

# TAX ALERT

## TAX REFORM: THE INTERNATIONAL PROVISIONS (PART 1) – SECTION 965 DEEMED REPATRIATION TAX

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The Tax Cuts and Jobs Act ("TCJA") introduced a one-time mandatory repatriation tax under Section 965 effective for tax year 2017 ("section 965 tax") which, in essence, modifies the current subpart F anti-deferral regime.<sup>1</sup> The section 965 tax is the precursor to the U.S. version of a territorial taxation system commencing with tax years post December 31, 2017.

This hybrid territorial system establishes a limited participation exemption whereby U.S. corporate shareholders in receipt of dividends from foreign corporations will be entitled to a 100% Dividends Received Deduction ("DRD"), provided certain threshold conditions are satisfied.<sup>2</sup> Further, under the territorial taxation system, foreign tax credits ("FTCs") and deductions attributable to such distributions are no longer permitted.<sup>3</sup>

As part of the transition to a territorial taxation system, U.S. shareholders are mandated to pay a one-time section 965 tax on their deferred foreign income with respect to certain specified foreign corporations ("SPC or SPCs") for tax year 2017.<sup>4</sup>

An SPC means (i) any controlled foreign corporation ("CFCs") pursuant to section 957; and (ii) any foreign corporation with respect to which one or more domestic corporations is a U.S. shareholder within the meaning of section 951.<sup>5</sup> It does not include passive foreign investment companies ("PFICs") so long as they are not also CFCs.<sup>6</sup>

Deferred foreign income refers to a corporation's earnings and profits ("E&P").<sup>7</sup> Under section 965, a U.S. shareholder would pay the section 965 tax at reduced rates on their E&P as determined on the measurement dates of November 2, 2017 or December 31, 2017 (whichever amount is greater).<sup>8</sup>

The tax rate reduction is accomplished via a participation exemption whereby section 965 permits a deduction against a U.S. shareholder's subpart F inclusion amount that is necessary to result in a 15.5% tax rate on cash or cash equivalent E&P, and an 8% tax rate on non-cash E&P (also referred to as the rate equivalent percentage method).

Deficits are permitted to offset deferred foreign income pursuant to the allocation rules under section 965.<sup>9</sup>

Similar to the participation exemption rules detailed above for E&P, foreign income taxes deemed paid by the U.S. shareholder with

respect to said E&P are limited pursuant to the disallowance rules under section 965.<sup>10</sup> 44.3% and 22.9% of the foreign income taxes paid as grossed up under Section 78 may be allowed as a credit for purposes of computing the section 965 tax (subject to section 904 limitation).<sup>11</sup>

It is significant that for purposes of applying section 965, U.S. shareholders include corporations, individuals, and domestic investors of pass-through entities.<sup>12</sup> The section 965 tax may be paid immediately or via installments.<sup>13</sup> There are also special deferral election provisions for S-corporations and real estate investment trusts ("REITS").<sup>14</sup> If you are a U.S. shareholder with an interest in an SFC, what should you do **today** in order to calculate your 965 tax cost?

First, ascertain whether you are a U.S. shareholder within the meaning of section 951, and have interests in any SFCs.<sup>15</sup> Second, calculate the E&P attributable to each SFC at the determination dates detailed above.<sup>16</sup> Third, determine if any deficits offset the E&P of your SFCs.<sup>17</sup> Fourth, net your deferred foreign income and deficit to calculate one pooled E&P amount.<sup>18</sup> Fifth, determine your aggregate foreign cash position, and calculate the participation exemption by applying the rate equivalent percentage method to your E&P.<sup>19</sup> Sixth, determine your tax pool and disallowed FTCs.<sup>20</sup> Last, calculate U.S. tax liability on the resulting base and apply FTCs (if any). The flow chart below can also assist you in making a determination as to whether and how section 965 may apply.

<sup>1</sup> Tax Cuts and Jobs Act, Pub. L. 115-97, §14103(a) (2017).

<sup>2</sup> I.R.C. §245A.

<sup>3</sup> I.R.C. §245A(d).

<sup>4</sup> I.R.C. §965(a).

<sup>5</sup> I.R.C. §965(e)(1).

<sup>6</sup> I.R.C. §965(e)(3).

<sup>7</sup> I.R.C. §965(d)(2).

<sup>8</sup> I.R.C. §§965(a), (c).

<sup>9</sup> I.R.C. §965(b).

<sup>10</sup> I.R.C. §965(g)(1).

<sup>11</sup> I.R.C. §965(g)(2), (g)(3), (g)(4).

<sup>12</sup> I.R.C. §§965(d)(1), 951(b), 957(c), 7701(a)(30).

<sup>13</sup> I.R.C. § 965(h).

<sup>14</sup> I.R.C. §§ 965(i), (m)(1)(B).

<sup>15</sup> I.R.C. § 965(e).

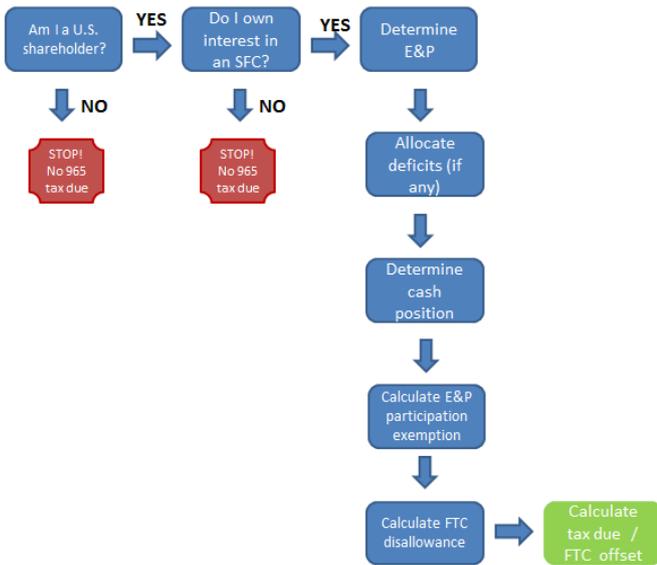
<sup>16</sup> I.R.C. §§965(d), (c)(3). To date, we have seen this step accomplished by taking the E&P amounts on Form 5471 ("Information Return of U.S. Persons With respect To Certain Foreign Corporations"), or by performing a proper E&P study for each SFC

<sup>17</sup> I.R.C. § 965(b).

<sup>18</sup> *Id.*

<sup>19</sup> I.R.C. § 965(c).

<sup>20</sup> I.R.C. § 965(g).



It is also significant to note that the section 965 tax is imposed on deferred foreign income whether or not it is actually repatriated. If said income is repatriated post December 31, 2017, then it is treated as previously taxed income ("PTI") under section 951 and not subject to double tax.<sup>21</sup>

Note, too, further guidance and regulations are expected to be released by Treasury to address certain fact patterns that create complications with respect to the application of section 965, as well as, anti-abuse rules.<sup>22</sup> To date, Notices 2018-07 and 2018-13 have been issued, addressing, *inter alia*, issues of SFCs with year ends that differ from that of the U.S. shareholder, double counting of deferred foreign income streams, treatment of certain account receivables, cash positions not yet known at time of tax filing, foreign exchange conversions and examples of the operation of section 965.<sup>23</sup>

Please contact your Mazars USA LLP professional for additional information.

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<sup>21</sup> I.R.C. §965(b)(4)(A).

<sup>22</sup> I.R.C. §§965(a), (d)(3).

<sup>23</sup> IRS Notice 2018-07 (released 12/29/17); IRS Notice 2018-13 (released 1/19/18).