP may assume that its pro rata share of the cash position of CFC2 will be zero as of November 30, 2018, for purposes of filing its U.S. federal income tax return due on April 15, 2018 (or due on October 15, 2018, with extension). Therefore, USP's aggregate foreign cash position is treated as \$300, which is the greater of (a) \$300, 50% of the sum of USP's pro rata shares of the cash position of CFC1 as of December 31, 2015, and December 31, 2016, and of the cash position of CFC2 as of November 30, 2015, and November 30, 2016, and (b) \$100, USP's pro rata share of the cash position of CFC1 as of December 31, 2017. If USP's pro rata share of the cash position of CFC2 as of November 30, 2018, in fact exceeds \$200, which would result in USP's aggregate foreign cash position being greater than \$300, USP must make appropriate adjustments to reflect a higher aggregate foreign cash position, under future guidance to be issued by the Treasury Department and the IRS.

(b) Treatment of Related-Party Transactions for Purposes of Determination of Cash Position

Net accounts receivables and short-term obligations between related specified foreign corporations may inflate the aggregate foreign cash position of a United States shareholder relative to the actual aggregate amount of liquid assets (other than the intercompany receivables) owned by the specified foreign corporations of the United States shareholder. For example, if a United States shareholder wholly owns two specified foreign corporations and one specified foreign corporation makes a short-term loan to the other specified foreign corporation, the borrowing corporation may invest the proceeds of such financing in illiquid assets or may spend the cash on operating expenses. The resulting intercompany receivable would be included in the United States shareholder's aggregate foreign cash position, notwithstanding that, if the specified foreign corporations were treated as a single corporation, the liquid assets of the specified foreign corporations would have been reduced by the amount of the borrowed proceeds.

Accordingly, for purposes of determining the cash position of a specified foreign corporation with respect to net accounts receivable and short-term obligations, the Treasury Department and the IRS intend to issue regulations providing that, with respect to a United States shareholder, any receivable or payable of a specified foreign corporation from or to a

related specified foreign corporation will be disregarded to the extent of the common ownership of such specified foreign corporations by the United States shareholder. For this purpose, a specified foreign corporation will be treated as related to another specified foreign corporation to the extent that the specified foreign corporations are related persons within the meaning of section 954(d)(3), substituting the term “specified foreign corporation” for “controlled foreign corporation” in each place that it appears.

(c) Treatment of Derivative Financial Instruments and Hedging Transactions for Purposes of Determination of Cash Position

Under section 965(c)(3)(B)(iii)(V), the Secretary may identify any asset as being economically equivalent to any asset described in section 965(c)(3)(B). The Treasury Department and the IRS intend to issue regulations that address the treatment of derivative financial instruments for purposes of measuring the cash position of a specified foreign corporation. Derivative financial instruments include notional principal contracts, options contracts, forward contracts, futures contracts, short positions in securities and commodities, and any similar financial instruments. These regulations will provide that the cash position of any specified foreign corporation will include the fair market value of each derivative financial instrument held by the specified foreign corporation that is not a “bona fide hedging transaction” (as defined in this section 3.01(c)). The Treasury Department and the IRS are considering whether future guidance should exclude derivative financial instruments that are not actively traded or that do not reference an asset described in section 965(c)(3)(B) (a “cash-equivalent asset”) from the definition of cash position. The value of each derivative financial instrument that must be taken into account in determining the cash position of a specified foreign corporation may be positive or negative; however, the aggregate amount taken into account for all derivative financial instruments (excluding bona fide hedging transactions) of a specified

foreign corporation cannot be less than zero. Furthermore, derivative financial instruments between related specified foreign corporations will be disregarded on the same terms as receivables and payables described in section 3.01(b) of this notice.

For purposes of this section 3.01(c), a bona fide hedging transaction means a hedging transaction that meets the requirements of a bona fide hedging transaction described in §1.954-2(a)(4)(ii) and that is properly identified as such in accordance with the requirements of that subparagraph. Consistent with the definition of a bona fide hedging transaction in §1.954-2(a)(4)(ii), in the case of an asset hedging transaction, the risk being hedged may be with respect to ordinary property, section 1231 property, or a section 988 transaction. Because the identification requirements of §1.954-2(a)(4)(ii) are generally relevant only to CFCs whereas section 965 applies to all specified foreign corporations, the Treasury Department and the IRS will provide guidance in the future on identifying bona fide hedging transactions of specified foreign corporations that are not CFCs.

If a derivative financial transaction is a bona fide hedging transaction that is used to hedge a cash-equivalent asset, the value of the cash-equivalent asset identified on the taxpayer's books and records as the asset being hedged must be adjusted by the fair market value of the bona fide hedging transaction that is used to hedge such cash-equivalent asset (such hedging transaction, a "cash-equivalent asset hedging transaction"). The value of a cash-equivalent asset hedging transaction must be taken into account in determining the cash position of a specified foreign corporation whether the cash-equivalent asset hedging transaction has positive or negative value, but only to the extent that the cash-equivalent asset hedging transaction (or transactions) does not reduce the fair market value of the asset being hedged below zero.

Finally, a bona fide hedging transaction with respect to an asset that is not a cash-equivalent asset or with respect to a liability (as described in §1.1221-2(b)(2)) is not included in a specified foreign corporation's cash position for purposes of section 965(c)(3)(B).

.02 Determination of Accumulated Post-1986 Deferred Foreign Income

(a) Adjustments to Post-1986 Earnings and Profits to Account for Certain Amounts Paid or Incurred Between Specified Foreign Corporations Between Measurement Dates

Certain transactions between specified foreign corporations may result in earnings and profits of a specified foreign corporation being taken into account more than once or not at all by a United States shareholder under section 965(a). In this regard, the Conference Report accompanying the Act states:

In order to avoid double-counting and double non-counting of earnings, the Secretary may provide guidance to adjust the amount of post-1986 earnings and profits of a specified foreign corporation to ensure that a single item of a specified foreign corporation is taken into account only once in determining the income of a United States shareholder subject to this provision. Such an adjustment may be necessary, for example, when there is a deductible payment (e.g., interest or royalties) from one specified foreign corporation to another specified foreign corporation between measurement dates.

H.R. Rep. No. 115-466, at 619 (2017). Consistent with congressional intent, the Treasury Department and the IRS intend to issue regulations to address the possibility of double-counting or double non-counting in the computation of post-1986 earnings and profits arising from amounts paid or incurred (including certain dividends) between related specified foreign corporations of a United States shareholder that occur between measurement dates and that would otherwise reduce the post-1986 earnings and profits as of December 31, 2017, of the specified foreign corporation that paid or incurred such amounts. For purposes of this section 3.02(a), the term "related" has the same meaning as given in section 3.01(b) of this notice.

The following examples illustrate fact patterns involving double-counting or double non-counting that will be addressed by future regulations.

Example 1. (i) Facts. USP, a domestic corporation, owns all of the stock of CFC1, a foreign corporation, which owns all of the stock of CFC2, also a foreign corporation. USP, CFC1, and CFC2 have calendar year taxable years. On November 2, 2017, each of CFC1 and CFC2 has post-1986 earnings and profits of 100u. Neither CFC1 nor CFC2 has previously taxed income or effectively connected income for any taxable year, and therefore each of CFC1's and CFC2's accumulated post-1986 deferred foreign income is equal to such corporation's post-1986 earnings and profits. On November 3, 2017, CFC2 makes a deductible payment of 10u to CFC1. The payment does not constitute subpart F income. CFC1 and CFC2 have no other items of income or deduction.

(ii) Analysis. Absent any adjustments, on December 31, 2017, CFC1 has post-1986 earnings and profits of 110u (100u plus 10u income from the deductible payment), and CFC2 has post-1986 earnings and profits of 90u (100u minus 10u deductible expense). The section 965(a) earnings amount with respect to CFC1 would be 110u, the greater of 100u accumulated post-1986 deferred foreign income on November 2, 2017, and 110u accumulated post-1986 deferred foreign income on December 31, 2017, and the section 965(a) earnings amount with respect to CFC2 would be 100u, the greater of 100u accumulated post-1986 deferred foreign income on November 2, 2017, and 90u accumulated post-1986 deferred foreign income on December 31, 2017. Disregarding the intercompany deductible payment, CFC1 and CFC2 would have, in the aggregate, section 965(a) earnings amounts of 200u. However, taking the deductible payment into account, CFC1 and CFC2 would have, in the aggregate, section 965(a) earnings amounts of 210u, because the 10u of income from the deductible payment would increase the post-1986 earnings and profits of CFC1 as of December 31, 2017, but the 10u of deductible expense would not decrease the post-1986 earnings and profits of CFC2 as of November 2, 2017. Under regulations to be issued by the Treasury Department and the IRS, an adjustment would be made with the result that CFC1 and CFC2 would have, in the aggregate, section 965(a) earnings amounts of 200u.

Example 2. (i) Facts. Assume the same facts as in Example 1, except instead of a deductible payment to CFC1, CFC2 makes a 10u distribution on November 3, 2017. The distribution increases CFC1's post-1986 earnings and profits as of December 31, 2017, by 10u and reduces CFC2's post-1986 earnings and profits as of December 31, 2017, by the same amount under section 965(d)(3)(B).

(ii) Analysis. Similar to the analysis in Example 1, the section 965(a) earnings amount with respect to CFC1 would be 110u, and the section 965(a) earnings amount with respect to CFC2 would be 100u, resulting in aggregate section 965(a) earnings amounts of 210u. Under regulations to be issued by the Treasury Department and the IRS, an adjustment would be made with the result that CFC1 and CFC2 would have, in the aggregate, section 965(a) earnings amounts of 200u. For an additional rule relating to dividends paid by one specified foreign corporation to another specified foreign corporation, see section 3.02(b) of this notice.

Example 3. (i) Facts. Assume the same facts as in Example 1, except that CFC2 does not make a deductible payment to CFC1, and, between measurement dates, CFC2 accrues gross income of 20u from a person that is not related to CFC2, and CFC1 incurs a deductible expense of 20u to a person that is not related to CFC1.

(ii) Analysis. Absent any adjustments, on December 31, 2017, CFC1 has post-1986 earnings and profits of 80u (100u minus 20u deductible expense), and CFC2 has post-1986 earnings and profits of 120u (100u plus 20u gross income). The section 965(a) earnings amount with respect to CFC1 would be 100u, the greater of 100u accumulated post-1986 deferred foreign income on November 2, 2017, and 80u accumulated post-1986 deferred foreign income on December 31, 2017, and the section 965(a) earnings amount with respect to CFC2 would be 120u, the greater of 100u accumulated post-1986 deferred foreign income on November 2, 2017, and 120u accumulated post-1986 deferred foreign income on December 31, 2017. CFC1 and CFC2 have, in the aggregate, section 965(a) earnings amounts of 220u. The section 965(a) earnings amounts, in the aggregate, are 20u greater than in Example 1, notwithstanding that CFC1 and CFC2 have, in the aggregate, earned no additional income. However, the additional 20u of section 965(a) earnings amount does not arise from an amount paid or incurred between specified foreign corporations that are related. The regulations to be issued by the Treasury Department and the IRS will not adjust the aggregate section 965(a) earnings amounts of CFC1 and CFC2.

Example 4. (i) Facts. Assume the same facts as in Example 3, except that CFC2 also makes a deductible payment of 10u to CFC1 on November 3, 2017.

(ii) Analysis. Absent any adjustments, on December 31, 2017, CFC1 has post-1986 earnings and profits of 90u (100u minus 20u deductible expense plus 10u intercompany income from the deductible payment), and CFC2 has post-1986 earnings and profits of 110u (100u plus 20u gross income minus 10u intercompany deductible expense). The section 965(a) earnings amount with respect to CFC1 would be 100u, the greater of 100u accumulated post-1986 deferred foreign income on November 2, 2017, and 90u accumulated post-1986 deferred foreign income on December 31, 2017, and the section 965(a) earnings amount with respect to CFC2 would be 110u, the greater of 100u accumulated post-1986 deferred foreign income on November 2, 2017, and 110u accumulated post-1986 deferred foreign income on December 31, 2017. Taking the intercompany deductible payment into account, CFC1 and CFC2 would have, in the aggregate, section 965(a) earnings amounts of 210u, because the 10u of income from the deductible payment would not increase the post-1986 earnings and profits of CFC1 as of November 2, 2017, but the 10u of deductible expense would decrease the post-1986 earnings and profits of CFC2 as of December 31, 2017. However, disregarding the intercompany deductible payment, CFC1 and CFC2 would have, in the aggregate, section 965(a) earnings amounts of 220u. Under regulations to be issued by the Treasury Department and the IRS, an adjustment would be made with the result that CFC1 and CFC2 would have, in the aggregate, section 965(a) earnings amounts of 220u.

(b) Determination of Amount of Diminution by Reason of Distributions to Specified Foreign Corporations

The post-1986 earnings and profits of a specified foreign corporation are reduced to reflect dividends distributed during the corporation's inclusion year to another specified foreign corporation ("the dividend reduction rule"). Section 965(d)(3)(B). As a result, a dividend paid by

a specified foreign corporation to another specified foreign corporation (whether in an inclusion year or a prior taxable year, including a prior taxable year that includes a measurement date) generally reduces the corporation's post-1986 earnings and profits with respect to any measurement date that such dividend precedes.

The dividend reduction rule is intended to address the potential double-counting of the earnings and profits of the distributing specified foreign corporation in calculating the section 965(a) inclusion amounts taken into account by a United States shareholder with respect to the distributing specified foreign corporation and the distributee specified foreign corporation. (See Example 2 in section 3.02(a) of this notice illustrating double-counting arising from dividends paid between measurement dates notwithstanding the application of the dividend reduction rule.) To the extent that a portion of a distribution reduces the post-1986 earnings and profits of a distributing specified foreign corporation (for example, by reason of a reduction pursuant to section 312(a)(3)) in an amount in excess of the increase in the post-1986 earnings and profits of the distributee specified foreign corporation, such reduction would not relieve double-counting and thus would be inconsistent with the purpose of the rule.

Accordingly, the Treasury Department and the IRS intend to issue regulations to clarify that the amount by which the post-1986 earnings and profits of a specified foreign corporation is reduced under section 965(d)(3)(B) as a result of a distribution made to a specified foreign corporation in the inclusion year may not exceed the amount by which the post-1986 earnings and profits of the distributee corporation is increased as a result of the distribution.

(c) Determination of Accumulated Post-1986 Deferred Foreign Income in the Case of a Controlled Foreign Corporation with Non-United States Shareholders

In the case of a CFC that has shareholders that are not United States shareholders on a measurement date, the Treasury Department and the IRS intend to issue regulations providing

that the accumulated post-1986 deferred foreign income of the CFC on such measurement date will be reduced by amounts that would be described in section 965(d)(2)(B) if such shareholders were United States shareholders. In such cases, the regulations will follow the principles of Revenue Ruling 82-16, 1982-1 C.B. 106, in order to determine the amounts by which accumulated post-1986 deferred foreign income is reduced.

Example. (i) Facts. USP, a domestic corporation, and FP, a foreign corporation unrelated to USP, have owned 70% and 30% respectively, by vote and value, of the only class of stock of FS, a foreign corporation, from January 1, 2016, until December 31, 2017. USP and FS both have a calendar year taxable year. FS had no income until its taxable year ending December 31, 2016, in which it had 100u of income, all of which constituted subpart F income, and USP included 70u in income with respect to FS under section 951(a)(1) for such year. FS earned no income in 2017. Therefore, FS's post-1986 earnings and profits are 100u as of both of the measurement dates.

(ii) Analysis. Because USP included 70u in income with respect to FS under section 951(a)(1), 70u of such post-1986 earnings and profits is previously taxed income and, if distributed, would be excluded from the gross income of USP under section 959. Thus, FS's accumulated post-1986 deferred foreign income would be reduced by 70u pursuant to section 965(d)(2)(B). Furthermore, the accumulated post-1986 deferred foreign income of FS is reduced by amounts that would be described in section 965(d)(2)(B) if FP were a United States shareholder, consistent with the principles of Revenue Ruling 82-16. Accordingly, FS's accumulated post-1986 deferred foreign income would be reduced by the remaining 30u of the 100u of post-1986 earnings and profits to which USP's 70u of section 951(a)(1) income inclusions were attributable. Accordingly, FS's accumulated post-1986 deferred foreign income is 0u (100u minus 70u minus 30u).

(d) Coordination Between Sections 959 and 965 in the Inclusion Year

The accumulated post-1986 deferred foreign income of a specified foreign corporation that is a CFC excludes earnings to the extent that they would, if distributed, be excluded from the gross income of a United States shareholder under section 959 (that is, previously taxed income). Section 965(d)(2)(B). Post-1986 earnings and profits of a specified foreign corporation are determined without diminution by reason of dividends distributed during the inclusion year, other than dividends distributed to another specified foreign corporation. Section 965(d)(3)(B).

In general, earnings and profits of a foreign corporation attributable to amounts which are, or have been, included in the gross income of a United States shareholder under section 951(a) are not again included in the gross income of such United States shareholder when distributed (or when they would but for section 959(a) be included under section 951(a)(1)(B)). Section 959(a). For purposes of applying section 959(a), a distribution from a foreign corporation is treated as attributable first to earnings and profits included in gross income under section 951(a)(1)(B), then to earnings and profits included in gross income under section 951(a)(1)(A), and then to other earnings and profits. Section 959(c). A distribution excluded from gross income under section 959(a) is treated, for purposes of Chapter 1, as a distribution which is not a dividend, except that such distributions immediately reduce earnings and profits. Section 959(d). Actual distributions are taken into account before amounts that would be included under section 951(a)(1)(B). Section 959(f)(2).

The Treasury Department and the IRS intend to issue regulations to clarify the interaction between the rules under sections 959 and 965 in the inclusion year of a DFIC and the taxable year of a United States shareholder of the DFIC in which or with which such inclusion year ends. Such regulations will describe the following steps for determining the section 965(a) inclusion amount of a DFIC, the treatment of distributions under section 959, and the amount of an inclusion under sections 951(a)(1)(B) and 956 with respect to a DFIC:

- (1) First, the subpart F income of the DFIC is determined without regard to section 965(a), and the United States shareholder's inclusion under section 951(a)(1)(A) by reason of such amount is taken into account.
- (2) Second, the treatment of a distribution from the DFIC to another specified foreign corporation that is made before January 1, 2018, is determined under section 959.

- (3) Third, the section 965(a) inclusion amount of the DFIC is determined, and the United States shareholder's inclusion under section 951(a)(1)(A) by reason of such amount is taken into account.
- (4) Fourth, the treatment of all distributions from the DFIC other than those described in step 2 is determined under section 959.
- (5) Fifth, an amount is determined under section 956 with respect to the DFIC and the United States shareholder, and the United States shareholder's inclusion under section 951(a)(1)(B) is taken into account.

Example. (i) Facts. USP, a domestic corporation, owns all of the stock of CFC1, a foreign corporation, which owns all of the stock of CFC2, also a foreign corporation. USP, CFC1, and CFC2 all have taxable years ending December 31, 2017. As of January 1, 2017, CFC1 has no earnings and profits, and CFC2 has 100u of earnings and profits described in section 959(c)(3) that were accumulated in taxable years beginning after December 31, 1986, while CFC2 was a specified foreign corporation. On March 1, 2017, CFC1 earns 30u of subpart F income (as defined in section 952), and CFC2 earns 20u of subpart F income. On July 1, 2017, CFC2 distributes 40u to CFC1, and the exception described in section 954(c)(6)(A) applies to such distribution. On November 1, 2017, CFC1 distributes 60u to USP.

(ii) Analysis. (A) Application of section 959 without regard to section 965. USP determines its inclusion under section 951(a)(1)(A) without regard to section 965(a), which is 30u with respect to CFC1 and 20u with respect to CFC2 for their taxable years ending December 31, 2017. As a result of the inclusions under section 951(a)(1)(A), CFC1 and CFC2 increase their earnings and profits described in section 959(c)(2) by 30u and 20u, respectively.

(B) Distributions between specified foreign corporations before January 1, 2018. The distribution of 40u from CFC2 to CFC1 is treated as a distribution of 20u out of earnings and profits described in section 959(c)(2) (attributable to inclusions under section 951(a)(1)(A) that are not by reason of section 965(a)) and 20u out of earnings and profits described in section 959(c)(3).

(C) Section 965(a) inclusion amount. USP determines CFC1's and CFC2's section 965(a) inclusion amounts. Because there are no aggregate foreign E&P deficits to be allocated to CFC1 and CFC2, the section 965(a) inclusion amount of CFC1 and CFC2 equals the section 965(a) earnings amount with respect to CFC1 and CFC2, respectively.

(1) CFC1 section 965(a) earnings amount. The section 965(a) earnings amount with respect to CFC1 is 20u, the amount of its accumulated post-1986 deferred foreign income as of both November 2, 2017, and December 31, 2017, which is equal to 70u of post-1986 earnings and profits (30u earned and 40u attributable to the CFC2 distribution) reduced by 50u of previously taxed income described in section 959(c)(2) (30u earned and 20u attributable to the CFC2 distribution) under section 965(d)(2)(B). Under section 965(d)(3)(B), the post-1986 earnings and profits of CFC1 are not reduced by the 60u distribution to USP.

(2) CFC2 section 965(a) earnings amount. The section 965(a) earnings amount with respect to CFC2 is 80u, the amount of its accumulated post-1986 deferred foreign income as of both November 2, 2017, and December 31, 2017, which is equal to the amount of CFC2's post-1986 earnings and profits of 80u. For purposes of calculating CFC2's accumulated post-1986 deferred foreign income, CFC2 has no previously taxed income and therefore no adjustment is made under section 965(d)(2)(B). CFC2's 80u of post-1986 earnings and profits consists of 120u of earnings and profits that it earned, reduced by the 40u distribution to CFC1 under section 965(d)(3)(B). The amount of the reduction to the post-1986 earnings and profits of CFC2 for the 40u distribution is not limited by the rules described in section 3.02(b) of this notice because CFC1's post-1986 earnings and profits are increased by 40u as a result of the distribution. Furthermore, because the 40u distribution was made on July 1, 2017, which is prior to any measurement date, section 3.02(a) of this notice is not relevant.

(3) Effect on previously taxed income. CFC1 and CFC2 increase their previously taxed income described in section 959(c)(2) by their section 965(a) inclusion amounts taken into account by USP, 20u and 80u, respectively, and reduce their earnings and profits described in section 959(c)(3) by an equivalent amount.

(D) Distribution to United States shareholder. The distribution from CFC1 to USP is treated as a distribution of 60u out of the earnings and profits of CFC1 described in section 959(c)(2), which include earnings and profits attributable to the section 965(a) inclusion amount taken into account by USP.

.03 Application of Section 961 to Amounts Treated as Subpart F Income Under Section 965

Section 965(o) authorizes the Treasury Department and the IRS to issue regulations or other guidance to provide appropriate basis adjustments in order to carry out the provisions of section 965. In order to provide certainty regarding the application of the rules described in section 961 with respect to amounts included under section 965, 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.

.04 Treatment of Affiliated Group Making a Consolidated Return For Purposes of Section 965

Pursuant to the Secretary's authority under sections 965(o) and 1502, the Treasury Department and the IRS intend to issue regulations providing that, solely with respect to the calculation of the amount included in gross income by a consolidated group (as defined in §1.1502-1(h)) under section 951(a)(1) by reason of section 965(a), all of the members of a consolidated group that are United States shareholders of one or more specified foreign corporations will be treated as a single United States shareholder. Thus, for example, 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 section 965(c)(1).

These regulations will provide that, consistent with the consolidated return regulations (and notwithstanding the calculation of the amount described in the prior paragraph), appropriate adjustments, for example, adjustments under §1.1502-32 to the basis of the stock of each member that is a United States shareholder, will be made to reflect the impact of amounts included in gross income under section 951(a)(1) by reason of section 965(a), and the impact of other attributes of each member on this calculation, such as the ownership of E&P deficit foreign corporations by particular members and the cash position of specified foreign corporations held by particular members. These regulations will also provide that taxpayers must make appropriate adjustments reflecting minority ownership interests in a member of the consolidated group that are owned by a person that is not a member of the consolidated group.

.05 Determination of Foreign Currency Gain or Loss under Section 986(c)

The Treasury Department and the IRS intend to issue regulations providing that any gain or loss recognized under section 986(c) with respect to distributions of previously taxed income described in section 959(c)(2) by reason of section 965(a) will be diminished proportionately to the diminution of the taxable income resulting from section 965(a) by reason of the deduction allowed under section 965(c). See H.R. Rep. No. 115-466, at 620.

The adjustments with respect to section 986(c) must be made so as to apply solely with respect to distributions of previously taxed income described in section 959(c)(2) by reason of section 965(a). Accordingly, future regulations will also provide ordering rules for determining the portion of a distribution that will be treated as previously taxed income described in section 959(c)(2) by reason of section 965(a).

SECTION 4. 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 section 3 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 section 3.

SECTION 5. REQUEST FOR COMMENTS AND CONTACT INFORMATION

The Treasury Department and the IRS request comments on the rules described in this notice. In addition, 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.

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@irsounsel.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).