

I.R.S. OFFERS ADDITIONAL GUIDANCE ON CODE §965 TRANSITION TAX

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INTRODUCTION

In light of the approaching tax filing deadline for 2017, the I.R.S. issued guidance (the “F.A.Q.”)¹ on the transition tax for 10% shareholders in a controlled foreign corporation (“C.F.C.”) and certain other foreign corporations under Code §965. The transition tax is imposed on post-1986 earnings and profits of foreign corporations that are C.F.C.’s or have at least one 10% shareholder that is a U.S. corporation. The F.A.Q. addresses taxpayers that are required to report, the method of reporting, the method of payment, and the process for filing under Code §965 on a 2017 tax return.

INCLUSION IN INCOME

In general, Code §965 requires U.S. Shareholders,² to pay a transition tax on the untaxed foreign earnings of certain specified foreign corporations as if those earnings had been repatriated to the United States on the last day of the 2017 taxable year. Where taxpayers own more than one corporation affected by Code §965, the amount included is computed on an aggregate basis. Taxpayers may reduce the inclusion from one specified corporation to reflect deficits in earnings and profits in other specified foreign corporations. The effective tax rates applicable to the income inclusions are adjusted by way of a participation deduction set out in Code §965(c).

ELECTIVE INSTALLMENT PAYMENT OF TRANSITION TAX

Pursuant to Code §965(h), taxpayers, may elect to pay the transition tax in installments over an eight-year period that is back-loaded. Over the first five years, 8% of the tax must be paid annually. The balance is paid in annual installments of 15%, 20%, and 25% in years six, seven, and eight, respectively. If installment payments are timely made, no interest is charged on the deferred tax amount.

CORPORATIONS AFFECTED BY TRANSITION TAX

Generally, a specified foreign corporation³ means either a C.F.C. or a foreign

¹ [“IRS Provides Additional Details on Section 965, Transition Tax: Deadlines Approach for Some 2017 Filers.”](#) news release IR-2018-53, March 13, 2018.

² Code §951(b).

³ Code §965(e).

corporation (other than a passive foreign investment company⁴ that is not also a C.F.C.) that has a U.S. Shareholder that is a domestic corporation. S-corporations and real estate investment trusts are allowed to make similar eight-year elections under Code §§965(i) and 965(m).

Code §965 applies to the last taxable year of the specified foreign corporation that begins before January 1, 2018. The specified foreign corporation's post-1986 earnings and profits are included in income for the year of the taxpayer in which or with which the entity's tax year ends.

REPORTING TRANSITION TAX

Calendar year taxpayers will be required to report the total income resulting from Code §965 when filing their tax returns in March or April 2018. Tax is due at that point or in installments.

Taxpayers who electronically file Form 1040, *U.S. Individual Income Tax Return*, are requested to wait to file their return on or after April 2, 2018. This will provide the I.R.S. time to make certain system changes to allow the returns to be accepted and processed.

WHO MUST REPORT TAX

According to the F.A.Q., reporting is required by a U.S. Shareholder of a Deferred Foreign Income Corporation⁵ ("D.F.I.C."). If the U.S. Shareholder is a partnership, an L.L.C. treated as a partnership, an S-corporation, or a simple trust that must distribute all income to beneficiaries, the member, partner, shareholder, or beneficiary reports the inclusion under Code §965 on its 2017 tax return. Consequently, domestic partnerships, S-corporations, or other pass-thru entities should attach a statement to the Schedule K-1's issued to their owners or beneficiaries for each D.F.I.C. that has a Code §965(a) inclusion amount. The statement should include the following details:

- The partner's, shareholder's, or beneficiary's share of the pass-thru entity's Code §965(a) inclusion amount (if applicable)
- The partner's, shareholder's, or beneficiary's share of the pass-thru entity's deduction under Code §965(c) (if applicable)
- Information necessary for a U.S. corporate partner, or an individual making an election under Code §962 to compute tax as a corporation, to compute its deemed paid foreign tax credits with respect to its share of the pass-thru entity's Code §965(a) inclusion amount (if applicable)

For corporations, and individuals who make an election under Code §962 to be taxed as a corporation with regard to income taxed under Subpart F, the indirect foreign tax credit is reduced under Code §965(g). Resolving a question among tax advisers, the F.A.Q. is silent regarding a possible reduction in foreign tax credits for an individual U.S. citizen resident in a foreign country. As no mention is made

⁴ Code §1297.

⁵ Code §965(d).

“Transition tax is imposed on post-1986 earnings and profits of foreign corporations that are C.F.C.’s or have at least one 10% shareholder that is a U.S. corporation.”

that those individuals suffer a reduction in creditable income taxes imposed by the country of residence, presumably, the matter is settled.

If the taxpayer is a U.S. corporation, or an individual who makes a Code §962 election to the partial dividends received deduction under Code §965(c), the deemed paid foreign taxes with respect to the relevant Code §965(a) amount and the disallowed foreign taxes under Code §965(g) are reported on Form 1118, *Foreign Tax Credit - Corporations*. In the absence of a Code §962 election, an individual is not entitled to a deemed paid foreign tax credit. Individuals report foreign tax credits on Form 1116, *Foreign Tax Credit (Individual, Estate, or Trust)*. There is no disallowance of foreign tax credits reported on that form.

IRC 965 TRANSITION TAX STATEMENT

A U.S. Shareholder must include an “IRC 965 Transition Tax Statement” with its return. The statement must be signed under penalty of perjury. In the case of an electronically filed return, it is submitted in Portable Document Format (.pdf) with a filename of “965 Tax.”

Among other things, the IRC 965 Transition Tax Statement must include the following information:

- The total amount required to be included in income under Code §965(a)
- The person’s aggregate foreign cash position (if applicable)
- The total deduction under Code §965(c)
- The deemed paid foreign taxes with respect to the total amount required to be included in income by reason of Code §965(a) if the taxpayer is a corporation or an individual making an election
- The disallowed deemed paid foreign taxes pursuant to Code §965(g) (if applicable)
- The total net tax liability under Code §965⁶ that will be assessed (if applicable)
- The amount of the net tax liability under Code §965 to be paid in installments under Code §965(h) (if applicable)
- The amount of the net tax liability under Code §965 for which the payment has been deferred under Code §965(i)⁷ in the case of a shareholder in a S-corporation (if applicable)
- A listing of elections under Code §965 or the election provided for in Notice 2018-13 that the taxpayer has made (if applicable)

The relevant Code §965(a) amount, the relevant Code §965(c) deduction, the deemed paid foreign taxes with respect to the relevant Code §965(a) amount, and

⁶ As determined under Code §965(h)(6), without regard to whether the paragraph is applicable.

⁷ Under Code §965(i), shareholders of S-corporations are entitled to an indefinite deferral of the start of the eight-year period for the payment of the transition tax.

the foreign taxes disallowed under Code §965(g) should not be entered on Form 1118. The deemed paid foreign taxes with respect to the Code §965(a) amount and the foreign taxes disallowed under Code §965(g) are reported on IRC 965 Transition Tax Statement, Lines 4a and 4b.

If applicable, a U.S. Shareholder must report the total amount of the net tax liability Under Code §965 on Page 3, Schedule J, Part I, Line 11. The total amount to be paid in installments under Code §965(h) for years beyond the 2017 year is reported on Page 3, Schedule J, Part II, Line 19d, if applicable.

REPORTING OF ELECTIONS

Code §965 permits multiple elections related to amounts included in income and the payment of a taxpayer's net tax liability. All elections with respect to Code §965 must be made by the due date (including extensions) for filing the return for the relevant year. This includes the following elections:

- Code §965(h) (regarding installment payments)
- Code §965(i) (regarding the indefinite deferral of the start of the eight-year installment period)
- Code §965(m) (regarding a special rule for R.E.I.T.'s)
- Code §965(n) (regarding the application of net operating losses)
- Section 3.02 of Notice 2018-13, 2018-6 I.R.B. 341 (regarding the use of October 31, 2017, rather than November 2, 2017)

For each election, a statement signed under penalty of perjury must be attached to a 2017 tax return and submitted, in the case of an electronically filed return, in Portable Document Format. Each statement must include the information specified in Q7.⁸

In the case of a consolidated group⁹ in which one or more members are U.S. Shareholders of a specified foreign corporation, the agent for the group¹⁰ must make the elections on behalf of the group members.

PAYMENT OF TAX

The date for the first installment payment of the transition tax is delinked from the date for making elections. Consequently, the first installment of the transition tax must be paid by the original due date (without extensions) for filing the return for the relevant year.

Taxpayers are advised to make two separate tax payments for 2017. One payment reflects tax owed without regard to Code §965, and the other reflects tax owed resulting from Code §965 (the "Code §965 Payment"). Both payments must be made

⁸ ["Questions and Answers About Reporting Related to Section 965 on 2017 Tax Returns,"](#) I.R.S., last reviewed or updated March 19, 2018.

⁹ Code §1.1502-1(h).

¹⁰ Code §1.1502-77.



by the due date of the applicable return (without extensions).

The Code §965 Payment must be made either by wire transfer, check, or money order. For the Code §965 Payment, there is no penalty for taxpayers electing to use wire transfers as an alternative to otherwise mandated EFTPS payments.

RECORD KEEPING

Adequate records must be kept supporting the Code §965(a) inclusion amount, the deduction under Code §965(c), and net tax liability under Code §965, as well as the underlying calculations of these amounts. Moreover, additional reporting may be required when filing returns for subsequent tax years, and the manner of reporting may be different.

TAX RETURNS PREVIOUSLY FILED

If a 2017 tax return has already been filed, the taxpayer should consider filing an amended return based on the information provided in the F.A.Q. and appendices. Taxpayers are advised that a failure to submit a return in this manner may result in processing difficulties and erroneous notices being issued. Failure to accurately reflect the net tax liability under Code §965 in total tax could result in interest and penalties. In order to amend a return, a person must file the applicable form for amending the return pursuant to regular instructions and include the following attachments:

- Amended versions of forms and schedules necessary to follow the instructions in the F.A.Q.
- Election statements
- IRC 965 Transition Tax Statement