TaxNewsFlash

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Initial impressions on Notice 2018-26 and guidance under section 965; special elections, reporting and paying the "transition tax"

The IRS today released an advance version of Notice 2018-26, addressing forthcoming guidance under the section 965 "transition tax" as enacted into the Code by the new tax law (Pub. L. No. 115-97, enacted December 22, 2017).

Notice 2018-26 [PDF 120 KB] describes a wide-ranging series of new rules and procedures relating to computations of certain items relevant to the transition tax, anti-abuse rules, certain special elections under or relevant to section 965, and the mechanics for how taxpayers report and pay the transition tax.

Notice 2018-26 also provides relief to taxpayers from certain estimated tax requirements and penalties arising from the enactment of the transition tax under section 965 and the change to existing stock attribution rules in the new tax law.

With today's notice, comments are requested about these rules and about what additional guidance would assist taxpayers in computing the transition tax. The IRS and Treasury stated additional future guidance will be issued.

The purpose of this report is to provide initial impressions, a high-level review, of certain issues presented by the IRS notice. Additional reports from KPMG will focus on other issues.

Background

Newly enacted Code section 965 imposes a transition tax on untaxed foreign earnings of foreign subsidiaries of U.S. companies by deeming those earnings to be repatriated. Foreign earnings held in the form of cash and cash equivalents are taxed at a 15.5% rate, and the remaining earnings are taxed at a rate of 8%. The transition tax generally may be paid in installments over an eight-year period.

Guidance previously issued by the IRS concerning section 965 includes:

- Notice 2018-07 describing regulations that the IRS and Treasury Department intend to issue, including rules for determining the amount of cash and cash equivalents for purposes of applying the 15.5% rate and rules for determining the impact of intercompany transactions (including distributions) on the amount of foreign earnings subject to the transition tax—read ***TaxNewsFlash***

- Notice 2018-13 describing to-be-issued regulations for determining amounts included in gross income by a United States shareholder under section 951(a)(1) by reason of new section 965—read ***TaxNewsFlash***

- Rev. Proc. 2018-17 to prevent the avoidance of the application of section 965 by changes in the tax years of certain "specified foreign corporations" (any controlled foreign corporation (CFC) and any foreign corporation with respect to which one or more domestic corporations is a "United States shareholder" (see section 965(e))—read ***TaxNewsFlash***

Notice 2018-26

International focused provisions

For an international perspective, the main portion (Section 3) of Notice 2018-26, announces that future regulations under section 965 will:

- Provide an exception to "specified foreign corporation" (SFC) status for certain foreign corporations when that status arises only because of the application of the sections 318 and 958 constructive ownership rules to, inter alia, a partnership from a less than 5% partner therein (Section 3(01) of Notice 2018-26)

- Address the inclusion of the "foreign cash positions" for SFCs that are transferred by the U.S. shareholder, or go out of existence, in between the various cash measurement dates set forth in section 965 (Section 3(02)

- Allow taxpayers to take into account a share of the foreign income taxes paid or accrued by SFCs in between November 2, 2017, and December 31, 2017, (the measurement dates) in determining the earnings and profits (E&P) of the SFCs subject to the transition tax, which appear largely limited to calendar-year taxpayers (Section 3(03))

- Include anti-abuse rules under section 965 that will address, inter alia, transactions entered into on or after November 2, 2017, that reduce a U.S. shareholder's 965 tax liability through reduction of the shareholder's foreign cash position, reduction in the E&P subject to the transition tax, or reduction in the shareholder's "pro rata share" of the E&P subject to the transition tax (Section 3(04)(a))

- Ignore for section 965 purposes the effect of any accounting method change filed on or after November 2, 2017, for an SFC's tax year ending in 2017 or 2018 that would reduce the 965 tax liability for the SFC's U.S. shareholder, even if the method change was properly made, and also ignore the effect of any "check-the-box" election filed on or after November 2, 2017, if the effect of the election is to reduce a U.S. shareholder's 965 tax liability, even if the election would have been effective for a date prior to November 2, 2017 (Section 3((04)(b))

- Address procedural matters, including: (a) how taxpayers document their aggregate foreign cash position; (b) confirming that U.S. investors in U.S. shareholders that are domestic pass-through entities may make the elections under sections 965(h), (m), and (n) with respect to their share of pass-through 965 amounts, and also addressing how S corporations that are owners of other domestic pass-through entities take into account those amounts for purposes of the 965(i) election; (c) how to determine the net tax liability under section 965(h) (the eight-year installment election); (d) confirming that the section 965(n) election applies both in determining the amount of net operating loss (NOL) for the current year of the 965 inclusion as well as the absorption of NOL carrybacks or carryforwards into the 965 inclusion year; and (e) filing deadlines for certain U.S. individuals living abroad (Section 3(05))

- Provide that the 965(c) deduction is not treated as an itemized deduction by individuals, including for purposes of the 2% floor under section 67 or the alternative minimum tax deduction disallowance in section 56 (Section 3(06))

The following substantive sections (Sections 4-7) of Notice 2018-26 announce:

- A modification to the definition of "accounts payable" and "accounts receivable" that were described in Notice 2018-13, to now exclude any receivable or payable with an initial term of one year or more

- Guidance under section 962 in connection with section 965, including that the electing individual must himself or herself be a U.S. shareholder with respect to the foreign corporation (that is, it is not sufficient to be an investor in a domestic pass-through entity that is the U.S. shareholder) and that, consistent with the legislative history, the section 965(c) deduction will apply for purposes of deemed tax calculation arising from the section 962 election

- Guidance concerning the application of the estimated tax rules in sections 6654 and 6655 and a waiver from the penalty imposed under those sections with respect to estimated taxes in connection with section 965 and the repeal of section 958(b)(4)—in particular, the notice provides that a taxpayer's required installments of estimated tax need not include amounts attributable to its net tax liability under section 965 to prevent the imposition of estimated tax penalties

- The effective dates of the regulations and other guidance under section 965, including a clarification of an effective date previously announced in Notice 2018-13