

LB&I Training Tax Cuts & Jobs Act (TCJA)

**Training
Participant Guide
October 2019**

Official IRS Training Material

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Welcome

LB&I Tax Cuts & Jobs Act Training



IRS Mission Statement



Mission Statement

Provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all.

14 General Principles of Ethical Conduct

Please see [Document 9300](#) for a complete list of the 14 General Principles of Ethical Conduct for Federal Employees.

Taxpayer Bill of Rights

Please see [Publication 1](#) to read the full text of Your Rights as a Taxpayer.

TCJA Course Overview

LB&I Tax Cuts & Jobs Act training sessions are a large part of LB&I's multi-pronged approach to tax reform training. This mandatory training course covers IRC § § 199A, 451, 163(j), 951A, 250, 59A, 965, 367 and 91.

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TCJA Course Agenda

Monday - October 21, 2019

- Executive Opening, Introductions and Admin
- IRC § 199A (Qualified Business Income Deduction)

Tuesday - October 22, 2019

- IRC § 451 (Income Recognition Guidance)
- IRC § 163(j) (Limitation on Business Interest Expense)

Wednesday - October 23, 2019

- IRC § 163(j) (Limitation on Business Interest Expense) (cont'd)
- IRC § 367 & 91 (Transfer Pricing/Outbound Transfers)

TCJA Course Agenda (cont'd)

Thursday - October 24, 2019

- IRC § 951A (Global Intangible Low-Taxed Income)
- IRC § 250 (Foreign Derived Intangible Income)

Tuesday - October 29, 2019

- IRC § 965 (Transition Tax)

Wednesday - October 30, 2019

- IRC § 59A (Base Erosion and Anti-abuse Tax)

Thursday – October 31, 2019

- Final Comments and Executive Closing

LB&I Training Tax Cuts & Jobs Act (TCJA)

IRC § 965
Transition Tax



Large Business
& International

Instructor Introductions

Instructor Introductions

Lesson Overview

- **Part I – Basics & Definitions**
 - Introduction
 - Definitions
 - Timing of section 965(a) inclusion
- **Part II – Calculation**
 - Section 965(a) earnings amount
 - Section 965(b) allocation of the aggregate foreign E&P deficit
 - Section 965(a) inclusion amount
 - Section 965(c) deduction
 - Aggregate foreign cash position & cash position
 - E&P and basis adjustments
 - Foreign tax credit issues

Lesson Overview (cont'd)

- **Part III – Anti-Abuse Rules, Elections & Affiliated and Consolidated Groups**
 - Deferral & other section 965 elections
 - Anti-abuse rules
 - Affiliated & consolidated groups
- **Part IV – Reporting & Audit Issues**
 - Reporting requirements & IDRS transcripts
 - FAQs
 - Audit issues
 - Other noteworthy rules

Lesson Objectives

At the end of this lesson, you will be able to:

- Explain new section 965 terminology;
- Calculate section 965(a) inclusions;
- Calculate section 965(c) deductions;
- Determine foreign tax credits associated with section 965(a) inclusions;
- Apply anti-abuse provisions;
- Explain section 965 elections;
- Explain reporting of section 965; and
- Apply audit techniques.

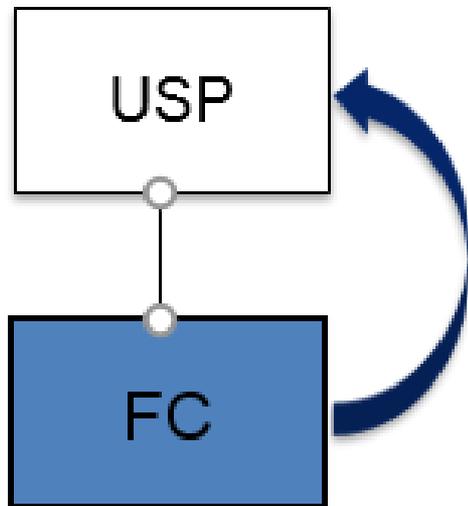
Part I – Basics & Definitions

- **Introduction**
 - Why section 965 exists
 - Who is subject to section 965
 - Key terminology
 - Section 958(a) U.S. shareholder
 - Specified foreign corporation
 - Deferred foreign income corporation
 - E&P deficit foreign corporation
 - E&P measurement date
 - Accumulated post-1986 deferred foreign income
 - Post-1986 earnings and profits
- **Section 965(a) inclusion**
 - Timing of section 965(a) inclusion

Why Section 965 Exists: Overview

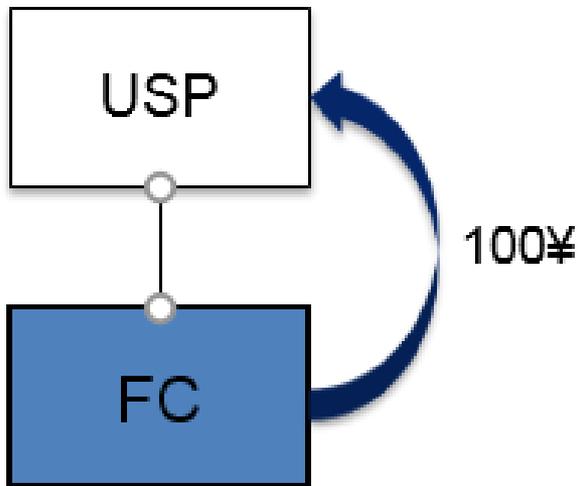
- Before tax reform, international taxation was generally a **worldwide system of taxation with a deferral component**.
- After tax reform, the system is generally a **territorial or exemption system of taxation**.
- Section 965 taxes certain deferred foreign income that has accumulated over time.

Why Section 965 Exists: Pre-TCJA Law



- Foreign income earned by FC generally is not subject to U.S. tax unless and until distributed
 - Exceptions for subpart F and section 956 inclusions
- When FC distributes its foreign income to USP, the income is generally subject to U.S. tax

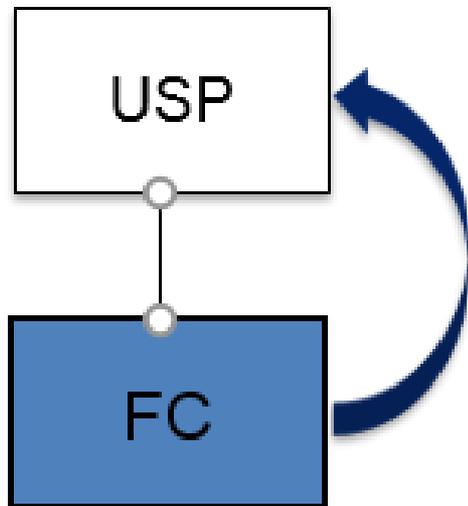
Why Section 965 Exists: Pre-TCJA Example



- FC is formed on 1/1/2001
- In 2001, FC earns 100 yen
 - FC's E&P increases by 100
 - No U.S. taxation yet
- In 2005, FC distributes 100 yen to USP and USP includes it in its taxable income
 - FC's E&P decreases by 100 yen

* Example assumes USP has no subpart F or section 956 inclusions

Why Section 965 Exists: Post-TCJA Law



- Dividends from FC generally receive 100% dividends received deduction (DRD) under section 245A
 - No tax on repatriation
- Subpart F remains intact
- GILTI subjects certain non-subpart F foreign income to tax
- Section 956 also remains in effect (but under regulations section 956 amounts are now generally reduced to the extent the section 245A DRD would apply to a dividend)

Who is Subject to Section 965?

- Any U.S. shareholder (as defined in section 951(b)) that directly or indirectly owns the stock of a **specified foreign corporation (“SFC”)** within the meaning of section 958(a) (**“section 958(a) U.S. shareholder”**).
 - For purposes of section 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.

Key Terms: SFC, DFIC and EPDFC

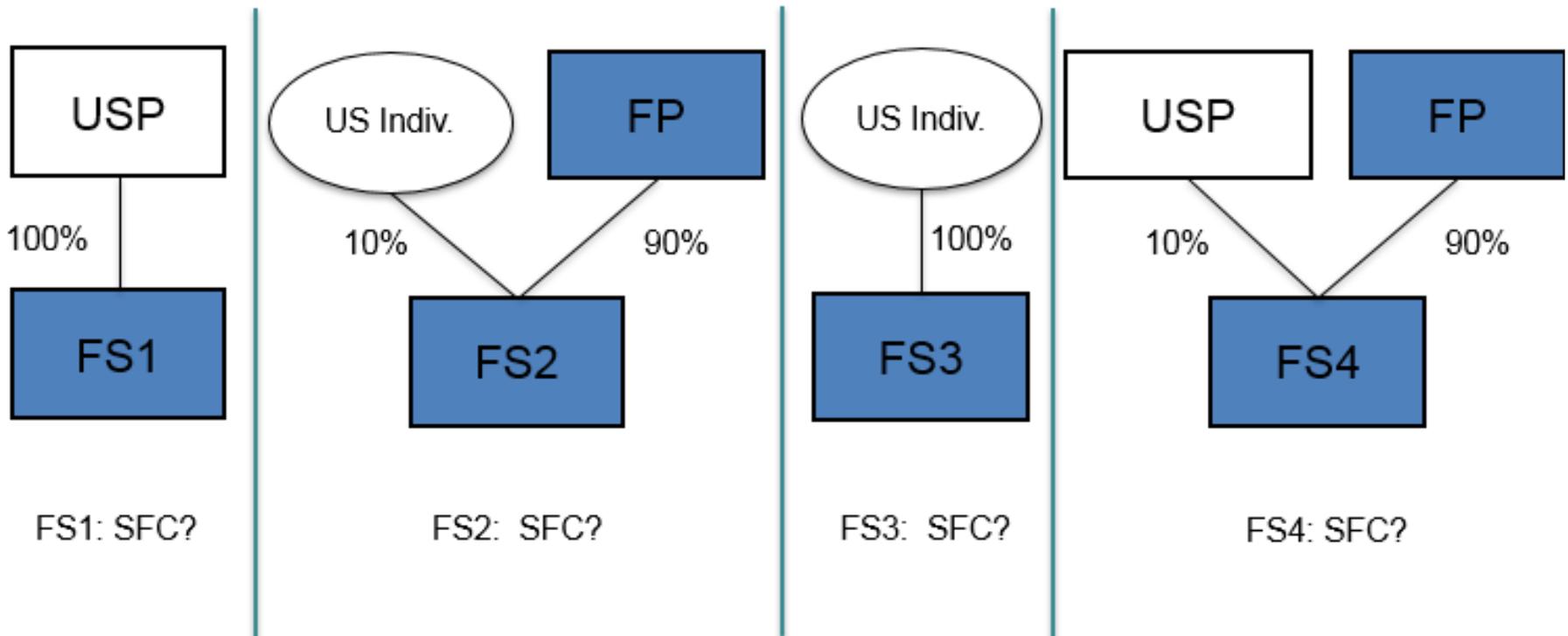
- Specified Foreign Corporation (“SFC”)
- Deferred Foreign Income Corporation (“DFIC”)
 - One type of SFC
- E&P Deficit Foreign Corporation (“EPDFC”)
 - Another type of SFC

Specified Foreign Corporation (SFC)

- An SFC is (1) a **controlled foreign corporation (“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 FC is not an SFC → 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.

Examples

Is the foreign corporation in each of these examples an SFC?



*Assume % refers to ownership by vote and value.

Answers to Examples

- FS1 is an SFC because it is a CFC. A U.S. shareholder controls more than 50% of the shares.
- FS2 is not an SFC because it is not a CFC or a foreign corporation with a domestic corporation as a U.S. shareholder.
- FS3 is an SFC because it is a CFC. A U.S. shareholder controls more than 50% of the shares.
- FS4 is an SFC because it is a foreign corporation with one corporate U.S. shareholder.

DFIC & 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”**).
 - If an SFC meets the definition of a DFIC, it is classified solely as a DFIC and not also as an EPDFC even if it otherwise meets the definition of an EPDFC (**“priority rule”**).
- **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.

Accumulated Post-1986 Deferred Foreign Income & Post-1986 Earnings and Profits

- **Post-1986 Earnings and Profits (“Post-1986 E&P”)**
 - An SFC’s post-1986 E&P is E&P accumulated in taxable years beginning after 12/31/86, but only taking into account periods in which the foreign corporation was an SFC and without diminution by reason of dividends distributed during the inclusion year other than dividends distributed to another SFC.
- **Accumulated Post-1986 Deferred Foreign Income (“DFI”)**
 - DFI includes the post-1986 earnings and profits of an SFC except generally to the extent the earnings and profits constitute effectively connected income (“ECI”) or previously taxed income (“PTI”).



DFIC & EPDFC Examples

SFC1

11/2/17 DFI: \$100
11/2/17 Post-'86 E&P: \$100
12/31/17 DFI: \$0
DFIC or EPDFC?

SFC2

11/2/17 DFI: (\$400)
11/2/17 Post-'86 E&P: (\$400)
12/31/17 DFI/Post'86 E&P: (\$400)
DFIC or EPDFC?

SFC3

11/2/17 DFI: \$300
11/2/17 Post-'86 E&P: \$300
12/31/17 DFI: (\$200)
DFIC or EPDFC?

SFC4

11/2/17 DFI: (\$250)
11/2/17 Post-'86 E&P: (\$250)
12/31/17 DFI: \$100
DFIC or EPDFC?

SFC5

11/2/17 DFI: (\$250)*
11/2/17 Post-'86 E&P: \$100*
12/31/17 DFI: (\$250)
DFIC or EPDFC?



Answers to DFIC & EPDFC Examples

- SFC1 is a DFIC because it has positive accumulated post-1986 deferred foreign income (DFI) on one of the E&P measurement dates, 11/2/17.
- SFC2 is a EPDFC because it has a deficit in post-1986 E&P as of 11/2/17 and does not have positive DFI on 12/31/17.
- SFC3 is a DFIC because it has DFI on one of the E&P measurement dates, 11/2/17. The priority rule classifies this entity as a DFIC even if it had otherwise met the EPDFC definition. In this example, the entity does not have a deficit on 11/2/17, so it would not meet the definition of EPDFC.

Answers to DFIC & EPDFC Examples (cont'd)

- SFC4 is a DFIC because it has DFI on one of the E&P measurement dates, 12/31/17. This entity could have met the definition of EPDFC because it has a deficit as of 11/2/17. However, the priority rule applies and it is a only DFIC.
- SFC5 is not a DFIC or a EPDFC. It is not a DFIC because it does not have positive DFI on either of the E&P measurement dates. It is not an EPDFC because it does not have a deficit on 11/2/17 since the deficit in untaxed E&P, (\$250), does not exceed the aggregate of the SFC's post-1986 PTEP of \$350.

Timing of Section 965(a) Inclusion

- Section 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).
- 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**”).
- 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**”).

Timing of Section 965(a) Inclusion: Ex. 1 & 2

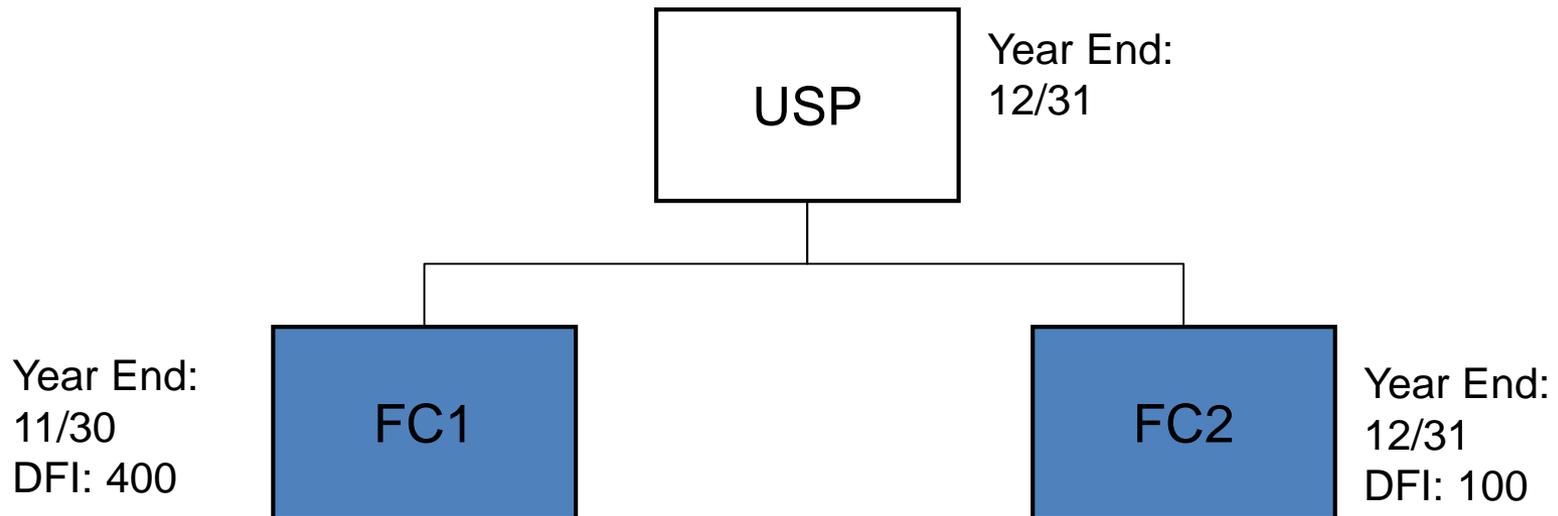
Example 1:

- DFIC has a taxable year ending 11/30, and its section 958(a) U.S. shareholder is a calendar year taxpayer.
- The DFIC'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 12/31/18.

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.

Timing of Section 965(a) Inclusion: Ex. 3



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.

Questions



Part II – Calculation

- Section 965(a) earnings amount
- Section 965(b) allocation of the aggregate foreign E&P deficit
- Section 965(a) inclusion amount
- Section 965(c) deduction
- Aggregate foreign cash position & cash position
- E&P and basis adjustments
- Foreign tax credit issues

Section 965(a) Earnings Amount

Section 965(a) Earnings Amount

Section 965(a) Earnings Amount

- To recap, section 965(a) increases the subpart F income of a 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's DFI as of each E&P measurement date, 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.

Section 965(b) Allocation of the Aggregate Foreign E&P Deficit

Section 965(b) Allocation of the Aggregate Foreign E&P Deficit



Section 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 EPDFCs.
 - 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.

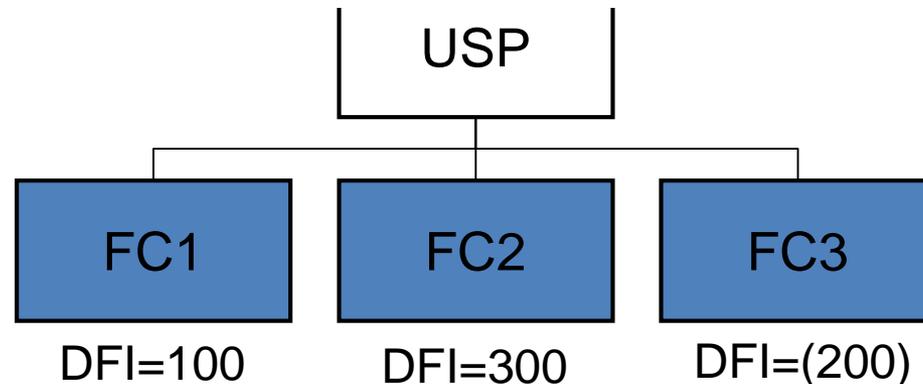


Section 965(b) – Allocation of Deficits (cont'd)

- 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.

Section 965(b) – Allocation of Deficits: Example

- USP's aggregate foreign E&P deficit = (200)
- FC1 allocated deficit = $(100/400) \times 200 = 50$
- FC2 allocated deficit = $(300/400) \times 200 = 150$
- Section 965(a) inclusion amount w/r/t FC1:
 - $100 - 50 = 50$
- Section 965(a) inclusion amount w/r/t FC2:
 - $300 - 150 = 150$



Section 965(c) Deduction 1

Section 965(c) Deduction

Section 965(c) Deduction 2

- 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:

15.5 percent rate equivalent percentage x AFCP

(not to exceed amount of the income inclusion)

and

8 percent rate equivalent percentage x (amount of income inclusion – AFCP)

Section 965(c) Deduction: Example 1

- 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 section 965(c) is
 - the 15.5 percent rate equivalent percentage of \$40 (the lesser of \$40 or \$100)
 - plus the 8 percent rate equivalent percentage of \$60 ($\$100 - \40).

Rate Equivalent Percentages

- ❖ 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.
- 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 subtract AFCP) if the highest corporate tax rate were in effect for the section 958(a) U.S. shareholder.

F965 Part II, Section 2

Rate Equivalent Percentages

SECTION 2—Rate Equivalent Percentages

1	Calendar Year Persons	2017 Calendar Year	2018 Tax Year
a	15.5 Percent Rate Equivalent Percentage	0.557142857	0.261904762
b	8 Percent Rate Equivalent Percentage	0.771428571	0.619047619
2	2017 Fiscal Year Persons		
a	Enter the section 15 blended rate calculated in accordance with section 905(c)(2) (see instructions) 15.5 Percent Rate Equivalent Percentage	2a	
b	Subtract 15.5% from line 2a	2b	
c	Divide line 2b by line 2a 8 Percent Rate Equivalent Percentage	2c	
d	Subtract 8% from line 2a	2d	
e	Divide line 2d by line 2a	2e	

For calendar years

2017 $(35\% - 15.5\%) / 35\% = .557142857$

$(35\% - 8\%) / 35\% = .771428571$

2018 $(21\% - 15.5\%) / 21\% = .261904762$

$(21\% - 8\%) / 21\% = .619047619$

For fiscal years, it is based on the section 15 blended rate



Rate Equivalent Percentages (cont'd)

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 (\$100 X .619047619, the 8% rate equivalent percentage)
- 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.

Aggregate Foreign Cash Position 1

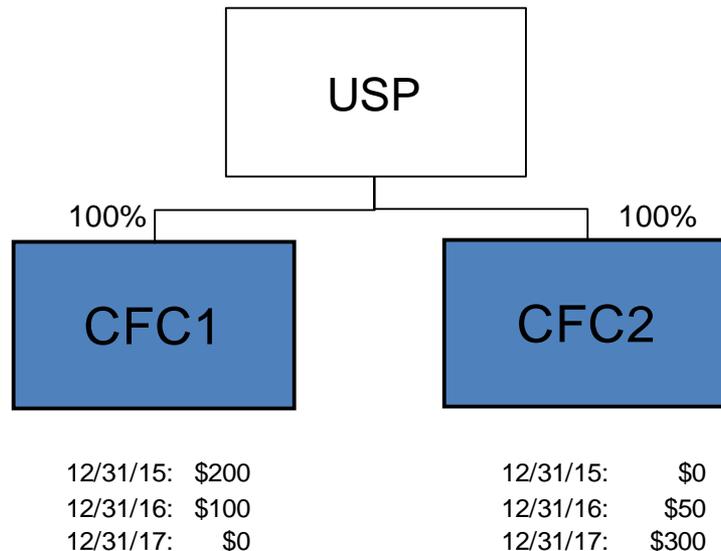
Aggregate Foreign Cash Position

Aggregate Foreign Cash Position 2

The AFCP is the *greater of*:

- the aggregate of a section 958(a) U.S. shareholder's pro rata share of the cash position of each SFC determined on the SFC's final cash measurement date, or
 - An SFC's final cash measurement date is the close of the last taxable year of the SFC that begins before 1/1/18, and ends on or after 11/2/17, if any.
- the average of the aggregate of a section 958(a) U.S. shareholder's pro rata share of the cash position of each SFC determined as of each SFC's first and second cash measurement dates.
 - The second cash measurement date of an SFC is the close of the last taxable year of the SFC that ends after 11/1/16, and before 11/2/17, if any.
 - The first cash measurement date of an SFC is the close of the last taxable year of the SFC that ends after 11/1/15, and before 11/2/16, if any.

Aggregate Foreign Cash Position: Example



Measurement Dates	Cash Position		
	First	Second	Final
	12/31/2015	12/31/2016	12/31/2017
CFC1	200	100	-
CFC2	-	50	300
	<u>200</u> (3)	<u>150</u> (2)	<u>300</u> (1)
AFCP 12/31/2017	(1)	300	
Average	$((2)+(3))/2$	175	
AFCP			<u>300</u>
AFCP - 2017			<u><u>300</u></u>

- USP's aggregate of the pro rata share of CFC1's and CFC2's cash positions on the final cash measurement date (12/31/17) is \$300.
- USP's average of the aggregate of the pro rata share of CFC1's and CFC2's cash positions on the first and second cash measurement dates (12/31/15 & 12/31/16) is \$175.
- Thus, USP's aggregate foreign cash position (the greater of the two amounts) is \$300.



Cash Position

The **cash position** of an SFC is the sum of the following:

- Cash held by the SFC;
- Net accounts receivable of the SFC; and
 - Net accounts receivable is the excess of an SFC's accounts receivable (if any) over its accounts payable.
- The fair market value (FMV) of certain assets held by the SFC, called cash-equivalent assets.
 - The value of the of the cash-equivalent asset must generally be adjusted by the FMV of any cash-equivalent asset hedging transaction with respect to the cash-equivalent asset.

Cash-equivalent Assets

- Personal property which is of a type that is actively traded and for which there is an established financial market, other than a **specified commodity**;
- Commercial paper, certificates of deposit, the securities of the Federal, State, or foreign government;
- Any foreign currency;
- Any short-term obligation (not including any accounts receivable); and
- Derivative financial instruments, other than **bona fide hedging transactions**.

Derivative Financial Instruments

- Notional principal contracts;
- Option contracts;
- Futures contracts;
- Forward contracts;
- Short positions in securities or commodities; and
 - Forward contracts and short positions with respect to specified commodities are excepted to the extent the SFC identified, or could have identified, the forward contract or the short position as a hedging transaction (within the meaning of Treas. Reg. §1.1221-2(b)) with respect to one or more specified commodities held by the SFC.
- Any financial instrument similar to the above.

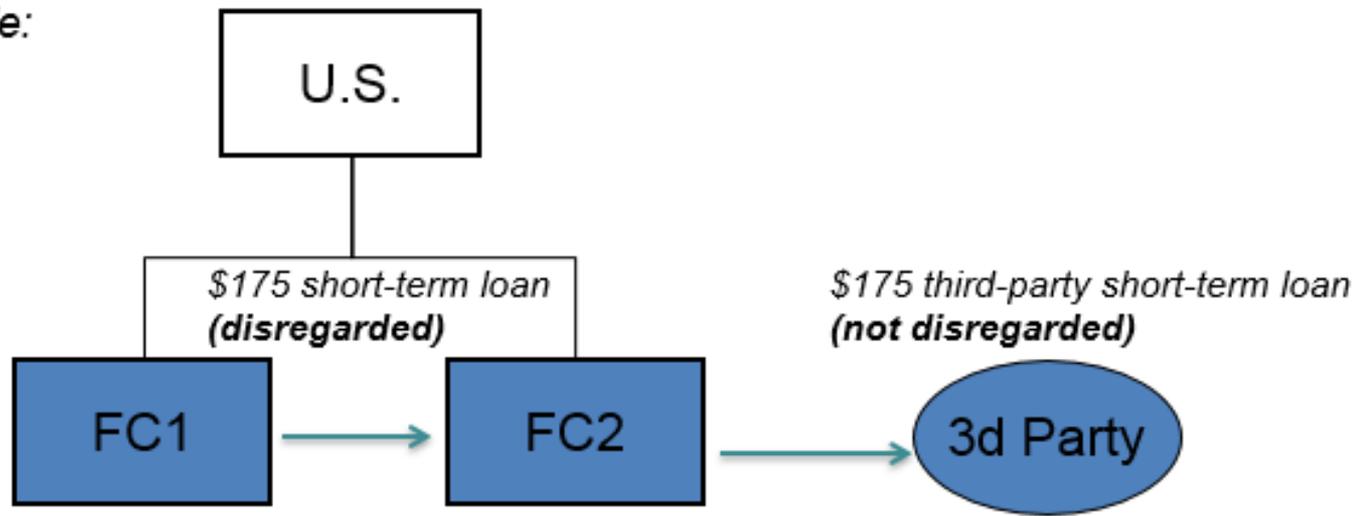
Exceptions

- **Specified Commodity**
 - Held, or, for purposes of Treas. Reg. §1.965-1(f)(18), to be held, by an SFC that, in the hands of the SFC is:
 - Property described in section 1221(a)(1) (inventory), or
 - Property described in section 1221(a)(8) (supplies).
 - Exception does not apply with respect to commodities held by an SFC in its capacity as a dealer or trader in commodities.
- **Bona Fide Hedging Transaction**
 - A hedging transaction that meets the requirements of a bona fide hedging transaction described in Treas. Reg. §1.954-2(a)(4)(ii), except
 - Where an SFC is not a CFC, the identification requirements of Treas. Reg. §1.954-2(a)(4)(ii)(B) do not apply.

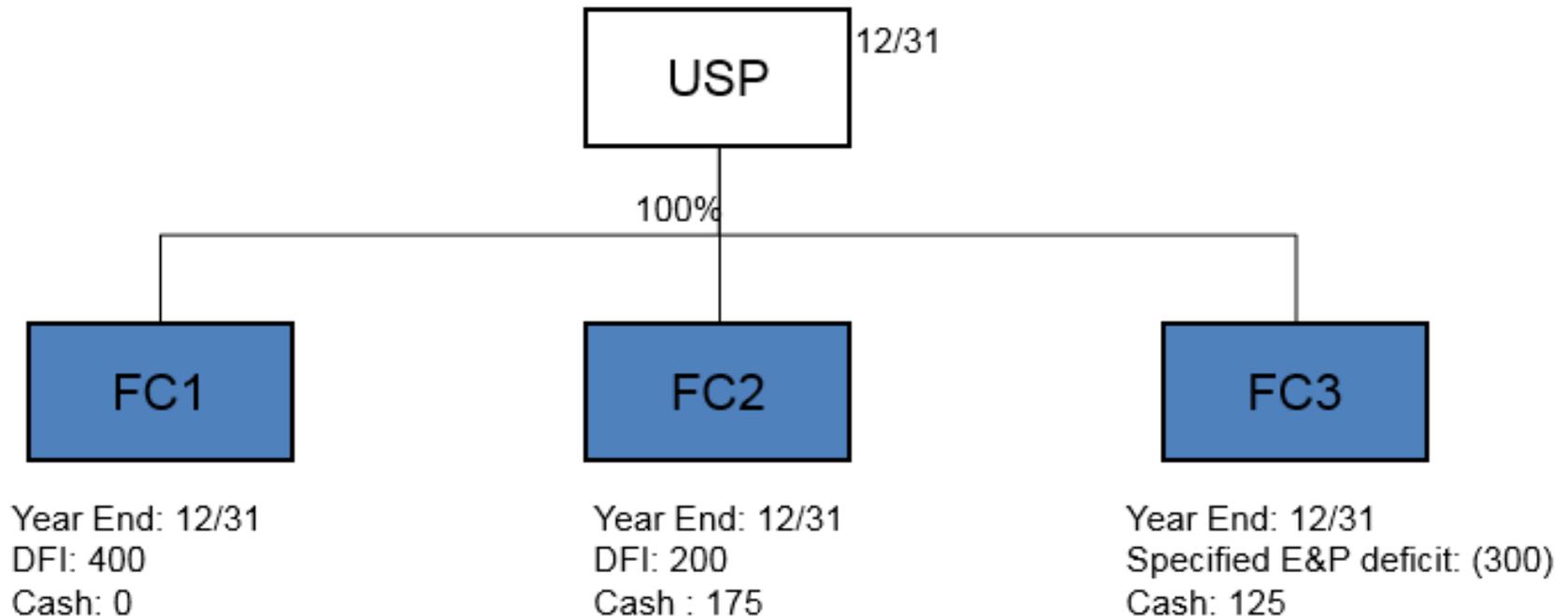
Related Parties & AFCP

- For purposes of determining the AFCP of a section 958(a) U.S. shareholder, accounts receivable and payable, short-term obligations, and derivative financial instruments between related SFCs are in certain circumstances disregarded on the corresponding cash measurement dates of the SFCs to the extent of the smallest ownership percentage of stock owned by the section 958(a) U.S. shareholder on the corresponding measurement dates.
- An SFC is treated as related to another SFC if the SFCs are related persons within the meaning of section 954(d)(3), substituting SFC for CFC.

Example:



Section 965(c) Deduction: Example 2



Section 965(c) Deduction: Example (cont'd)

12/31/2017	Section 965(a) earnings amount		USSH prorata share	Deficit Allocation Ratio	US SH's Aggregate Foreign E&P Deficit	Section 965(a) Inclusion Amount	2017
FC1	400	100%	400	0.6667	200	200	200
FC2	200	100%	200	0.3333	100	100	100
			<u>600</u>		<u>300</u>	<u>300</u>	<u>300</u>

Section 965(c) deduction calculation

Section 965(a) inclusion	300
Aggregate Foreign Cash Position	<u>300</u>
	300
2017 15.5% Rate Equivalent Percentage	0.557142857
Section 965(c) Deduction Related to 15.5% Rate Equivalent Percentage	- 167
2017 8% Rate Equivalent Percentage	0.771428571
Section 965(c) Deduction Related to 8%Rate Equivalent Percentage	<u>0</u>
Section 965(c) deduction	<u><u>167</u></u>
Section 965(a) inclusion	300
Section 965(c) deduction	<u>167</u>
	<u><u>133</u></u>
	35% 47
Effective tax rate	<u><u>15.5%</u></u>

- FC3's deficit is allocated to FC1 and FC2.
FC1: $(400/600) \times 300 = 200$; FC2 $(200/600) \times 300 = 100$.
- The inclusion amount with respect to FC1 is $400 - 200 = 200$.
- The inclusion amount with respect to FC2 is $200 - 100 = 100$.
- USP's aggregate foreign cash position: 300.
- Assume 35% applicable rate: USP claims deduction of ~\$167, yielding an effective tax rate of 15.5%.



E&P and Basis Adjustments

E&P and Basis Adjustments



Overview of Sections 959 and 961

Pre-TCJA

- CFC E&P subject to tax under an anti-deferral regime (e.g., subpart F) could be also subject to tax on the distribution of such E&P if not for section 959
- Section 959 (addressing adjustments to E&P) and its corollary, section 961 (addressing adjustments to basis) prevent this type of double taxation

Post -TCJA

- Section 965(a) inclusion also creates PTI
- Rules to address new PTEP under development

E&P Categories

- Under section 959, E&P is classified into three categories –
 - 1) 959(c)(1): Includes E&P attributable to section 956 inclusions
 - 2) 959(c)(2): Includes E&P attributable to subpart F income (and now GILTI)
 - 3) 959(c)(3): All other E&P (generally previously untaxed E&P)
- When we've talked about "E&P" during this presentation, we are referring to the sum of all three of these categories.
- Section 959(c)(1) and 959(c)(2) E&P is E&P that has previously been subject to U.S. taxation, and is fittingly referred to as:
 - Previously taxed earnings and profits (PTEP), or
 - Previously taxed income (PTI).

Ordering Rule

Treas. Reg. §1.965-2(b) sets forth a rule that dictates the sequence in which adjustments to different categories of an SFC's E&P must be made (“**ordering rule**”):

(b)(1) Subpart F and 1248: USSH's inclusions under section 951(a)(1)(A) (other than by reason of section 965) and section 1248 are determined and section 959(c)(2) E&P is adjusted.

(b)(2) Certain distributions: The treatment of SFC-to-SFC distributions made before 1/1/18 and any other distribution made in a pre-inclusion year before the relevant E&P measurement date is determined under section 959.

(b)(3) Section 965(a): E&P of a DFIC is adjusted for USSH's section 965(a) inclusion amount, and adjustments are made for EPDFCs.

(b)(4) Other distributions (including to the U.S. parent): (B)(2) distributions, if disregarded are then redetermined, and all other distributions are determined under section 959.

(b)(5) Section 956: Section 959(c)(2) E&P are reclassified as 959(c)(1) E&P, as applicable.

Remember

- 959(c)(1): Includes E&P attributable to section 956 inclusions
- 959(c)(2): Includes E&P attributable to subpart F income
- 959(c)(3): All other E&P (generally untaxed)

E&P Adjustments Due to Sections 965(a) and (b)

- If a section 958(a) U.S. shareholder has a section 965(a) inclusion with respect to a DFIC, the section 959(c)(2) E&P of the DFIC with respect to the shareholder is increased by an amount equal to the section 965(a) inclusion amount, translated using the spot rate on 12/31/17 (“**section 965(a) PTEP**”).
 - The section 959(c)(3) E&P of the DFIC with respect to the section 958(a) U.S. shareholder is reduced by an amount equal to the section 965(a) PTEP.
- If a section 958(a) U.S. shareholder’s pro rata share of the section 965(a) earnings amount of a DFIC is reduced under section 965(b), the section 959(c)(2) E&P of the DFIC with respect to the shareholder is increased by an amount equal to the amount of the reduction, translated using the spot rate on 12/31/17 (“**section 965(b) PTEP**”).
 - The section 959(c)(3) E&P of the DFIC with respect to the section 958(a) U.S. shareholder is reduced (or, in the case of a deficit, increased) by an amount equal to the section 965(b) PTEP.

Basis Issue

- The section 965(b) PTEP (section 959(c)(2)) increase is not accompanied by a basis increase in the DFIC (section 961)
- When the section 965(b) PTEP is distributed it will trigger a capital gain unless there is sufficient basis
- To mitigate the DFIC's section 965(b) PTEP, the regulations under section 965 provide an election to effectively shift basis from EPDFC to DFIC

Basis Adjustment Election

- A binding election under Treas. Reg. §1.965-2(f) allows a section 958(a) U.S. shareholder's basis in the stock of a DFIC to be increased by part or all of the section 965(b) PTEP of that corporation to the extent there is a commensurate reduction in basis with respect to the stock of the section 958(a) U.S. shareholder's EPDFC.
- The basis adjustment election must be made no later than the due date (taking into account extensions, if any) of the section 958(a) U.S. shareholder's return for the first taxable year that includes the last day of the last taxable year of a DFIC or an EPDFC of the shareholder that begins before 1/1/18.
- A “transition rule” allows taxpayers whose returns were due before 5/6/19 to make the binding basis election and taxpayers who made a basis election before 2/5/19 to revoke the previously-made election by 5/6/19.
- The section 958(a) U.S. shareholder and all related persons must make the basis adjustment election, and it applies to all DFICs and EPDFCs.



Foreign Tax Credit Issues

Foreign Tax Credit Issues

Section 965(g): Foreign Tax Credit Haircut

- Neither a credit under section 901 nor a deduction is allowed for the applicable percentage (“haircut”) of any foreign income taxes paid or accrued (or treated as paid or accrued) with respect to income for which the deduction under section 965(c) is allowed.
- Direct foreign taxes on distributions of section 965(a) PTEP and 965(b) PTEP to U.S. shareholder are subject to haircut.
 - Applies for both an election to credit (section 901) and deduct (section 164) those foreign taxes
- Taxes treated as paid or accrued and subject to haircut include:
 - Foreign income taxes deemed paid under section 960(a)(1) with respect to a section 965(a) inclusion;
 - Foreign income taxes deemed paid under section 960(a)(3) or section 960(b) with respect to distributions of section 965(a) PTEP or section 965(b) PTEP;
 - Foreign income taxes allocated under Treas. Reg. §1.901-2(f)(4); and
 - A distributive share of foreign income taxes paid or accrued by a partnership.

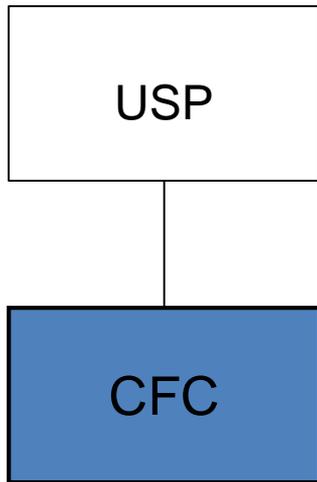


Section 965(g): Applicable Percentage

- The **applicable percentage**, which must be separately determined by the section 958(a) U.S. shareholder for each inclusion year, is generally equal to the sum of two percentages:
 - $0.771 \times (\text{non-cash position} / (\text{cash} + \text{non-cash position})) +$
 - $0.557 \times (\text{cash position} / (\text{cash} + \text{non-cash position}))$
- If a section 958(a) U.S. shareholder does not have an aggregate section 965(a) inclusion amount, the shareholder's applicable percentage is 0.557.
- A domestic pass-through owner's applicable percentage applied to foreign income taxes attributable to the owner's share of the section 965(a) inclusion amount or of distributions of section 965(a) PTEP or 965(b) PTEP is equal to the applicable percentage determined under the rules described above with respect to its domestic pass-through entity.



Example 1: Foreign income taxes deemed paid under section 960(a)(1) with respect to a section 965(a) inclusion



All corporations have a 12/31/17 tax year.
All corporations have a U.S. dollar functional currency

- USP's section 965(a) inclusion amount is: \$200
- USP's deemed paid taxes before disallowance are (S.960(a)(1)):

$$\frac{\text{S. 965(a) inclusion}}{\text{Post-1986 undistributed earnings}} \times \text{Post-1986 foreign income taxes}$$

$$\frac{\$200}{\$200} \times \$40 = \$40$$

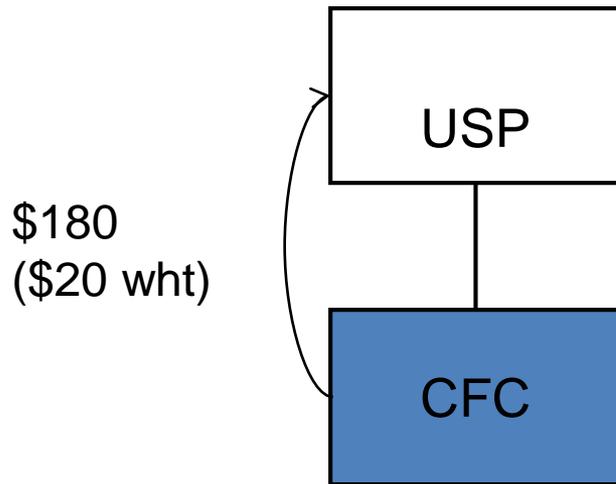
- DFI: \$200
- Cash: \$120
- Post-1986 undistributed earnings: \$200 (S.902(c)(1))
- Post-1986 foreign income taxes: \$40 (S.902(c)(2))

- USP's applicable percentage is:
 $((\$120 / \$200) * 55.7\%) + ((\$80 / \$200) * 77.1\%) = 64.26\%$

- Before considering the foreign tax credit limitation, USP's allowed deemed paid taxes are:

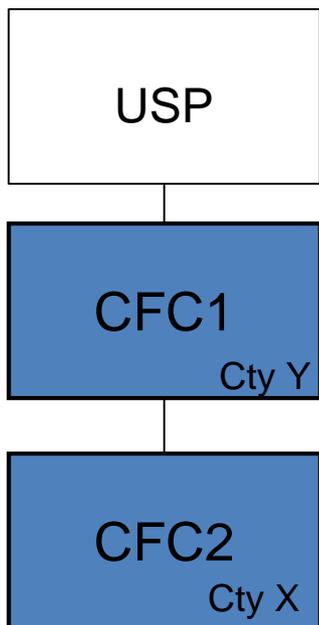
$$\$40 \times (1 - 64.26\%) = \$14.30$$

Example 2: Direct foreign taxes attributable to distributions of section 965(a) PTEP



- Same facts as prior slide.
- In addition:
 - In 2017, CFC distributes \$200, subject to a \$20 withholding tax by Country Y.
 - Such distribution is section 965(a) PTEP.
 - USP may credit \$7.15 of the withholding tax imposed by Country Y ($\$20 * (1 - 64.26\%)$)
- If instead, CFC distributes \$200 and withholds \$20 in a year after 2017, USP would be entitled to credit \$7.15 in that year.

Example 3: Foreign income taxes deemed paid under section 960(a)(1) with respect to a section 965(a) inclusion – lower-tier CFC



All corporations have a 12/31/17 tax year.
All corporations have a U.S. dollar functional currency

- CFC1 DFI: \$0
- CFC1 Post-1986 foreign income taxes: \$0 (S.902(c)(2))
- CFC2 DFI: \$200
- CFC2 Cash: \$120
- CFC2 Post-1986 undistributed earnings: \$200 (S.902(c)(1))
- CFC2 Post-1986 foreign income taxes: \$40 (S.902(c)(2))

- USP's section 965(a) inclusion amount with respect to CFC2 is: \$200
- USP's deemed paid taxes before disallowance are (S.960(a)(1)):

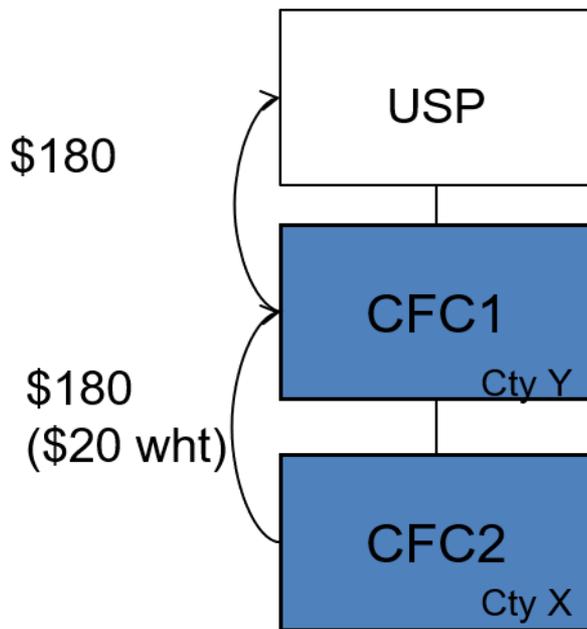
$$\frac{\text{S. 965(a) inclusion}}{\text{Post-1986 undistributed earnings}} \times \text{Post-1986 foreign income taxes}$$

$$\frac{\$200}{\$200} \times \$40 = \$40$$

- USP's applicable percentage is:
 $((\$120 / \$200) * 55.7\%) + ((\$80 / \$200) * 77.1\%) = 64.26\%$
- Before considering the foreign tax credit limitation, USP's allowed deemed paid taxes are:

$$\$40 \times (1 - 64.26\%) = \$14.30$$

Example 4: Foreign income taxes deemed paid under section 960(a)(3) or section 960(b) with respect to distributions of section 965(a) PTEP



- The facts are the same as the prior slide.
- In addition:
 - In 2017, CFC2 distributes \$200 to CFC1 subject to a Country X withholding tax (wht) of \$20, but not subject to Country Y tax.
 - In 2017, CFC1 distributes \$180 to USP which is not subject to a Country Y wht.
 - USP is deemed to pay the \$20 wht paid by CFC1. Section 960(a)(3).
 - USP is only allowed to credit \$7.15 of that \$20 wht. ($\$20 * (1-64.26\%)$)
- If CFC2 instead made the distribution and withheld the tax after 2017, and CFC1 made a distribution to USP, USP would only be allowed a credit of \$7.15 (Section 960(b)).
- If instead, CFC2 made the distribution and withheld the tax in 2017, and CFC1 made the distribution in 2018, USP would only be allowed a credit of \$7.15 (Section 960(b)).

Section 965(g): Applicable Percentage (cont'd)

- Special rules ensure that there is a disallowance of a portion of the section 78 gross-up. However, the disallowance is not exactly the same as the disallowance for the deemed paid taxes.
 - A taxpayer electing FTCs includes in gross income under section 78 only amounts equal to the deemed paid taxes multiplied by the following ratio:

(Section 965(a) inclusion – section 965(c) deduction)

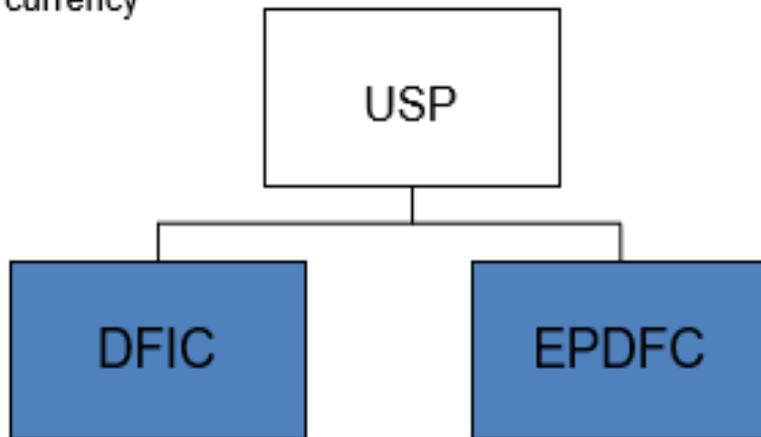
Section 965(a) inclusion

No Credit Allowed Under Section 960(a)(3)

- No credit is allowed under section 960(a)(3) for foreign income taxes that would have been deemed paid under section 960(a)(1) with respect to the portion of a section 965(a) earnings amount that is reduced by an aggregate foreign E&P deficit.

Example 5: No Credit Allowed Under Section 960(a)(3)

All corporations have a 12/31/17 tax year.
All corporations have a U.S. dollar functional currency



- DFI: \$200
- Cash: \$120
- Post-1986 undistributed earnings: \$200 (S.902(c)(1))
- Post-1986 foreign income taxes: \$40 (S.902(c)(2))
- Specified E&P deficit: (\$150)
- Post-1986 foreign income taxes: \$100

- USP's section 965(a) inclusion amount is: \$50
- USP's deemed paid taxes before disallowance are (S.960(a)(1)):

$$\frac{\text{S. 965(a) inclusion}}{\text{foreign Post-1986 undistributed earnings taxes}} \times \text{Post-1986 income taxes}$$

$$\frac{\$50}{\$200} \times \$40 = \$10$$

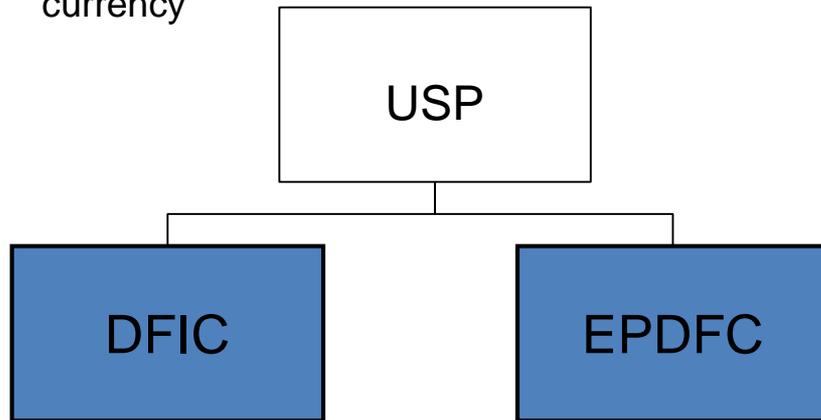
- USP's applicable percentage is:

$$((\$50 / \$50) * 55.7\%) + ((\$0 / \$50) * 77.1\%) = 55.7\%$$
- Before considering the foreign tax credit limitation, USP's allowed deemed paid taxes are:

$$\$10 \times (1 - 55.7\%) = \$4.43$$

Example 5: No Credit Allowed Under Section 960(a)(3) (cont.)

All corporations have a 12/31/17 tax year.
All corporations have a U.S. dollar functional currency

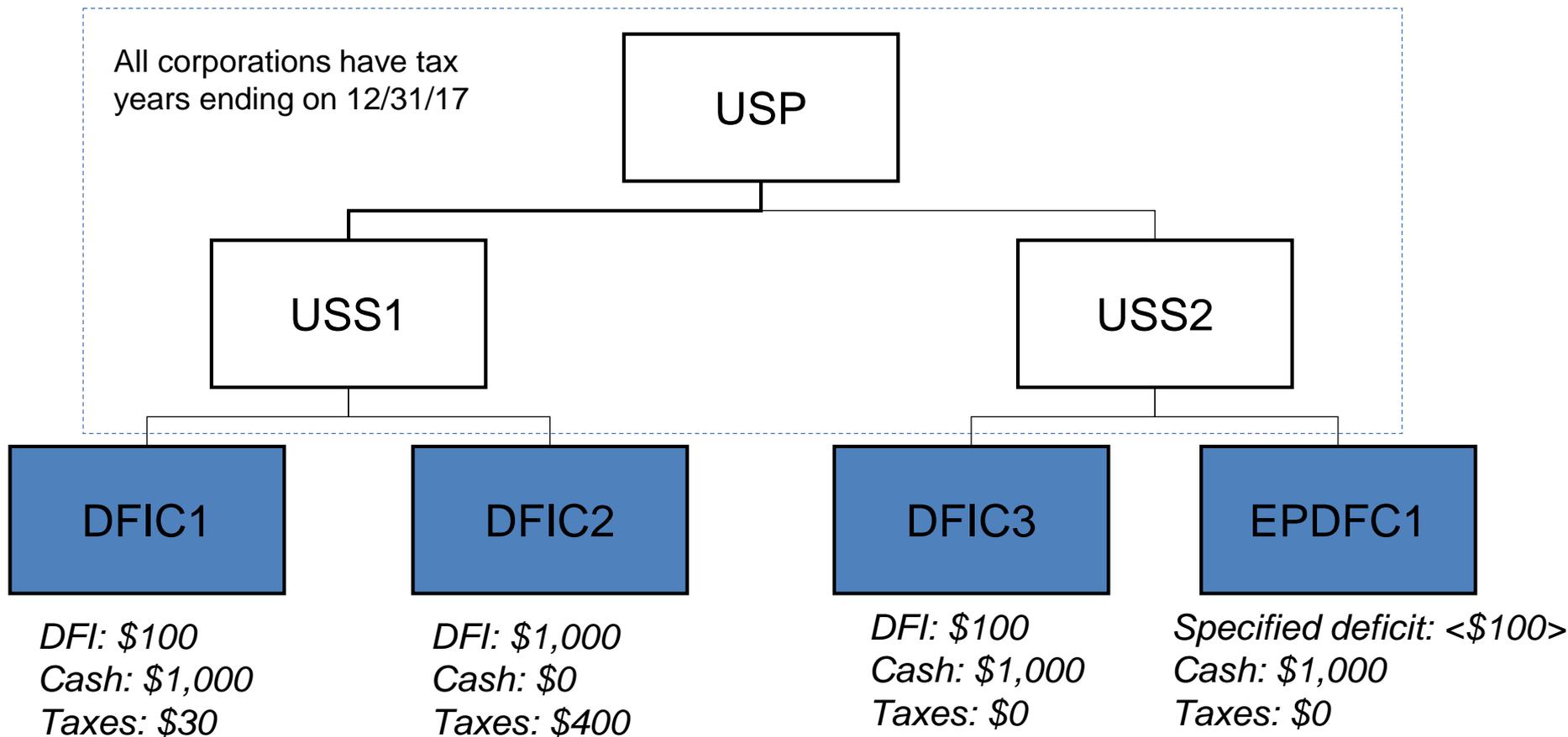


- DFI: \$200
- Cash: \$120
- Post-1986 undistributed earnings: \$200 (S.902(c)(1))
- Post-1986 foreign income taxes: \$40 (S.902(c)(2))

- Specified E&P deficit: (\$150)
- Post-1986 foreign income taxes: \$100

- USP is also deemed to include the \$150 of other DFI of DFIC because USP has section 965(b) PTEP as a result of EPDFC's specified E&P deficit.
- As a result, USP is deemed to pay the \$30 of taxes associated with the \$150 of DFI.
- Because the \$150 of DFI is not actually included in USP's taxable income, there is no deemed paid credit.
- As a result, USP is never allowed a credit for the remaining \$30 of post-1986 foreign income taxes.

Example 6



Example 6 (cont'd)

Deemed paid taxes

	E&P 2 Nov & 31 Dec	USSH	USSH ownership	DFI	E&P Deficit 2 Nov	Taxes	Cash Position 31 Dec
DFIC1	100	USS1	100%	100		30	1,000
DFIC2	1,000	USS1	100%	1,000		400	-
USS1				1,100	-		1,000
DFIC3	100	USS2	100%	100			1,000
EPDFC1	(100)	USS2			(100)		1,000
USS2				100	(100)		2,000
				1,200	(100)	Consolidated AFCP	3,000

Section 965(a) inclusion

Post-1986 undistributed earnings

	DFI	USSH pro rata share	Deficit Allocation Ratio	US SH's Aggregate Foreign E&P Deficit	Section 965(a) Inclusion Amount	2017	2018
DFIC1	100	100%	100	0.0833	8	92	92
DFIC2	1,000	100%	1,000	0.8333	83	917	917
DFIC3	100	100%	100	0.0833	8	92	92
			1,200		100	1,100	1,100
					(100)		-

Assumptions:

- Deemed paid taxes: includes opening balance in post-1986 tax pools and foreign taxes paid and deemed paid for tax year indicated
- Separate category of income: general

Example 6 (cont'd) 2

USP Group Cash ratio

$$\begin{array}{rcl} \text{AFCP} & & 3,000 \\ \text{Section 965(a) Inclusion Amount} & \frac{\quad}{\quad} & 1,100 \end{array} = 2.73$$

	Section 965(a) Inclusion Amount	USP Group Cash ratio	AFCP
USS1	1,008	2.73	2,750
USS2	92	2.73	250
	<u>1,100</u>		<u>3,000</u>

Section 965(c) deduction

	USS1	USS2	Consol Total
Section 965(a) inclusion	1,008	92	
Aggregate Foreign Cash Position	2,750	250	
@min(965(a) incl, AFCP)	1,008	92	
2017 15.5% Rate Equivalent Percentage	0.557142857	0.557142857	
Section 965(c) Deduction Related to 15.5% Rate Equivalent Percentage	562	51	
2017 8% Rate Equivalent Percentage	0.771428571	0.771428571	
Section 965(c) Deduction Related to 8%Rate Equivalent Percentage	-	-	
Section 965(c) deduction	<u>562</u>	<u>51</u>	<u>613</u>

Example 6 (cont'd) 3

Foreign Taxes Deemed Paid by Domestic Corporation

	(a)	(b)	(c)	(d)	(e)
	Section 965(a) Inclusion in Functional Currency	Post-1986 Undistributed Earnings in Functional Currency	Divide Column (a) by Column (b)	Post-1986 Foreign Income Taxes	Taxes Deemed Paid
DFIC1	92	100	92.0%	30	27.60
DFIC2	917	1,000	91.7%	400	366.80
DFIC3	92	100	92.0%	-	-
	<u>1,100</u>	<u>1,200</u>			<u>394.40</u>

- Deemed paid tax calculated for each DFIC
- USSH must own 10% or more of **the voting stock of DFIC**

Example 6 (cont'd) 4

Disallowed Foreign Taxes

Portion of the aggregate 2017 tax year section 965(a) inclusion amount not corresponding to the aggregate foreign cash position, divided by		0
Total section 965(a) inclusion amount		1,100
Times		0.00000000
Applicable percentage w/r/t aggregate 2017 tax year section 965(a) inclusion amount not corresponding to the aggregate foreign cash position	77.1%	0.00%
Portion of the aggregate 2017 tax year section 965(a) inclusion amount corresponding to the aggregate foreign cash position, divided by		1,100
Total section 965(a) inclusion amount		1,100
Times		1.00000000
Applicable percentage w/r/t aggregate 2017 tax year section 965(a) inclusion amount corresponding to the aggregate foreign cash position	55.7%	55.70%
<i>2017 Applicable Percentage</i>		55.70%

Foreign Taxes Deemed Paid by Domestic Corporation

	(e)		(f)	
	Taxes Deemed Paid	Applicable Percentage	Disallowed foreign taxes	Deemed paid taxes after disallowance
DFIC1	27.60	55.7%	15.37	12.23
DFIC2	366.80	55.7%	204.31	162.49
DFIC3	-	-	-	-
	<u>394.40</u>		<u>219.68</u>	<u>174.72</u>

Example 6 (cont'd) 5

Deemed paid taxes	\$394.40	(reported on F1118 Sch B)
Section 965(g) disallowed taxes	<u>\$219.68</u>	(reported on F1118 Sch G)
Total foreign taxes	<u><u>\$174.72</u></u>	
Section 78 gross-up	<u><u>\$174.61</u></u>	

$$\text{Deemed paid taxes} \times \frac{(\text{section 965(a) inclusion} - \text{section 965(c) deduction})}{\text{section 965(a) inclusion}}$$

Section 78 gross up

Deemed paid taxes	x	<u>(section 965(a) inclusion - section 965(c) deduction)</u>	
		section 965(a) inclusion	
394.40 x ((1,100-613)/1,100)	=	174.61	

Part III – Anti-Abuse Rules, Elections & Affiliated and Consolidated Groups

- Section 965 Elections
- Anti-Abuse Rules
- Affiliated and Consolidated Groups

Section 965 Elections 1

Section 965 Elections

Section 965 Elections

Six elections are available to taxpayers with respect to section 965:

- Section 965(h) – Election to Pay Net Tax Liability Under Section 965 in Installments
- Section 965(i) – S Corporation Shareholder Election to Defer Payment of Net Tax Liability Under Section 965
- Section 965(m) – Election for REITs to Defer Section 965 Inclusions
- Section 965(n) – Election Not to Apply NOL Deduction
- Election to Use Alternative Method to Compute Post-1986 E&P
- Election to Use Basis Adjustments Under Treas. Reg. §1.965-2(f)

Section 965(h) Election

- Any section 958(a) U.S. shareholder or any owner of a domestic pass-through entity that is a section 958(a) U.S. shareholder (but not the domestic pass-through entity itself) may elect to pay its net tax liability under section 965 in interest-free installments over a period of 8 years.
 - 8% of the section 965(h) net tax liability would be due in each of the first 5 years;
 - 15% would be due in year 6;
 - 20% would be due in year 7; and
 - 25% would be due in year 8.
- The election must be made by the due date (including extensions, even if no request for additional time was made) for filing the return for the relevant year.
 - Relief not available under Treas. Reg. §301.9100-2 or -3 to file a late election.
- Tax deferred under section 965(h) may be due sooner if an acceleration event occurs.
 - In certain instances, an acceleration event will not accelerate payment of the tax if a transfer agreement is timely filed.

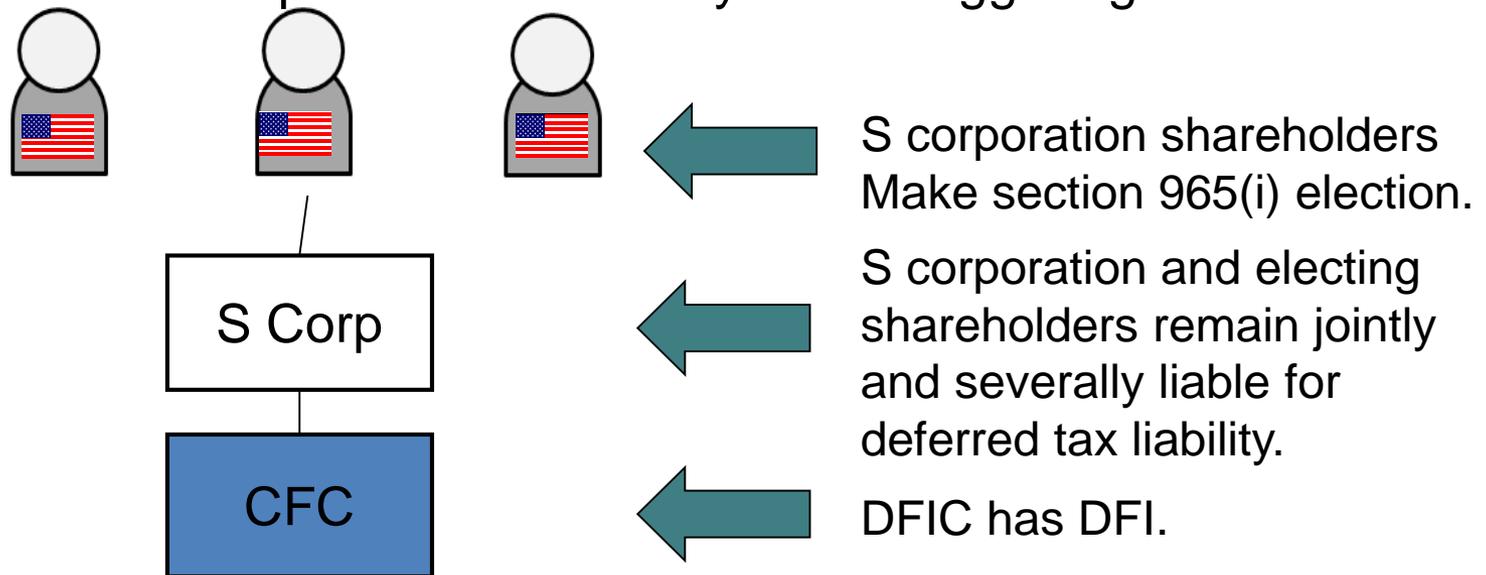


Acceleration Events

- Any of the following constitutes an **acceleration event**:
 - 1) Failure to timely pay an installment;
 - 2) Liquidation, sale, exchange, or other disposition of substantially all of the assets of the person making the installment election (including bankruptcy or death);
 - 3) Cessation of business by the person;
 - 4) Any event that results in the person no longer being a U.S. person (e.g., expatriation);
 - 5) The person becoming a member of a consolidated group;
 - 6) The cessation of the existence of a consolidated group;
 - 7) A determination by the IRS that there was a material misstatement or omission in a transfer agreement.
- Continued deferral under section 965(h) may be possible if the acceleration event is a **covered acceleration event**, and a transfer agreement is properly entered into.
 - An acceleration event is a covered acceleration event if it is described in #2, #5, or #6 above, and the transferee is an eligible section 965(h) transferee (a single U.S. person that is not a domestic pass-through entity).

Section 965(i) Election

- Each shareholder of an S corporation that is a U.S. shareholder of a DFIC may elect to defer payment of its section 965(i) net tax liability with respect to the S corporation indefinitely until a triggering event occurs.



If any shareholder of an S corporation makes a section 965(i) election, the S corporation is jointly and severally liable for the payment of the shareholder's section 965(i) net tax liability with respect to the S corporation, as well as any penalties, additions to tax, or other additional amounts attributable to such net tax liability.

Triggering Events

Any of the following constitutes a **triggering** event:

- 1) The S corporation ceases to be an S corporation;
- 2) Liquidation, sale, exchange, or other disposition of substantially all of the assets of the S corporation (including in bankruptcy);
- 3) Cessation of the business or existence of the S corporation;
- 4) Transfer of the shares of the S corporation (including by reason of death or otherwise);
- 5) A determination by the IRS that there has been a material misrepresentation or omission in a transfer agreement.

Triggering Events (cont'd)

Continued deferral under section 965(i) may be possible if the triggering event is a covered triggering event, and a transfer agreement is properly entered into.

- An event is a covered triggering event if described in #4 above, and the transferee is an eligible section 965(i) transferee (a single U.S. person that becomes a shareholder of the S corporation but not the domestic pass-through entity itself).
- In case of a transfer that consists of multiple partial transfers, a transfer agreement may be entered into by the shareholder with respect to which the triggering event occurs and an eligible section 965(i) transferee for each partial transfer.
- If a triggering event occurs and continued deferral under section 965(i) is not possible, the shareholder may elect to pay its section 965(i) net tax liability over 8 years.

Section 965(m) Election: REITs

- Section 965(m) and Treas. Reg. §1.965-7(d) provide special rules for real estate investment trusts (REITs).
- A REIT may make an election under section 965(m) to defer the inclusion in gross income of its “REIT section 965 amounts” and include them in income according to the following schedule:
 - 1) 8% of the REIT section 965 amounts would be includible in each taxable year in the five-taxable year period beginning with the taxable year the amount would otherwise be included;
 - 2) 15% would be includible in year 6;
 - 3) 20% would be includible in year 7; and
 - 4) 25% would be includible in year 8.
- **“REIT section 965 amounts”** means, with respect to a REIT and a taxable year of the REIT, the aggregate amount of section 965(a) inclusions and section 965(c) deductions that would (but for the section 965(m) election) be taken into account in determining the REIT’s income for the taxable year.



Section 965(n) Election: NOLs

- Under section 965(n) and Treas. Reg. §1.965-7(e), a person may make an election to not take into account the “applicable amount”:
 - In determining its net operating loss (NOL) under section 172 for the taxable year, or
 - In determining the amount of taxable income for such taxable year that may be reduced by NOL carryovers or carrybacks to such taxable year.
- The “**applicable amount**” is defined as the sum of:
 - The person’s section 965(a) inclusions reduced by the person’s section 965(c) deductions for the taxable year and,
 - In the case of a domestic corporation, the taxes deemed paid under section 960(a)(1) associated with the section 965(a) inclusions that are treated as dividends under section 78.

Section 965(n) Election: Example

Current year NOL example

Without section 965(n) Election

Section 965(a) inclusion less section 965(c) deduction	\$100
Section 78 gross-up with respect to section 965(a) inclusion	30
Taxable loss from operations	<u>(60)</u>
Taxable income	70

With section 965(n) Election

Section 965(a) inclusion less section 965(c) deduction	\$100
Section 78 gross-up with respect to section 965(a) inclusion	30
Taxable loss from operations	(60)
Reduction for applicable amount	<u>(130)</u>
Net operating loss to be carried back or forward	<u><u>(60)</u></u>

Section 965(a) inclusion less section 965(c) deduction	\$100
Section 78 gross-up with respect to section 965(a) inclusion	<u>30</u>
Taxable income	<u><u>\$130</u></u>

Section 965(n) Election: Example (cont'd)

Carryover NOL example: Taxpayer has carryover of \$100

Without section 965(n) Election

Section 965(a) inclusion less section 965(c) deduction	\$ 100
Section 78 gross-up with respect to section 965(a) inclusion	30
Taxable loss from operations	<u>(60)</u>
Income	70
Net operating loss deduction	<u>(70)</u>
Taxable income	<u><u>0</u></u>

With section 965(n) Election

Section 965(a) inclusion less section 965(c) deduction	\$ 100
Section 78 gross-up with respect to section 965(a) inclusion	30
Taxable loss from operations	(60)
Reduction for applicable amount	<u>60</u>
Taxable income	130

Net operating loss carryovers

Carryover into 2017	\$ 100
Current year	<u>60</u>
	<u><u>\$ 160</u></u>

Alternative Method for Calculating Post-1986 E&P

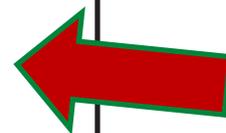
- Generally, a proration method cannot be used to determine post-1986 E&P on an E&P measurement date.
- However, an irrevocable elective alternate method available under Treas. Reg. §1.965-7(f), allows an SFC to calculate its post-1986 E&P as of another date in certain circumstances.
- An SFC that does not have a 52-53-week taxable year may make the election to use the alternative method for purposes of determining its post-1986 E&P on 11/2/17 but not on 12/31/17.
- An SFC that has a 52-53-week taxable year may make the election to use the alternative method to compute the amount of the post-1986 E&P (including a deficit) as of both E&P measurement dates.
- An SFC that makes this election may compute the post-1986 E&P as the sum of (i) the corporation's post-1986 E&P (including a deficit) determined as of the notional measurement date, as if it were an E&P measurement date, and (ii) the corporation's annualized E&P amounts with respect to the notional measurement date.

Alternative Method for Calculating Post-1986 E&P (cont'd) 1

- The use of the alternative method of calculating the post-1986 E&P for 2017 is reported on the Transition Tax Statement.

Listing of applicable elections under section 965 or the election provided for in Notice 2018-13 that the taxpayer has made, if applicable.

<u>Provision Under Which Election is Made</u>	<u>Title</u>	<u>Attached (Y or N)</u>
Section 965(h)(1)	Election to Pay Net Tax Liability Under Section 965 in Installments under Section 965(h)(1).	
Section 965(i)(1)	S Corporation Shareholder Election to Defer Payment of Net Tax Liability Under Section 965 Under Section 965(i)(1)	
Section 965(m)(1)(B)	Statement for Real Estate Investment Trusts Electing Deferred Inclusions Under Section 951(a)(1) By Reason of Section 965 Under Section 965(m)(1)(B)	
Section 965(n)	Election Not to Apply Net Operating Loss Deduction under section 965(n)	
Notice 2018-13, Section 3.02	Election Under Section 3.02 of Notice 2018-13 to Use Alternative Method to Compute Post-1986 Earnings and Profits	



Alternative Method for Calculating Post-1986 E&P (cont'd) 2

- The use of the alternative method of calculating post-1986 E&P for a DFIC is also reported on Schedule B of Form 965.

SCHEDULE B
(Form 965)
(January 2019)
Department of the Treasury
Internal Revenue Service

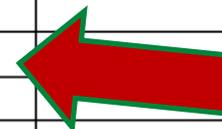
Deferred Foreign Income Corporation's Earnings and Profits (E&P)
▶ Attach to Form 965.
▶ Go to www.irs.gov/Form965 for instructions and the latest information.
▶ Complete for Deferred Foreign Income Corporations.
▶ List E&P Deficit Foreign Corporations in Schedule C.

OMB No. 1545-0123

Name of person filing this return _____ Identifying number _____

a Separate Category (Enter code—see instructions.) _____ ▶
b If code 901 is entered on line a, enter the country code for the sanctioned country (see instructions) _____ ▶

	(a) Name of Deferred Foreign Income Corporation	(b) EIN or Reference ID Number of the Foreign Corporation (see instructions)	(b)(1) November 2, 2017 Post-1986 E&P in Functional Currency	(b)(2) Check box if Alternative Method for Calculating E&P Elected (see instructions)	(c) November 2, 2017 Post-1986 Previously Taxed E&P in Functional Currency (see instructions)	(d) November 2, 2017 Post-1986 E&P Attributable to ECI in Functional Currency
1						
2						
3						
4						
5						
6						
7						
8						
9						
10						
11						



Anti-Abuse Rules

Anti-Abuse Rules



Anti-abuse Rules: In General

- Under the general rule in Treas. Reg. §1.965-4(b)(1), certain transactions are disregarded for purposes of determining the section 965 elements of a U.S. shareholder if the following conditions are met:
 - The transaction occurs, in whole or in part, on or after 11/2/17;
 - The transaction is undertaken with a principal purpose of changing the amount of a section 965 element of the U.S. shareholder; and
 - The transaction would, absent the anti-abuse rule, change the amount of a section 965 element of the U.S. shareholder.
- The section 965 elements are a U.S. shareholder's section 965(a) inclusion amount, its aggregate foreign cash position, and the amount of deemed paid foreign taxes that may be claimed with respect to a section 965(a) inclusion.
- A change in the amount of a section 965 element is a ↓ decrease in the section 965(a) inclusion amount, a ↓ decrease in the aggregate foreign cash position, or an ↑ increase in the deemed paid foreign taxes with respect to 965(a) inclusion.



Cash Reduction Transactions & Specified Distributions

- A **cash reduction transaction** is presumed to be undertaken with a principal purpose of changing the amount of a 965 element of a U.S. shareholder unless the transaction occurs in the ordinary course of business.
- A cash reduction transaction includes:
 - A transfer of cash, accounts receivable, or cash-equivalent assets by an SFC to a U.S. shareholder of the SFC or a person related to a U.S. shareholder of the SFC, or
 - An assumption by the SFC of an account payable of the U.S. shareholder of the SFC or a person related to the U.S. shareholder of the SFC, if the transfer or assumption reduces the aggregate foreign cash position of the U.S. shareholder.

Cash Reduction Transactions & Specified Distributions (cont'd)

- A cash reduction transaction that is a distribution by an SFC to a U.S. shareholder of the SFC is treated per se as not undertaken with a principal purpose of changing the amount of a section 965 element of a U.S. shareholder, unless it is a **specified distribution**.
- A specified distribution, which is treated as per se undertaken with a principal purpose of changing the section 965 element of a U.S. shareholder, is:
 - A cash reduction transaction that is a distribution by an SFC to a U.S. shareholder if and to the extent that, at the time of the distribution, there was a plan or intention for the distributee to transfer cash, accounts receivable, or cash equivalent assets to any SFC of the U.S. shareholder, or
 - There is no plan or intention for the distributee to transfer cash, accounts receivable, or cash-equivalent assets to any SFC of the U.S. shareholder if the transfer is pursuant to a legal obligation entered into before 11/2/17.
 - A distribution that is a non pro rata distribution to a foreign person related to the U.S. shareholder.



E&P Reduction Transactions & Specified Transactions

- An **E&P reduction transaction** is presumed to be undertaken with a principal purpose of changing the amount of a section 965 element of a U.S. shareholder, unless the transaction occurs in the ordinary course of business.
- An E&P reduction transaction means:
 - A transaction between an SFC and any of a U.S. shareholder of the SFC, another SFC of a U.S. shareholder of the SFC, or any person related to the U.S. shareholder of the SFC, if the transaction would, without regard to the anti-abuse rule, reduce either the DFI or the post-1986 undistributed earnings (as defined in section 902(c)(1)) of the SFC or another SFC of any U.S. shareholder of such SFC.

E&P Reduction Transactions & Specified Transactions (cont'd)

- A **specified transaction** is treated per se as being undertaken with a principal purpose of changing the amount of a section 965 element of a U.S. shareholder.
- A specified transaction means an E&P reduction transaction that involves one or more of the following:
 - A complete liquidation of an SFC to which section 331 applies;
 - A sale or other disposition of stock by an SFC; or
 - A distribution by an SFC that reduces the E&P of the SFC pursuant to section 312(a)(3).

Pro Rata Share, E&P Deficit & Internal Group Transactions

- A **pro rata share transaction** is presumed to be undertaken with a principal purpose of changing the amount of a U.S. shareholder.
- A pro rata share transaction means either a **pro rata share reduction transaction** or an **E&P deficit transaction**.
- A pro rata share reduction transaction means a transfer of the stock of an SFC by either a U.S. shareholder of the SFC or a person related to the U.S. shareholder of the SFC to a person related to the U.S. shareholder if the transfer would, without regard to the anti-abuse rule:
 - Reduce the U.S. shareholder's pro rata share of the SFC's section 965(a) earnings amount,
 - Reduce the U.S. shareholder's pro rata share of the cash position of the SFC, or
 - Both.



Pro Rata Share, E&P Deficit & Internal Group Transactions (cont'd)

- An E&P deficit transaction is a transfer to a U.S. shareholder or a person related to the U.S. shareholder of the stock of an EPDFC by a person related to the U.S. shareholder if the transfer would, without regard to the anti-abuse rule, increase the U.S. shareholder's pro rata share of the specified E&P deficit of the EPDFC.
- An **internal group transaction**, which is a pro rata share transaction if, immediately before or after the transfer, the transferor and the transferee of the SFC's stock are members of an affiliated group in which a U.S. shareholder is a member, is treated per se as undertaken with a principal purpose of changing the amount of a section 965 element.



Changes in Method of Accounting & Entity Classification Elections

- Any **change in method of accounting** made for a taxable year of an SFC that ends in 2017 or 2018 and filed on or after November 2, 2017, is disregarded for purposes of determining the amounts of the section 965 elements with respect to a U.S. shareholder if the change in method of accounting would, without regard to the anti-abuse rule:
 - Decrease a U.S. shareholder's section 965(a) inclusion amount,
 - Decrease a U.S. shareholder's aggregate foreign cash position, or
 - Increase the deemed paid foreign taxes that may be claimed with respect to a section 965(a) inclusion other than by reason of an increase in a section 965(a) inclusion amount with respect to the SFC.

Changes in Method of Accounting & Entity Classification Elections (cont'd)

- Except as provided with respect to certain incorporation transactions, an election to change the classification of an entity that is filed on or after 11/2/17 is disregarded for purposes of determining the amounts of all section 965 elements of a U.S. shareholder if the election would, without regard to the anti-abuse rule, change the amount of any section 965 element of the U.S. shareholder.
- The anti-abuse rules described above apply regardless of whether the change in method of accounting or the election to change the classification of an entity is made with a principal purpose of changing the section 965 element.

Affiliated and Consolidated Groups

Affiliated and Consolidated Groups

Consolidated Groups

- The rules in Treas. Reg. §1.965-8 and in other parts of the section 965 regulations provide that members of a consolidated group that are section 958(a) U.S. shareholders are treated as a single shareholder for certain section 965 purposes.
- Single shareholder treatment applies to the determination of the aggregate foreign E&P deficit under section 965(b), basis adjustment election, payment of the section 965 liability in installments under section 965(h), extension of the SOL in section 965(k), election to forgo use of NOLs in section 965(n), and calculation of the section 965(c) deduction (but note special rule for determination of the AFCP).
- Single section 958(a) U.S. shareholder or single person treatment does not apply for purposes of determining the amount of a section 958(a) U.S. shareholder's inclusion (before accounting for any deductions or E&P deficits), the foreign income taxes deemed paid with respect to a section 965(a) inclusion, and for any purpose other than those specifically enumerated in Treas. Reg. §1.965-8(e)(1) or another provision of the section 965 regulations.

Affiliated and Consolidated Groups

- Section 965(b)(5) allows U.S. shareholders that are members of the same affiliated group (as defined in section 1504) to take into account the affiliated group's aggregate unused E&P deficit.
- Specifically, a section 958(a) U.S. shareholder that has an overall section 965(a) inclusion amount with respect to all of the SFCs it owns (an "**E&P net surplus shareholder**") is allowed to reduce its section 965(a) inclusion amounts by its applicable share of the affiliated group's aggregate unused E&P deficit.
- An affiliated group's aggregate unused E&P deficit is determined by reference to only those section 958(a) U.S. shareholders that have an aggregate foreign E&P deficit that exceeds their aggregate pro rata share of section 965(a) earnings amounts, and is the sum of such excess.
- Treas. Reg. §1.965-8 provides special rules related to the application of section 965(b)(5), and treats a consolidated group that is part of an affiliated group as a single member of the affiliated group for this purpose.

Questions



Part IV – Reporting & Audit Issues

- Reporting Requirements & IDRS Transcripts
- FAQs
- Audit Issues
- Other Noteworthy Rules

Reporting Requirements & IDRS Transcripts



Form 1120 Reporting for 2017

- Section 965 components are *not* reported on Form 1120 (U.S. Corporation Income Tax Return) or Form 1118 (Foreign Tax Credit—Corporations).
- Section 965 components *are* reported on IRC 965 Transition Tax Statement.
- Net tax liability under section 965 is included on Form 1120, Schedule J, Part I, Line 11.
 - Triggers math error routing return to ERS.
- Installments to be paid in future taxable years are reported in Form 1120, Schedule J, Part II, Line 19d.

Form 1120 Example

- U.S. shareholder, a calendar-year domestic corporation, files its Form 1120 for 2017.
- U.S. shareholder owns 100% of a specified foreign corporation that generates a section 965(a) inclusion for the U.S. shareholder's 2017 taxable year.
- The components necessary to determine the U.S. shareholder's net tax liability under section 965 for 2017 are as follows (*continued on next slide*):

Form 1120 Example (cont'd)

- Total Tax = \$23,060,000
 - Net tax liability under section 965 = \$4,160,000
 - Net tax liability outside of section 965 = \$18,900,000
- 2017 Estimated Taxes Paid = \$19,000,000
- First Installment Payment = \$332,800
- Second Installment Payment = \$232,800

Proposed 965 CFOL Screen 1

	A	B	C	D	E	F
1	BMFOLM12-3456789		201712 IRC 965 Liability Schedule			NM CTRL: NNNN
2						
3		<i>TC971, AC114</i>		<i>TC766 CRN 263</i>		
4	Tax Liability and Installments:	4,160,000	Deferral Amount:	3,727,200		Due Date
5						
6	Installment 1 (8%)	332,800		332,800		04/15/18
7	Installment 2 (8%)	332,800		100,000	<i>PY18 Manual Adj</i>	04/15/19
8	Installment 3 (8%)	332,800		0		04/15/20
9	Installment 4 (8%)	332,800		0		04/15/21
10	Installment 5 (8%)	332,800		0		04/15/22
11	Installment 6 (15%)	624,000		0		04/15/23
12	Installment 7 (20%)	832,000		0		04/15/24
13	Installment 8 (25%)	1,040,000		0		04/15/25
14						
15	<i>Difference in column B and Column D is balance due, TP is current if column B and Column D are equal.</i>					
16						

Taxpayer's Master File Account Balance 1

TP 12-3456789		Tax Year 201712		NM CTRL: NNNN	
TC 716	4/15/2017	0			
TC 660	6/15/2017	-4,500,000	Estimated Tax Payment		
TC 660	9/15/2017	-4,500,000	Estimated Tax Payment		
TC 660	1/15/2018	-10,000,000	Estimated Tax Payment		
TC 610	4/15/2018	-332,800	Section 965 Designated Payment - DPC 64		
TC 150	8/7/2018	23,060,000	Total Tax - Non 965 Tax of 18,900,000 and 965 Tax of 4,160,000		
TC 766 CRN 263	8/15/2018	-3,827,200	Section 965(h) Balance (92%)		
TC 767 CRN 263	8/15/2018	100,000	Overpayment applied to Section 965(h) Balance		
	Balance 8/15/2018	0			
TC971, AC114	8/7/2018	4,160,000	Misc Transaction, Information Only - Total Section 965 Liability		
TC 670	4/15/2019	-232,800	Section 965 Designated Payment - DPC 64		
TC 767 CRN 263	4/15/2019	232,800	Payment applied to Section 965(h) Balance		
		0			
Check:				Should be 84% (100-8% Yr 1 and 8% Yr 2) of TC971 AC114	
Sum of 766 and 767		-3,494,400		Year 2 Bal:	3,494,400

Form 1040 Reporting for 2017

- Section 965 components are reported on Form 1040.
- Section 965 components are reported on IRC 965 Transition Tax Statement.
- Net section 965 inclusion included on Form 1040, line 21.
- Taxpayers were instructed to write “SEC 965” on the dotted line to the left of line 21.
- Report section 965(a) inclusion and section 965(c) deduction on Part I of Form 1116, unless section 962 election is made, in which case they’re reported on Form 1118.

Form 1040 Reporting for 2017 (cont'd) 1

Section 965(h) election

- If a section 965(h) election is made, the entire section 965 net tax liability is included on line 63 (total tax)
- The section 965 net tax liability to be paid in installments under section 965(h) for years beyond the 2017 taxable year is included on Form 1040, line 73;
 - Taxpayers were instructed to check box “d,” and write TAX to the right of the box.

Form 1040 Reporting for 2017 (cont'd) 2

Section 965(i) election

- Tax liability deferred under section 965(i) reduces the amount reported on Form 1040, line 44 and thus is **not** included in total tax (line 63)

Form 1040 Example – Section 965(h) Election

- Wages = \$400,000
- Interest income = \$80,000
- Section 965(a) inclusion = \$900,000
- Section 965(c) deduction = \$501,429
- In 2017, reported on line 21: net section 965 amount = \$398,571
- Itemized deductions = \$40,057
- Total tax = \$280,322
 - Net tax liability under section 965 = \$160,604
 - Net tax liability outside of section 965 = \$119,718

The individual makes the election to pay tax in eight installments.

Proposed 965 CFOL Screen 2

	A	B	C	D	E	F	G
1	IMFOLM12-3456789		201712 IRC 965 Liability Schedule			NM CTRL: NNNN	
2							
3		<i>TC971, AC114</i>		<i>TC766 CRN 263</i>			
4	Tax Liability and Installments:	160,604	Deferral Amount:	147,756		Due Date	
5							
6	Installment 1 (8%)	12,848		12,848		04/15/18	
7	Installment 2 (8%)	12,848		0		04/15/19	
8	Installment 3 (8%)	12,848		0		04/15/20	
9	Installment 4 (8%)	12,848		0		04/15/21	
10	Installment 5 (8%)	12,848		0		04/15/22	
11	Installment 6 (15%)	24,091		0		04/15/23	
12	Installment 7 (20%)	32,121		0		04/15/24	
13	Installment 8 (25%)	40,151		0		04/15/25	
14							
15	<i>Difference in column B and Column D is balance due, TP is current if column B and Column D are equal.</i>						

Taxpayer's Master File Account Balance 2

	A	B	C	D	E	F	G	H	I
1	TP 123-45--6789		Tax Year 201712			NM CTRL: NNNN			
2									
3	TC 716		4/15/2017	0					
4	TC 660		1/15/2018	0					
5	TC 610		4/15/2018	0					
6	TC 806		4/15/2018	-120,000	Federal tax withholding				
7	TC 150 - Total Tax		8/7/2018	280,322	Total Tax - Non965 Tax of 119,718 and 965 Tax of 160,604				
8	TC 766 CRN 252		8/7/2018	-12,500	Excess SS Credit				
9	TC 766 CRN 263		8/15/2018	-147,756	Section 965(h) Balance (92%)				
10	Balance		8/15/2018	66	Balance due with return				
11									
12	TC 971 AC 114		8/7/2018	160,604	Misc Transaction, Information Only - Total Section 965 Liability				
13									
14	TC 670		4/15/2019	-12,848	Section 965 Designated Payment - DPC 64				
15	TC 767 CRN 263		4/15/2019	12,848	Payment applied to Section 965(h) Balance				
16				0					
17									
18	Check:					Should be 84% (100-8% Yr1 and 8% Yr2) of TC 971 AC114			
19	Sum of 766 and 767			-134,908		Year 2 Balance:	134,907		
20									

Form 1040 Example – Section 965(i) Election

- The facts are the same as the section 965(h) example
- The taxpayer does not include the \$160,164 net tax liability under section 965 on line 44
- Only the net tax liability outside of section 965 of \$119,718 is assessed (TC150 posting) and included on line 63 (total tax)

Section 965 Guidance

- Final 965 Regulations – published 2/5/19
 - <https://www.federalregister.gov/documents/2019/02/05/2019-00265/regulations-regarding-the-transition-tax-under-section-965-and-related-provisions>
- Technical Corrections – published 4/10/19
 - <https://www.federalregister.gov/documents/2019/04/10/2019-07012/regulations-regarding-the-transition-tax-under-section-965-and-related-provisions-correction>
- Proposed FTC Regulations – published 12/7/18
 - <https://www.federalregister.gov/documents/2018/12/07/2018-26322/guidance-related-to-the-foreign-tax-credit-including-guidance-implementing-changes-made-by-the-tax>
- Final GILTI Regulations – published 6/21/19
 - <https://www.govinfo.gov/content/pkg/FR-2019-06-21/pdf/2019-12437.pdf>
- Revenue Procedure 2018-17 (changes in accounting periods)
 - <https://www.irs.gov/pub/irs-drop/rp-18-17.pdf>
- Publication 5292 – How to Calculate Section 965 Amounts and Elections Available to Taxpayers (*2017 returns only*)
 - <https://www.irs.gov/pub/irs-pdf/p5292.pdf>
- Section 965 FAQs (*discussed next*)

Questions



Section 965 FAQs

- “Questions and Answers about Reporting Related to Section 965 on 2017 Tax Returns,” *available at* <https://www.irs.gov/newsroom/questions-and-answers-about-reporting-related-to-section-965-on-2017-tax-returns>
- “Questions and Answers about Tax Year 2018 Reporting and Payments Arising under Section 965,” *available at* <https://www.irs.gov/newsroom/questions-and-answers-about-tax-year-2018-reporting-and-payments-arising-under-section-965>
- “General Section 965 Questions and Answers (Including Transfer and Consent Agreements),” *available at* <https://www.irs.gov/newsroom/general-section-965-questions-and-answers-including-transfer-and-consent-agreements>



FAQs – Payments, Overpayments and Relief

- **FAQ 14 (2017)**

- Involves “overpayment” of tax when a section 965(h) election is made on 2017 return.
- No overpayment unless total 2017 payments exceed total tax for the year, including section 965(h) net tax liability.
- Taxpayers may not receive a refund or credit of any portion of properly applied 2017 tax payments unless and until the amount of payments exceeds the entire unpaid 2017 income tax liability, including all amounts to be paid in installments under section 965(h) in subsequent years.
- “Overpayment” is treated as voluntary prepayment of future installments.
- Same treatment where section 965(h) election is made on 2018 return. See FAQ 4 (2018).

FAQ 15 Relief (2017)

- Taxpayers impacted by FAQ 14 are granted relief from estimated tax penalties if they underpaid the first required 2018 estimated tax installment.
- To qualify for relief, underpayment for first installment must be satisfied by the due date of the second installment (generally, 6/15/18).
- This relief from the addition to tax for the underpayment of estimated taxes applies only to taxpayers whose first required installment for 2018 was due on or before 4/18/18.

FAQ 16 Relief (2017)

- Applies to individual taxpayers with a net tax liability under section 965 of less than \$1 million for 2017.
- If a taxpayer described above made a timely section 965(h) election, no acceleration event even if first installment was not paid in full as long as the amount is satisfied by the unextended due date of the 2018 return.
- Although the IRS will not assess an addition to tax for failure to timely pay the first installment in this case, the taxpayer will be liable for interest on such amount from the due date of the installment.

FAQ 17 Relief (2017)

- Available to individuals who fail to make timely section 965(h) elections on their original returns.
- Such individuals are allowed to make the section 965(h) election on an amended return (1040-X) through due date of 2017 as if an extension of time to file was requested and received.
- No need to actually have a valid extension.

Questions



Audits Issues

Audit Issues



**Large Business
& International**

Audit Issues

- Identify whether taxpayer is a US shareholder subject to section 965
- Identify Specified Foreign Corporations
- Verify correct E&P and tax pool calculations for SFCs
- Review Section 965 (c) deduction calculation

Audit Issues (cont'd)

- Review the proper treatment of intercompany transactions treated as disregarded
 - Short-term receivables and net accounts payable/receivable and derivatives
- Review section 965 elections
- Determine whether anti-abuse rules apply
- Identify foreign tax credit issues, including section 965(g) foreign tax credit “haircut” and section 78 gross-up

Other Noteworthy Rules

Other Noteworthy Rules



Other Noteworthy Rules & Guidance

Corporate

- Foreign taxes in EPDFCs are not creditable.
 - But foreign taxes associated with a hovering deficit are available to the extent of current E&P of SFC with the hovering deficit.
- Foreign taxes accruing between 11/2/17 and 12/31/17 are prorated to determine post-1986 E&P as of 11/2/17.
- Specified E&P deficit is generally allocated to common stock first.
- There is a gain reduction rule for distributions of section 965 PTEP during inclusion year.

Individuals

- Applies to individual section 958(a) U.S. shareholders, even though they are ineligible for participation exemption system.
- Cannot claim deemed-paid FTCs under section 960 . . .
 - Unless section 962 election is made.
- Section 965(c) deduction is not treated as an itemized deduction and thus is not subject to 2% floor or the AMT.
- Election under Treas. Reg. §1.1411-10(g) may be made to include subpart F inclusions, including section 965(a) inclusions, in income for NIIT purposes at the same time the amounts are included in income for regular tax purposes.



Lesson Summary 8

You should now be able to:

- Explain new section 965 terminology;
- Calculate section 965(a) inclusions;
- Calculate section 965(c) deductions;
- Determine foreign tax credits associated with section 965(a) inclusions;
- Apply anti-abuse provisions;
- Explain section 965 elections;
- Explain reporting of section 965; and
- Apply audit techniques.

Questions



International Knowledge Base Resources

Business Outbound				
Income Shifting (Outbound)	Deferral Planning	FTC Management	Repatriation	
Business Inbound				
Jurisdiction to Tax (Inbound)	Income Shifting (Inbound)	Inbound Financing	Repatriation / Withholding	
Individual Outbound				
Jurisdiction to Tax (Outbound)	Foreign Tax Credit	Foreign Corporations	Pass Thru Entities	Offshore Arrangements
Individual Inbound				
U.S. Business Activities	Withholding			
Cross-Over				
Treaties	Exchange of Information	Information Gathering	Foreign Currency	Organization/ Restructuring

<https://portal.ds.irsnet.gov/sites/vl008/Pages/default.aspx>



Thank You

Thank you for your participation!