

## US IRS issues guidance on Section 965 transition tax in form of frequently asked questions

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### Executive summary

The United States (US) Internal Revenue Service (IRS) has posted to IRS.gov new guidance under Internal Revenue Code<sup>1</sup> Section 965 in the form of [frequently asked questions](#) (FAQs) to help taxpayers meet their reporting, filing and payment requirements under Section 965 (the transition tax) enacted by the *Tax Cuts and Jobs Act*, P.L. 115-97. The guidance addresses how to report the amount of gross income recognized by US shareholders as an inclusion of deferred foreign income as required by Sections 965 and 951(a) (a Section 965 mandatory inclusion) and how to report and pay the “net tax liability” with respect to the inclusion. The guidance also provides details on certain elections taxpayers can make under Section 965 and Notice 2018-13 (including how to elect to pay the associated liability in installments).

### Detailed discussion

#### Background

The transition tax requires a mandatory inclusion of the accumulated foreign earnings of a controlled foreign corporation (CFC) and other foreign corporations with a 10% domestic corporate shareholder, collectively referred to as “specified foreign corporations” (SFCs).

Section 965(a) provides that, for the last tax year of a deferred foreign income corporation (DFIC) beginning before 1 January 2018 (the inclusion year), the subpart F income of the corporation shall be increased by the greater of:

- (1) the accumulated post-1986 deferred foreign income of such corporation determined as of 2 November 2017, or
- (2) the accumulated post-1986 deferred foreign income of such corporation determined as of 31 December 2017 (the measurement dates). For purposes of Section 965, a DFIC is any SFC of a US shareholder that has accumulated post-1986 deferred foreign income (as of a measurement date) greater than zero.

The Section 965 mandatory inclusion would be subject to tax at reduced rates of 15.5% or 8%. The two rates are achieved by allowing a deduction against the required inclusion, based on the top marginal corporate income tax rate applicable in the year the US shareholder recognizes the Section 965 mandatory inclusion (Section 965 deduction). The 15.5% transition tax rate applies to an amount of the Section 965 mandatory inclusion equal to a US shareholder's aggregate foreign cash position, and the 8% transition tax rate applies to the remaining amount of the Section 965 mandatory inclusion.

In general, taxpayers may elect to pay the net tax liability resulting from the Section 965 mandatory inclusion in installments. The "net tax liability" as a result of Section 965 is determined based on the taxpayer's net income tax for the tax year in which a Section 965 mandatory inclusion is recognized over the taxpayer's net tax liability for that tax year, determined without regard to Section 965 and any income or deduction properly attributable to dividends received by that US shareholder from a DFIC.

For more information on the transition tax, see EY Global Tax Alert, [US House and Senate release the Conference Report on the Tax Cuts and Jobs Act](#), dated 21 December 2017. The IRS has previously issued guidance on the transition tax in [Notice 2018-07](#) (EY Global Tax Alert, [US IRS issues guidance on transition tax on foreign earnings](#), dated 2 January 2018), [Notice 2018-13 and Revenue Procedure 2018-17](#) (See EY Global Tax Alert, [US IRS Guidance under new Section 965 prevents certain foreign corporations from making accounting period changes US IRS Guidance under new Section 965 prevents certain foreign corporations from making accounting period changes](#), dated 20 February 2018).

## FAQs

In the instructions to the FAQs, the IRS states that the guidance is for filing 2017 tax returns with an amount under Section 965 (Section 965 amounts). Section 965 amounts include the Section 965 mandatory inclusion, the deduction permitted against the inclusion to achieve the 15.5% or 8% effective rate, and the foreign income taxes deemed paid with the respect to the inclusion. The IRS adds that failure to follow the instructions "may result in difficulties in processing tax returns, including rejection, processing delays, or erroneous notices being issued." In addition, the IRS requests that taxpayers that electronically file Form 1040 wait to file until on or after 2 April 2018, to give the IRS time to make certain system changes to accept and process the returns.

### *Q1. Who must report Section 965 amounts on a 2017 return.*

In general, any person required to include amounts in income under Section 965 in its 2017 tax year must report those amounts on its 2017 tax return. Such persons include a direct US shareholder of a DFIC recognizing a Section 965 mandatory inclusion and a direct or indirect partner in a domestic partnership that is a US shareholder of a DFIC and recognizes a Section 965 mandatory inclusion.

*Q2. How to report Section 965 amounts.* The FAQs include an appendix showing how to report amounts included in income under Section 965 on a 2017 tax return. Included next are some of the instructions for individuals, partnerships and C corporations:

- Individuals (Form 1040) – The Section 965 mandatory inclusion net of the Section 965 deduction is reported on Line 21, Other Income. Also, the Section 965 mandatory inclusion and the Section 965 deduction are both reported on Form 1116. If a Section 962 election is made, the reporting will be on Form 1118 instead of Form 1116.
- Partnerships (Form 1065) – Report the Section 965 mandatory inclusion on Schedule K, Line 11, Other Income. Report the Section 965 deduction on Schedule K, Line 13d, Other Deductions. See Q9 for additional information required to be provided with Schedule K-1s.
- C corporations (Form 1120) – Do not report the Section 965 mandatory inclusion, the Section 965 deduction, or the foreign income taxes deemed paid with the respect to the Section 965 mandatory inclusion on Form 1120 or Form 1118. Such amounts are only reported on the IRC 965 Transition Tax Statement discussed in Q3. The net tax liability under Section 965 should be included on Form 1120, Schedule J.

*Q3. Other required 2017 reporting in connection with Section 965.* Taxpayers with income under Section 965 in their 2017 tax years must also include with their returns an [IRC 965 Transition Tax Statement](#). The answer specifies certain information that must be included in the IRC 965 Transition Tax Statement and provides a model statement. The answer notes that adequate records must be kept supporting the amounts reported and that additional reporting may be required when filing returns for subsequent tax years, and the manner of reporting may be different.

*Q4. What elections are available with respect to Section 965.* The answer notes that multiple elections are related to amounts includable in income under Section 965. Statutory elections are found in Section 965(h) (the election to pay net tax liability in installments), Section 965(i) (the election available to a shareholder in an S corporation to defer payment of net tax liability), Section 965(m) (the election available to a REIT<sup>2</sup> to recognize the Section 965 mandatory inclusion in installments), and Section 965(n) (the election not to apply a net operating loss against the net tax liability). There is also an available election for the determination of the post-1986 earnings and profits of an SFC that is described in Notice 2018-13.

*Q5. Who can make Section 965 elections on 2017 tax returns.* The answer describes who is eligible to make the available elections under Section 965, specifically limiting eligibility to taxpayers with a net tax liability under Section 965. Notably S corporations and domestic partnerships may not make any Section 965 elections, including the election to pay the transition tax in installments over eight years under Section 965(h). The IRS intends to issue guidance before 2 April 2018, concerning the availability of elections under Section 965 to direct and indirect partners in domestic partnerships, shareholders in S corporations, and beneficiaries in other pass-throughs that are US shareholders of DFICs. The election under Notice 2018-13, Section 3.02, may be made on behalf of a SFC under the rules of Reg. Section 1.964-1(c)(3).

*Q6. When elections must be made.* Elections with respect to Section 965 must be made by the due date (including extensions) for filing the return for the relevant year. The answer adds that, even if an election is made to pay the net tax liability in installments, the first installment must be paid by the due date (without extensions) for filing the return for the relevant year.

*Q7. How to make elections on a 2017 return.* To make the election under Section 965 or as provided in Notice 2018-13, taxpayers must attach a statement for each election to their 2017 tax return. The statement must be signed under penalties of perjury and, for an electronically filed return, attached in a Portable Document Format (.pdf) for each such election. The FAQs specify certain requirements for those statements. The appendix to the FAQs includes model statements.

*Q8. Required Forms 5471 with respect to all SFCs.* The answer states that a Form 5471 must be filed with respect to all SFCs for their inclusion years for which a person is a US shareholder, regardless of whether the SFCs are CFCs. The Form 5471 must include identifying information on page 1 of Form 5471 above Schedule A, as well as Schedule J.

*Q9. Required reporting to owners of pass-through entities.* Domestic partnerships, S corporations and other pass-through entities must report the Section 965 mandatory inclusion, the Section 965 deduction, and certain additional information to their partners, shareholders or beneficiaries in connection with Section 965. The answer specifies certain information that such entities should include in an explanatory statements. For partnerships, the guidance also outlines the content of footnotes provided to the partners on or with their Schedule K-1s. This is especially important for partnerships in the asset management, private equity and real estate fund sectors, which provide Schedule K-1 disclosures to their partners. Open questions remain about required reporting for non-US partnerships that file a US tax return and have US partners.

*Q10. How to pay the Section 965 tax for a 2017 tax return.* The answer states that the a taxpayer should make two separate payments: one reflecting tax owed without regard to Section 965, and a second reflecting tax owed resulting from Section 965 (the Section 965 Payment). Both payments must be paid by the due date of the applicable return (without extensions). Taxpayers may pay the 965 Payment by wire transfer, check or money order. The answer expressly provides that the Section 965 Payment may not be paid through EFTPS,<sup>3</sup> and that taxpayers should submit the Section 965 Payment via wire transfer or potentially be subject to penalties. The Section 965 Payment may be for the full net tax liability or for the first installment (for taxpayers making an election to pay the net tax liability in installments under Section 965(h)).

*Q11. When an individual should electronically file 2017 tax return.* The IRS states that individual taxpayers filing electronically should file on or after 2 April 2018. Paper filers may file at any time.

*Q12. What a person has already filed for 2017 should do.* The person should consider filing an amended return based on the information included in the FAQs to avoid any difficulties or interest or penalties related to inaccurate reporting.

## Implications

The FAQs posted by the IRS provide some much-needed guidance on the timing of elections, method of payment and reporting obligations. One of the IRS's primary goals in posting the FAQs was to have taxpayers report their regular tax liability without the effects of the mandatory inclusion separate from the net tax liability on the mandatory inclusion. Presumably, the IRS wants this reporting so it can quantify the additional tax that will be collected by reason of Section 965. This approach will require taxpayers to do two tax computations to complete their 2017 tax return: one that takes into account the Section 965 mandatory inclusion and one that does not (which is consistent with Section 965(h)(6)). For a corporate taxpayer, this is accomplished by not including on Forms 1120 and 1118 the Section 965 mandatory inclusion, the Section 965 deduction, and foreign income taxes deemed paid with the respect to the Section 965 mandatory inclusion. Instead the overall tax impact of Section 965 should be reflected on Schedule J, Tax Computations and payments. The FAQs

provide guidance on reporting the Section 965 mandatory inclusion rather than guidance on the application of the statute. As a result, the net tax liability with respect to the Section 965 mandatory inclusion is to be determined by doing a full computation, including accounting for any available net operating loss deductions (unless an election to forego a deduction is made), Section 861 expense apportionment, and all available foreign tax credits (including carryforwards).

Separately, the requirement for all SFCs to file a Form 5471 presents issues for non-CFCs regarding the category of Form 5471 filer, availability of information, and coordination with other US shareholders that may be unrelated. Also, the IRS did not provide any guidance on whether the first installment payment for taxpayers planning to elect to pay the transition tax in installments must be precisely accurate to avoid an acceleration of the due date for the subsequent payments.

Due to the requirement to pay the tax related to the Section 965 mandatory inclusion separately, it appears that taxpayers are not able to utilize overpayments from the taxpayer's regular tax, without the net tax liability related to the Section 965 mandatory inclusion, to offset the tax payable on the Section 965 mandatory inclusion.

The IRS is continuing to consider other issues associated with Section 965, and we should see additional guidance on both reporting the Section 965 mandatory inclusion and on substantive issues related to the interpretation of Section 965.

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## Endnotes

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
2. Real Estate Investment Trust.
3. Electronic Federal Tax Payment System.

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