Internal Revenue Service
DEPARTMENT OF THE TREASURY

LB&I Concept Unit

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Table of Contents

(View this PowerPoint in "Presentation View" to click on the links below)

IRC 965 Transition Tax Overview

On December 22, 2017, IRC 965 was 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 (Tax Cuts and Jobs Act [“TCJA”]). As a result of the amendment, certain taxpayers are required to include in income an amount (section 965(a) inclusion amount) based on the accumulated post-1986 deferred foreign income of certain foreign corporations that they own either directly or indirectly through other entities. Other taxpayers may have inclusions in income under IRC 951(a) by reason of IRC 965 due to ownership of deferred foreign income corporations (“DFICs”) through pass-through entities that are themselves U.S. shareholders of DFICs.

In general, IRC 965 requires United States shareholders, as defined under IRC 951(b), 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. Very generally, IRC 965 allows taxpayers to reduce the amount of such inclusion based on deficits in earnings and profits (“E&P”) with respect to other specified foreign corporations. The effective tax rates applicable to such income inclusions are adjusted by way of a participation deduction set out in IRC 965(c). A reduced foreign tax credit applies to the inclusion under IRC 965(g). Generally, a specified foreign corporation means either a controlled foreign corporation(“CFC”), as defined under IRC 957, or a foreign corporation (other than a passive foreign investment company, as defined under IRC 1297, that is not also a CFC) that has a United States shareholder that is a domestic corporation.

Certain taxpayers may make certain elections with respect to IRC 965. These elections include:

- An election to pay the section 965 net tax liability over eight years.
- An election by S corporation shareholders to defer payment of the section 965 net tax liability with respect to such S corporation until a triggering event.
- An election by real estate investments trusts to take both section 965(a) inclusions and the corresponding section 965(c) deductions into account over eight years.,
- An election not to apply a net operating loss.
- An election to use an alternative method to calculate post-1986 earnings and profits (post 1986 E&P).
- An election to use basis adjustments under Treas. Reg. 1.965-2(f).

Detailed Explanation of the Concept

IRC 965 Transition Tax Overview

Analysis	Resources
Section 965 Terminology ▪ Accumulated Post-1986 Deferred Foreign Income - This term includes all post-1986 E&P reduced by both: 1. Post-1986 E&P that, if distributed, would be excluded from the gross income of a U.S. shareholder under IRC 959 (previously taxed E&P); and 2. Post-1986 E&P attributable to income which is effectively connected with the conduct of a trade or business in the U.S. and subject to U.S. income tax (Effectively Connected Income [“ECI”] E&P). ▪ Controlled Foreign Corporation (“CFC”) - Any foreign corporation if more than 50% of the voting power of all classes of stock or 50% of the total value of the stock of the foreign corporation is owned (directly, indirectly, or constructively) by U.S. shareholders on any day during the tax year of the foreign corporation. ▪ Deferred Foreign Income Corporation (“DFIC”) - With respect to any U.S. shareholder, any specified foreign corporation of a U.S. shareholder that has accumulated post-1986 deferred foreign income as of November 2, 2017, or December 31, 2017, that is greater than zero. ▪ E&P Deficit Foreign Corporation (“EPDFC”) - With respect to any taxpayer, a specified foreign corporation with respect to which the taxpayer is a U.S. shareholder, if, as of November 2, 2017, the specified foreign corporation has a deficit in post-1986 E&P. For purposes of determining whether a specified foreign corporation is an EPDFC, all post-1986 E&P must be taken into account.	▪ Form 965 Instructions ▪ Pub. 5292

Detailed Explanation of the Concept (cont'd)

<table>
<tr><th colspan="2">IRC 965 Transition Tax Overview</th></tr>
<tr><th>Analysis</th><th>Resources</th></tr>
<tr><td>
<u>Section 965 Terminology (cont'd)</u>
▪ Post-1986 Earnings and Profits ("Post-1986 E&P") - The E&P of the foreign corporation, including previously taxed E&P, accumulated in taxable years beginning after December 31, 1986, during periods when the foreign corporation was a specified foreign corporation. It is calculated without any reduction for dividends distributed by the foreign corporation during its last taxable year that begins before January 1, 2018, other than dividends distributed to another specified foreign corporation.
▪ U.S. Shareholder - For tax years of foreign corporations beginning before January 1, 2018, a U.S. person who owns (directly, indirectly, or constructively) 10% or more of the total combined voting power of all classes of stock of a foreign corporation. A U.S. person for this purpose is defined in IRC 957(c).
▪ Specified Foreign Corporation ("SFC") - An SFC is (1) any CFC and (2) any foreign corporation with respect to which one or more domestic corporations is a U.S. shareholder. However, if a passive foreign investment company (as defined in IRC 1297) with respect to the shareholder is not a CFC, then such corporation is not an SFC. Solely for purposes of determining whether a foreign corporation is an SFC within the meaning of IRC 965(e)(1)(B), stock owned, directly or indirectly, by or for a partner will not be considered as being owned by a partnership under IRC 958(b) and 318(a)(3)(A) if such partner owns less than five percent of the interests in the partnership's capital or profits.
</td><td>
▪ Form 965 Instructions
▪ Pub. 5292
▪ Notice 2018-26
▪ IRC 957
</td></tr>
</table>

Detailed Explanation of the Concept (cont'd)

<table>
<tr><th colspan="2">IRC 965 Transition Tax Overview</th></tr>
<tr><th>Analysis</th><th>Resources</th></tr>
<tr><td>Revenue Procedure 2019-40
On October 1, 2019, IRS issued Revenue Procedure 2019-40 and proposed regulations to address the implications from TCJA's repeal of IRC 958(b)(4). Prior to repeal, IRC 958(b)(4) provided that IRC 318(a)(3) "Downward Attribution Rules" did not apply to attribute ownership of a foreign corporation by a foreign person to a US shareholder causing a U.S. person to be a10% owner of the foreign corporation and potentially a CFC.

As a result of the repeal of IRC section 958(b)(4), the IRS recognizes that certain U.S. shareholders may have been unable to obtain information necessary for the U.S. shareholder to calculate its section 965 liability in the case of certain SFCs consistent with the requirements of IRC 964 and therefore, Rev. Proc 2019-40 provides guidance to allow taxpayers to choose to use alternative information for determining a subpart F inclusion amount and Global Intangible Low-taxed Income ("GILTI") inclusion amount or related recordkeeping or reporting on a Form 5471 with respect to a foreign-controlled CFC.

However, nothing in this revenue procedure affects the application of the requirements for determining foreign income taxes paid or accrued by a foreign-controlled CFC for purposes of applying IRC 960 (relating to deemed paid foreign income taxes).</td><td>▪ Rev. Proc. 2019-40</td></tr>
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Detailed Explanation of the Concept (cont'd)

IRC 965 Transition Tax Overview	
Analysis	**Resources**
Who is Subject to IRC Section 965? ▪ Any U.S. shareholder (as defined in IRC 951(b)) that directly or indirectly owns the stock of an SFC within the meaning of section 958(a) ("section 958(a) U.S. shareholder"). For purposes of IRC 965, a U.S. shareholder is a U.S. person that owns 10% of the voting power of a foreign corporation. If a domestic pass-through entity is a section 958(a) U.S. shareholder of an SFC, the domestic pass-through owners are subject to section 965. ▪ An SFC is (1) CFC, or (2) a foreign corporation (other than a passive foreign investment company ("PFIC")) that has a corporate U.S. shareholder. A CFC is a foreign corporation greater than 50% directly, indirectly, or constructively owned, by vote or value, by one or more U.S. shareholders at any time during the taxable year of the corporation. ▪ If a foreign corporation is not an SFC, there is no section 965(a) inclusion. ▪ Thus, the starting point in determining whether there is a section 965 inclusion is to identify whether there are any SFCs and section 958(a) U.S. shareholders.	▪ IRC 951 ▪ IRC 958

Detailed Explanation of the Concept (cont'd)

<table>
<tr><th colspan="2">IRC 965 Transition Tax Overview</th></tr>
<tr><th>Analysis</th><th>Resources</th></tr>
<tr><td><u>What is the Basis on Which IRC 965 Tax is Calculated?</u>
▪ IRC 965 Transition tax is applied against the U.S. shareholder's pro-rata share of accumulated post-1986 Deferred Foreign Income ("DFI") less EPDFC.
▪ Deferred foreign income corporation ("DFIC"). A DFIC is an SFC that has accumulated post-1986 deferred foreign income greater than zero as of either 11/2/17 or 12/31/17 (each, an "E&P measurement date"), except generally to the extent the E&P constitute effectively connected income ("ECI") or previously taxed income ("PTI").
▪ E&P deficit foreign corporation ("EPDFC"). An EPDFC is, with respect to a section 958(a) U.S. shareholder, an SFC if, as of 11/2/17, the SFC had a deficit in post-1986 earnings and profits, the corporation was an SFC, and the shareholder was a U.S. shareholder of the corporation.</td><td>▪ IRC 965(a)
▪ IRC 965(b)</td></tr>
</table>

Detailed Explanation of the Concept (cont'd)

IRC 965 Transition Tax Overview	
Analysis	**Resources**
Year of Inclusion and Timing of IRC 965 Inclusion	
▪ IRC 965(a) increases the subpart F income of a DFIC for its last taxable year beginning before 1/1/18, by the greater of its DFI as of each E&P measurement date (11/2/17 or 12/31/17).	▪ Treas. Reg. 1.965-1(b)(1)
▪ A section 958(a) U.S. shareholder of a DFIC must include in its income the pro rata share of the DFI of the DFIC for the last taxable year of the DFIC beginning before 1/1/18 ("inclusion year").	▪ Treas. Reg. 1.965-1(f)(26)
▪ The amount required to be included in the section 958(a) U.S. shareholder's income is reported on the shareholder's return for the taxable year in which or with which the last day of the DFIC's taxable year on which it is an SFC occurs ("section 958(a) U.S. shareholder inclusion year").	▪ Treas. Reg. 1.965-1(f)(37)

Back to Table of Contents

Detailed Explanation of the Concept (cont'd)

IRC 965 Transition Tax Overview	
Analysis	**Resources**
IRC 965 (a) Earnings Amount	
▪ A person who is a U.S. shareholder of a DFIC may be required to report the amounts needed to compute its U.S. tax liability resulting from section 965. In addition, a direct or indirect partner in a domestic partnership, a shareholder in an S corporation, or an owner or beneficiary of another domestic passthrough entity that is a U.S. shareholder of a DFIC may also be required to report its section 965 amounts. For example, if a domestic partnership is a U.S. shareholder of a DFIC, its partners may be required to report their share of the partnership's section 965(a) inclusion amount.	▪ IRC 958(a) ▪ Treas. Reg. 1.965-1(f)(26), (30)(i), (32) &(33),(34),(36) and (37)
▪ Other taxpayers may have inclusions in income under IRC 951(a) by reason of IRC 965 due to ownership of DFICs, through pass-through entities that are themselves U.S. shareholders of DFICs. Section 965 income amounts reported as a U.S. shareholder of a DFIC or as a owner of a passthrough of a DFIC are identified on Form 965 and these instructions use the term "section 965(a) inclusion."	▪ Treas. Reg. 1.965-1(f)(28)

Detailed Explanation of the Concept (cont'd)

IRC 965 Transition Tax Overview	
Analysis	**Resources**
IRC 965 (a) Earnings Amount (cont'd) ▪ To the extent that taxpayers have inclusions in income pursuant to IRC 965(a), under section 951(a), the amount increases the subpart F income of the DFIC in the last taxable year starting before 1/1/18. ▪ The increase, which the section 965 regulations call the section 965(a) earnings amount, is the greater of the SFC DFI as of each E&P measurement date, 11/2/2017 or 12/31/2017, determined in the functional currency of the SFC. ▪ If the functional currency of the SFC changes between the two E&P measurement dates, the comparison must be made in the SFC's functional currency as of 12/31/17, by translating the SFC's DFI as of 11/2/17 into the new functional currency using the spot rate on 11/2/17.	▪ Treas. Reg. 1.965-1(b)(1) ▪ Treas. Reg. 1.965-1(f)(36)

Detailed Explanation of the Concept (cont'd)

IRC 965 Transition Tax Overview	
Analysis	**Resources**
IRC 965 (b) - Allocation of Deficits ▪ If a section 958(a) U.S. shareholder owns at least one DFIC and at least one EPDFC, the portion of the section 965(a) earnings amount that would otherwise be included in the U.S. shareholder's subpart F income is reduced by the amount of such shareholder's aggregate foreign E&P deficit that is allocated to such DFIC. The resulting amount is the section 965(a) inclusion amount. ▪ The aggregate foreign E&P deficit is the total of a section 958(a) U.S. shareholder's pro rata share of the specified E&P deficits of its EPDFC's. The specified E&P deficit of an EPDFC should be translated into U.S. dollars (if not in U.S. dollars) using the spot rate on 12/31/17. ▪ The specified E&P deficit is, with respect to an EPDFC, the amount of its deficit on 11/2/17.	▪ Treas. Reg. 1.965-1(b)(2) ▪ Treas. Reg. 1.965-1(f)(9) ▪ Treas. Reg. 1.965-1(f)(11) ▪ Treas. Reg. 1.965-1(f)(22)(i)(A) ▪ Treas. Reg. 1-965-1(f)(44)

Detailed Explanation of the Concept (cont'd)

<table>
<tr><th colspan="2">IRC 965 Transition Tax Overview</th></tr>
<tr><th>Analysis</th><th>Resources</th></tr>
<tr><td><u>IRC 965 (b) - Allocation of Deficits (cont'd)</u>

▪ The aggregate foreign E&P deficit is allocated among the section 958(a) U.S. shareholder's DFICs in an amount that bears the same proportion to such aggregate as such U.S. shareholder's pro rata share of the section 965(a) earnings amount of each such DFIC, bears to:
− The aggregate of such U.S. shareholder's pro rata share of the section 965(a) earnings amount of all DFICs of such U.S. shareholder.
− Section 965(a) earnings amounts are translated (if necessary) into U.S. dollars using the spot rate on 12/31/17.
− See example 4 included on slide 20.</td><td></td></tr>
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Detailed Explanation of the Concept (cont'd)

IRC 965 Transition Tax Overview	
Analysis	**Resources**
<u>IRC 965 (c) Deduction</u> ▪ A section 958(a) U.S. shareholder with a section 965(a) inclusion amount is allowed a deduction intended to result in the inclusion being taxed at a 15.5% rate to the extent attributable to the section 958(a) U.S. shareholder's aggregate foreign cash position ("AFCP"), and at 8% otherwise. ▪ These tax rates are generated by providing for a deduction equal to the sum of: − 8 percent rate equivalent percentage x (amount of income inclusion minus AFCP) − 15.5 percent rate equivalent percentage x AFCP (not to exceed amount of the income inclusion) <u>Example:</u> ▪ USP is a section 958(a) U.S. shareholder of a single corporation, a DFIC. ▪ Section 965(a) requires USP to include $100 in gross income. ▪ USP's AFCP is $40. − USP's deduction under IRC 965(c) is the 8 percent rate equivalent percentage of $60 ($100 minus $40) plus the 15.5 percent rate equivalent percentage of $40 (the lesser of $40 or $100).	▪ Treas. Reg. 1.965-1(c) ▪ Treas. Reg. 1.965-1(f)

Detailed Explanation of the Concept (cont'd)

IRC 965 Transition Tax Overview	
Analysis	**Resources**
IRC 965 (c)(2) Rate Equivalent Percentages ▪ The 8 percent rate equivalent percentage is the percentage that would be needed to achieve an 8 percent rate of tax on the specified base (income inclusion minus AFCP) if the highest corporate tax rate were in effect for the section 958(a) U.S. shareholder. ▪ The 15.5 percent rate equivalent percentage is the percentage that would be needed to achieve a 15.5 percent rate of tax on the specified base (AFCP not in excess of the income inclusion) if the highest corporate tax rate were in effect for the section 958(a) U.S. shareholder. Example: ▪ USP, a C corporation, is a section 958(a) U.S. shareholder of a DFIC. ▪ USP has an AFCP of $0. ▪ USP is required to include $100 from the DFIC under section 965(a). ▪ The top corporate tax rate is 21 percent. ▪ USP's deduction under section 965(c) is $61.90. − The resulting net inclusion under section 965, $38.10, when multiplied by USP's actual tax rate of 21 percent, results in a tax of $8, which is 8 percent of $100.	▪ IRC 965(c)(2)(A) ▪ IRC 965(c)(2)(B)

Detailed Explanation of the Concept (cont'd)

IRC 965 Transition Tax Overview	
Analysis	**Resources**
IRC 965 Elections ▪ The elections under IRC 965 include: − IRC 965(h): taxpayers with a net tax liability under IRC 965. − IRC 965(i): taxpayers that are shareholders of S corporations and have a net tax liability under IRC 965. − IRC 965(m): taxpayers that are REITs. − IRC 965(n): taxpayers with an NOL. − Election to use alternative method to compute post-1986 E&P. − Election to use basis adjustments under Treas. Reg. 1.965-2(f).	▪ Notice 2018-13, Section 3.02 ▪ Treas. Reg. 1.965-2(f)(2) ▪ Treas. Reg. 1.965-7 ▪ IRS.gov - *Questions and Answers about Reporting Related to Section 965 on 2017 Tax Returns,* Q/A#5

IRC 965 Transition Tax Overview	
Analysis	**Resources**
IRC 965 Elections (cont'd) ▪ The elections under IRC 965 are limited to taxpayers with a net tax liability under section 965 (in the case of IRC 965(h)), taxpayers that are shareholders of S corporations and have a net tax liability under section 965 (in the case of IRC section 965(i)), taxpayers that are REITs (in the case of IRC 965(m)), or taxpayers with an NOL (in the case of IRC 965(n)). Thus, a domestic partnership or an S corporation that is a U.S. shareholder of a DFIC may not make any of the elections under section 965 of the Code. ▪ An IRC 965 election must be made by the due date (including extensions) for filing the return for the relevant year. However, even if an election is made under IRC 965(h) to pay a net tax liability under IRC 965 in installments, the first installment must be paid by the due date (without extensions) for filing the return for the relevant year.	

Back to Table of Contents

Examples of the Concept

IRC 965 Transition Tax Overview
Examples
Examples Timing of Section 965(a) Inclusion Example 1: ▪ FC1 (a DFIC) has a taxable year ending 11/30, and its section 958(a) U.S. shareholder is a calendar year taxpayer. ▪ FC1's inclusion year is its taxable year ending 11/30/18, and the section 958(a) U.S. shareholder inclusion year is the taxable year ending 12/30/18. Example 2: ▪ DFIC has a taxable year ending 12/31, and its section 958(a) U.S. shareholder has a taxable year ending 11/30. ▪ The DFIC's inclusion year is its taxable year ending 12/31/17, and the section 958(a) U.S. shareholder inclusion year is the taxable year ending 11/30/18.

Examples of the Concept (cont'd)

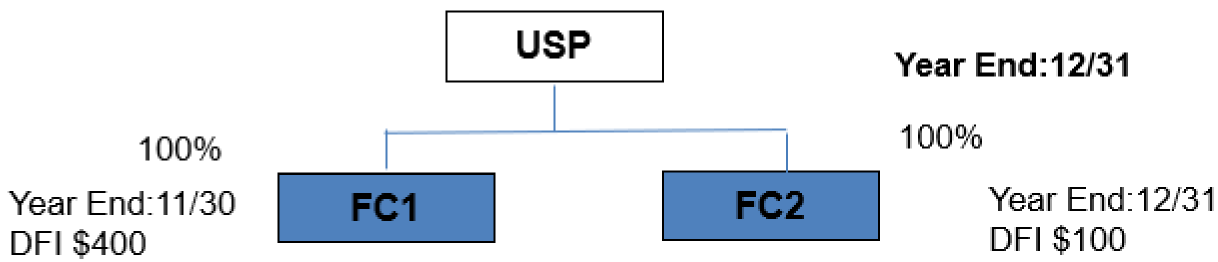
IRC 965 Transition Tax Overview

Examples

<u>Examples Timing of Section 965(a) Inclusion (cont'd)</u>

<u>Example 3:</u>

- The method of taxation:
  - Subpart F income of DFIC is increased
- The timing:
  - In the last taxable year of the DFIC beginning before January 1, 2018, by
- The amount:
  - The greater of:
    1. The DFI of such corporation determined as of November 2, 2017, or
    2. The DFI of such corporation determined as of December 31, 2017.



1. USP includes FC1's DFI of $400 in its income in 2018.
2. USP includes FC2's DFI of $100 in its income in 2017.

Examples of the Concept (cont'd)

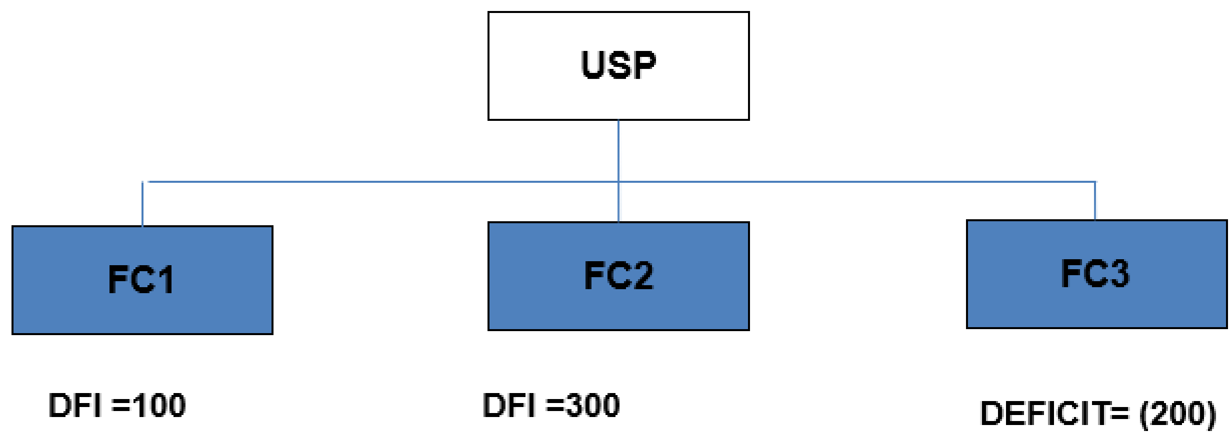
IRC 965 Transition Tax Overview

Examples

Example Section 965(b) - Allocation of Deficits

Example 4:

- USP's aggregate foreign E&P deficit =(200)
- FC1 allocated deficit = (100/400) x 200 = 50
- FC2 allocated deficit = (300/400) x 200 = 150
- Section 965(a) inclusion amount with respect to FC1: 100-50 = 50
- Section 965(a) inclusion amount with respect to FC2: 300-150 = 150



Back to Table of Contents

Index of Referenced Resources

IRC 965 Transition Tax Overview
IRC 951
IRC 957
IRC 958
IRC 965
Treas. Reg. 1.965-1
Treas. Reg. 1.965-2(f)(2)
Treas. Reg. 1.965-7
Notice 2018-13, Section 3.02
Notice 2018-26
Rev. Proc. 2019-40
Form 965 Instructions
Pub. 5292
IRS.gov - *Questions and Answers about Reporting Related to Section 965 on 2017 Tax Returns,* Q/A#5

Training and Additional Resources

IRC 965 Transition Tax Overview	
Type of Resource	**Description(s)**
Saba Meeting Sessions	▪ *965 Transition Tax Part I* - 2019 Saba Meeting ▪ *965 Transition Tax Part II* - 2019 Saba Meeting
Issue Toolkits	▪ Audit Tool - Workbook To Assist in Calculating Section 965 Amounts
White Papers / Guidance	▪ Rev. Proc. 2018-17 - Changes in Accounting Periods and Methods of Accounting
Databases / Research Tools	▪ Repatriation Book in the International Knowledge Base
Reference Materials – Treaties	▪ Treas. Reg. 1.965
Other Training Materials	▪ IRS.gov - *Questions and Answers about Reporting Related to Section 965 on 2017 Tax Returns* ▪ IRS.gov - *Questions and Answers about Tax Year 2018 Reporting and Payments Arising under Section 965*

Glossary of Terms and Acronyms

Term/Acronym	Definition
AFCP	Aggregate Foreign Cash Position: Defined in IRC 965(c)(3)(A) and Treas. Reg. 1.965-1(f)(8).
DFI	Deferred Foreign Income: Defined in IRC 965(d)(2) and in general means the post-1986 earnings and profits except to the extent such earnings are attributable to income of the specified foreign corporation which is effectively connected with the conduct of a trade or business within the United States and subject to tax under this chapter (ECI), or in the case of a controlled foreign corporation, if distributed, would be excluded from the gross income of a United States shareholder under section 959 (PTI).
DFIC	Deferred Foreign Income Corporation: Defined in Treas. Reg. 1.965-1(f)(17) and in general means a specified foreign corporation that has accumulated post-1986 deferred foreign income greater than zero as of an E&P measurement date of 11/02/2107 or 12/31/2017.
DPT	Deemed Paid Taxes: When there is an inclusion into US taxable income, through for example, Subpart F, there is a corresponding deemed paid foreign tax credit.
ECI	Effectively Connected Income: See publication 519, *U.S. Tax Guide for Aliens*: https://www.irs.gov/forms-pubs/about-publication-519 Generally, when a foreign person engages in a trade or business in the United States, all income from sources within the United States connected with the conduct of that trade or business is considered to be ECI.
EPDFC	Earnings and Profit Deficit Foreign Corporation: Defined in Treas. Reg. section 1.965-1(f)(22). Generally, a EPDFC is an SFC which has a deficit in post 1986 E&P. An EPDFC is, with respect to a section 958(a) U.S. shareholder, an SFC if, as of 11/2/17, the SFC had a deficit in post-1986 earnings and profits, the corporation was an SFC, and the shareholder was a U.S. shareholder of the corporation.

Back to Table of Contents

Glossary of Terms and Acronyms (cont'd)

Term/Acronym	Definition
GILTI	Global Intangible Low-taxed Income
PTEP	Previously Taxed Earnings & Profits: PTEP refers to E&P of a foreign corporation to amounts which are, or have been, included in the gross income of a U.S. shareholder under IRS section 951(a) or under IRC 1248(a). See also IRC 959(a) and (e).
PTI	Previously Taxed Income: Under IRC 959(a), a distribution by a CFC out of E&P that has been included in the income of a USSH is PTI. The PTI rules were designed to prevent double taxation of a CFC's earnings. Generally, PTI is 959(c)(1) and 959(c)(2) E&P.
SFC	Specified Foreign Corporation: Defined IRC section 958(a) and Treasury Regulation section 1.965-1(f)(45).
TCJA	Tax Cuts and Jobs Act: Public Law 115–97, passed in November 2017, was a congressional revenue act that amended the Internal Revenue Code of 1986 and introduced the new concepts of IRC 965, GILTI, FDII, BEAT, etc.
USSH	United States Shareholder: Defined in section 951(b) as referenced in Treasury Regulation section 1.965-1(f)(47) and generally means, with respect to any foreign corporation, a United States person who owns 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation, or 10 percent or more of the total value of shares of all classes of stock of such foreign corporation.

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit
	None at this time.