¶710 Treatment of Deferred Foreign Income Upon Transition to Participation Exemption System of Taxation

NEW LAW EXPLAINED

Transition tax imposed on accumulated foreign earnings upon transition to participation exemption system.— A transition tax is imposed on accumulated post-1986 foreign earnings determined as of a certain measurement date, without requiring an actual distribution, upon the transition to the new participation exemption system. The transition rule requires mandatory inclusion of such deferred foreign income as subpart F income by U.S. shareholders of deferred foreign income corporations. The included amount is taxed at a reduced rate that depends on whether the deferred earnings are held in cash or other assets (Code Sec. 965, as amended by the Tax Cuts and Jobs Act).

COMMENT

In transitioning to the new participation exemption (territorial) system of taxation, many U.S. corporations with undistributed accumulated foreign earnings will be eligible for the 100-percent participation exemption deduction for foreign-source dividends under new Code Sec. 245A (a participation dividends-received deduction (DRD)). To avoid a potential windfall for such corporations, and to ensure that all distributions from foreign corporations are treated in the same manner under the participation exemption system, a transition rule is provided under which accumulated foreign earnings are taxed as if they had been distributed under prior law, but at a reduced rate of tax. Generally, the new participation exemption system for taxation of foreign income replaces the prior-law system of taxing U.S. corporations on the foreign earnings of their foreign subsidiaries when the earnings are distributed. The exemption is provided in the form of a participation DRD, which is intended to encourage U.S. companies to repatriate their accumulated foreign earnings and invest them in the United States. See ¶705 for a discussion of the participation DRD.

Subpart F income inclusion of deferred foreign income. As mentioned above, the mechanism for the mandatory inclusion of accumulated foreign earnings is subpart F. In particular, for the last tax year beginning before January 1, 2018, the subpart F income of a deferred foreign income corporation (as otherwise determined for that tax year under Code Sec. 952) is increased by the greater of (i) the accumulated post-1986 deferred foreign income of the corporation determined as of November 2, 2017, or (ii) the accumulated post-1986 deferred foreign income of the corporation determined as of December 31, 2017 (Code Sec. 965(a), as amended by the 2017 Tax Cuts Act).

COMMENT

Foreign corporations no longer in existence and for which there is no tax year beginning or ending in 2017 are not within the scope of this transition rule.

For this purpose, a deferred foreign income corporation with respect to any U.S. shareholder is any specified foreign corporation of the U.S. shareholder that has accumulated post-1986 deferred foreign income as of November 2, 2017, or December 31, 2017, greater than zero (Code Sec. 965(d)(1), as amended by the 2017 Tax Cuts Act).

A specified foreign corporation is (1) a CFC, or (2) any foreign corporation in which a domestic corporation is a U.S. shareholder, other than a PFIC that is not a CFC. For purposes of the Code Sec. 951 subpart F inclusion rules and the Code Sec. 961 rules requiring adjustments to the basis of the CFC stock, a foreign corporation described in item (2), above, is treated as a CFC solely for purposes of taking into account the subpart F income of the corporation under the transition rule and determining the U.S. shareholder pro rata share of that income (Code Sec. 965(e), as amended by the 2017 Tax Cuts Act).

COMMENT

A non-CFC foreign corporation must have at least one U.S. shareholder that is a domestic corporation in order for the foreign corporation to be a specified foreign corporation. In addition, unlike the participation DRD that is available only to domestic corporations that are U.S. shareholders under subpart F, the transition rule applies to all U.S. shareholders of a specified foreign corporation. The subpart F definitions of a U.S. shareholder and CFC are expanded so that they are used for purposes of Title 26, and not just the subpart F provisions (Act Sec. 14101(e)(1) and (2) of the 2017 Tax Cuts Act, amending Code Secs. 951(b) and 957(a); see ¶705). The U.S. shareholder definition is further expanded so that a U.S. shareholder includes a U.S. person that owns at least 10 percent of the total combined voting power of all classes of stock entitled to vote or at least 10 percent of the total value of all classes of stock of the foreign corporation (Act Sec. 14214(a) of the 2017 Tax Cuts Act, amending Code Sec. 951(b); see ¶745).

COMMENT

For purposes of taking into account its subpart F income under the transition rule, a noncontrolled 10/50 corporation is treated as a CFC (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

The accumulated post-1986 deferred foreign income includes the post-1986 earnings and profits that (i) are not attributable to income that is effectively connected with the conduct of a trade or business in the United States and subject to tax under Chapter 1 of the Code, or (ii) if distributed, in the case of a CFC, would be excluded from the gross income of a U.S. shareholder as previously taxed income under Code Sec. 959 (Code Sec. 965(d)(2), as amended by the 2017 Tax Cuts Act).

To the extent provided in regulations or other guidance, the accumulated post-1986 deferred foreign income of a CFC that has non-U.S. shareholders is appropriately reduced by amounts which would be described in item (ii), above (i.e., amounts excluded from the U.S. shareholder's income as previously taxed earnings) if such shareholders were U.S. shareholders.

Post-1986 earnings and profits include the earnings and profits of the foreign corporation accumulated in tax years beginning after December 31, 1986, and determined (i) as of November 2, 2017, or December 31, 2017, whichever measurement date applies to the foreign corporation, and (ii) without decrease for dividends distributed during the last tax year beginning before January 1, 2018, other than dividends distributed to another specified foreign corporation. Post-1986 earnings and profits are computed under the rules of Code Secs. 964(a) and 986 for determining earnings and profits of a CFC, but only taking into account periods when the foreign corporation was a specified foreign corporation (Code Sec. 965(d)(3), as amended by the 2017 Tax Cuts Act).

PRACTICE NOTE

Therefore, post-1986 earnings and profits that are subject to the transition tax do not include earnings and profits that were accumulated by a foreign corporation prior to attaining its status as a specified foreign corporation. However, post-1986 earnings and profits are taken into account even if arising from periods during which the U.S. shareholder did not own stock of the foreign corporation.

Reduction of amounts included in the U.S. shareholder's income. Consistent with the general operation of subpart F, each U.S. shareholder of a deferred foreign income corporation must include in income its pro rata share of the foreign corporation's subpart F income attributable to its accumulated post-1986 deferred foreign income. In the case where the taxpayer is a U.S. shareholder of at least one deferred foreign income corporation and at least one E&P deficit foreign corporation, the mandatory inclusion amount of the U.S. shareholder that otherwise would be taken into account as the U.S. shareholder's pro rata share of the subpart F income of each deferred foreign income corporation is reduced by the amount of the U.S. shareholder's aggregate foreign earnings and profits (E&P) deficit that is allocated to that deferred foreign income corporation (Code Sec. 965(b)(1), as amended by the 2017 Tax Cuts Act).

COMMENT

In other words, the mandatory inclusion amount under the transition rule is reduced by the portion of the aggregate foreign E&P deficit allocated to the U.S. shareholder by reason of the shareholder's interest in one or more E&P deficit foreign corporations.

PRACTICE NOTE

For purposes of the mandatory inclusion rule, the determination of the U.S. shareholder's pro rata share of any amount with respect to any specified foreign corporation is determined under the subpart F inclusion rules by treating that amount in the same manner as subpart F income, and by treating the specified foreign corporation as a CFC. The portion of the U.S. shareholder's mandatory inclusion amount that is equal to the deduction allowed under Code Sec. 965(c) (discussed further below) is treated tax-exempt income for purposes of Code Sec. 705(a)(1)(B) (which requires an increase in a partner's basis in a partnership by the partner's distributive share of the partnership's tax-exempt income) and Code Sec. 1367(a)(1)(A) (which requires an increase in an S shareholder's basis in stock for tax-exempt income). However, that amount is not treated as tax-exempt income for purposes of determining whether an adjustment is made to an accumulated adjustment account under Code Sec. 1368(e)(1)(A) (Code Sec. 965(f), as amended by the 2017 Tax Cuts Act).

The U.S. shareholder allocates the aggregate foreign E&P deficit among the deferred foreign income corporations in which the shareholder is a U.S. shareholder. The aggregate foreign E&P deficit is allocable to a specified foreign corporation in the same ratio as (i) the U.S. shareholder's pro rata share of post-1986 deferred income in that corporation bears to (ii) the aggregate of the U.S. shareholder's pro rata share of accumulated post-1986 deferred foreign income from all deferred income companies of the shareholder (Code Sec. 965(b)(2), as amended by the 2017 Tax Cuts Act).

The aggregate foreign E&P deficit is the lesser of (i) the aggregate of the U.S. shareholder's pro rata shares of the specified E&P deficits of the E&P deficit foreign corporations of the shareholder, or (ii) the aggregate of the U.S. shareholder's pro rata share of the accumulated post-1986 deferred foreign income of all deferred foreign income corporations (Code Sec. 965(b)(3)(A)(i), as added by the 2017 Tax Cuts Act). If the amount described in (ii), above, is less than the amount described in (i), above, then the shareholder must designate (in the form and manner determined by the Secretary of the Treasury):

1) the amount of the specified E&P deficit that is to be taken into account for each E&P deficit corporation with respect to the taxpayer; and
2) in the case of an E&P deficit corporation that has a qualified deficit (as defined in Code Sec. 952), the portion (if any) of the deficit taken into account under item (1), above, that is attributable to a qualified deficit, including the qualified activities to which such portion is attributable (Code Sec. 965(b)(3)(A)(ii), as added by the 2017 Tax Cuts Act).

An E&P deficit foreign corporation is any specified foreign corporation with respect to which the taxpayer is a U.S. shareholder, if as of November 2, 2017 (i) the specified foreign corporation has a deficit in post-

1986 earnings and profits, (ii) the corporation was a specified foreign corporation, and (iii) the taxpayer was a U.S. shareholder of the corporation. The specified E&P deficit with respect to any E&P deficit foreign corporation is the amount of the deficit in its post-1986 earnings and profits, described in the previous sentence (Code Sec. 965(b)(3)(B), as amended by the 2017 Tax Cuts Act).

COMMENT

Accordingly, the deficits of a foreign subsidiary that accumulated prior to its acquisition by the U.S. shareholder may be taken into account in determining the aggregate foreign E&P deficit of the U.S. shareholder.

COMMENT

According to the Conference Committee Report, the deficits (including hovering deficits described in Reg. §1.367(b)-17(d)(2)) of a foreign subsidiary that accumulated while it was a specified foreign corporation may be taken into account in determining the aggregate foreign E&P deficit of a U.S. shareholder. Therefore, the amount of post-1986 earnings and profits of a specified foreign corporation is the amount of positive earnings and profits accumulated as of the measurement date reduced by any deficit in earnings and profits of the specified foreign corporation as of the measurement date, without regard to the foreign tax credit limitation category of the earnings or deficit.

For example, if a foreign corporation organized after December 31, 1986, has $100 of accumulated earnings and profits as of November 2, 2017, and December 31, 2017 (determined without reduction for dividends distributed during the tax year and after any increase for qualified deficits), which consist of $120 general limitation earnings and profits and a $20 passive limitation deficit, the foreign corporation's post-1986 earnings and profits would be $100, even if the $20 passive limitation deficit was a hovering deficit. Foreign income taxes related to the hovering deficit, however, would not generally be deemed paid by the U.S. shareholder recognizing an incremental income inclusion. However, it is expected that the Secretary may issue guidance to provide that, solely for purposes of calculating the amount of foreign income taxes deemed paid by the U.S. shareholder with respect to a mandatory inclusion, a hovering deficit may be absorbed by current year earnings and profits and the foreign income taxes related to the hovering deficit may be added to the specified foreign corporation's post-1986 foreign income taxes in that separate category on a pro rata basis in the year of inclusion (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

Treatment of earnings and profits in future years. For purposes of excluding previously taxed earnings from the U.S. shareholder's income in any tax year beginning with the last tax year beginning before January 1, 2018, an amount equal to the reduction for the U.S. shareholder's aggregate foreign E&P deficit allocated to the deferred foreign income corporation is treated as an amount included in the U.S. shareholder's gross income under the subpart F inclusion rules (Code Sec. 965(b)(4)(B), as amended by the 2017 Tax Cuts Act).

COMMENT

Accordingly, the reduced earnings and profits are treated as previously taxed income when distributed.

In addition, the U.S. shareholder's pro rata share of the earnings and profits of any specified E&P deficit foreign corporation is increased by the amount of the corporation's specified E&P deficit taken into account in computing the mandatory inclusion. For purposes of determining subpart F income, this increase is attributable to the same activity to which the deficit taken into account was attributable (Code Sec. 965(b)(4)(A), as amended by the 2017 Tax Cuts Act).

Intragroup netting among U.S. shareholders in an affiliated group. The transition rule permits intragroup netting among U.S. shareholders in an affiliated group in which there is at least one U.S. shareholder with a net E&P surplus (i.e., the shareholder's mandatory inclusion amount is greater than zero) and another with a net E&P deficit (i.e., the aggregate foreign E&P deficit of the shareholder exceeds the shareholder's mandatory inclusion amount). The net E&P surplus shareholder may reduce its net surplus by the shareholder's applicable share of the group's aggregate unused E&P deficit, based on the group ownership percentage of the members (Code Sec. 965(b)(5), as amended by the 2017 Tax Cuts Act).

COMMENT

Accordingly, deferred earnings of a U.S. shareholder are reduced by the shareholder's share of deficits as of November 2, 2017, from a specified foreign corporation that is not a deferred foreign income corporation, including the pro rata share of deficits of another U.S. shareholder in a different U.S. ownership chain within the same U.S. affiliated group.

The applicable share with respect to any E&P net surplus shareholder in the group is the amount that bears the same proportion to the group's aggregate unused E&P deficit as (i) the product of the shareholder's group ownership percentage, multiplied by the mandatory inclusion amount that would otherwise be taken into account by the shareholder, bears to (ii) the aggregate amount in item (i) determined with respect to all E&P net surplus shareholders in the group (Code Sec. 965(b)(5)(E), as amended by the 2017 Tax Cuts Act).

The group's aggregate unused E&P deficit is the lesser of the sum of the net E&P deficit of each E&P net deficit shareholder in the group (or a percentage of that amount based on the group ownership percentage of each shareholder), or the amount determined in item (ii), above (Code Sec. 965(b)(4)(D), as amended by the 2017 Tax Cuts Act).

The group ownership percentage with respect to a U.S. shareholder in the group is the percentage of the value of the U.S. shareholder stock that is held by other includible corporations in the group. However, the group ownership percentage of the common parent of the affiliated group is 100 percent (Code Sec. 965(b)(5)(F), as amended by the 2017 Tax Cuts Act).

EXAMPLE

A U.S. corporation has two domestic subsidiaries, X and Y, each of which it owns 100 percent and 80 percent, respectively. If X has a $1,000 net E&P surplus, and Y has $1,000 net E&P deficit, X is an E&P net surplus shareholder, and Y is an E&P net deficit shareholder. The net E&P surplus of X is reduced by the net E&P deficit of Y to the extent of the group's ownership percentage in Y, which is 80 percent. The remaining net E&P deficit of Y is unused. If the U.S. shareholder Z is also a wholly owned subsidiary of the same U.S. parent as X and Y, the group ownership percentage of Y is unchanged, and the surpluses of X and Z are reduced ratably by 800 of the net E&P deficit of Y.

COMMENT

The Conference Committee Report states that it is expect that the Secretary of the Treasury will exercise his authority under the consolidated return provisions to appropriately limit the netting across chains of ownership within a group of related parties in the application of the mandatory inclusion rules. However, nothing in these rules is intended to be interpreted as limiting the Secretary's authority to use such regulatory authority to prescribe regulations on proper application of the mandatory inclusion rules on

a consolidated basis for affiliated groups filing a consolidated return (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

Deduction from mandatory inclusion. A U.S. shareholder of a specified foreign corporation is allowed a deduction of a portion of the increased subpart F income attributable to the mandatory inclusion of deferred foreign income. The amount of the deduction is the sum of (i) the 15.5-percent rate equivalent percentage of the inclusion amount that is the shareholder's aggregate foreign cash position, and (ii) the eight percent rate equivalent percentage of the portion of the inclusion amount that exceeds the shareholder's aggregate foreign cash position (Code Sec. 965(c)(1), as added by the 2017 Tax Cuts Act).

COMMENT

The calculation is based on the highest rate of tax applicable to corporations in the tax year of inclusion, even if the U.S. shareholder is an individual.

The eight-percent rate equivalent percentage (or the 15.5-percent rate equivalent percentage) with respect to any U.S. shareholder for any tax year is the percentage that would result in the amount to which that percentage applies being subject to an eight-percent rate of tax (or a 15.5-percent rate of tax, respectively) determined by only taking into account a deduction equal to the percentage of that amount and the highest rate of tax under Code Sec. 11 for the tax year. In the case of any tax year of a U.S. shareholder to which Code Sec. 15 applies, the highest rate of tax under Code Sec. 11 before the effective date of the change in rates and the highest rate of tax under that section after the effective date of that change is each taken into account under this rule in the same proportions as the portion of the year that is before and after that effective date, respectively (Code Sec. 965(c)(2), as added by the 2017 Tax Cuts Act).

COMMENT

The use of rate equivalent percentages is intended to ensure that the rates of tax imposed on the deferred foreign income is similar for all U.S. shareholders, regardless of the year of the mandatory inclusion. By stating the permitted deduction in the form of a tax rate equivalent percentage, the transition rule ensures that the accumulated post-1986 deferred foreign income is subject to either an eight-percent or 15.5-percent rate of tax, depending on the underlying assets as of the measurement date, without regard to the corporate tax rate that may be in effect at the time of the inclusion. For example, fiscal-year corporate taxpayers may report the increased subpart F income in a tax year for which a reduced corporate tax rate would otherwise apply (on a prorated basis under Code Sec. 15), but the allowable deduction would be reduced so that the rate of U.S. tax on the income inclusion would be eight or 15.5 percent.

Aggregate foreign cash position. With respect to any U.S. shareholder, the aggregate foreign cash position is the greater of:

1) the aggregate of the U.S. shareholder's pro rata share of the cash position of each specified foreign corporation of the U.S. shareholder determined as of the close of the last tax year of the specified foreign corporation that begins before January 1, 2018; or
2) one half of the sum of:
    a) the aggregate described in item (1), above, determined as of the close of the last tax year of each specified foreign corporation that ends before November 2, 2017, plus
    b) the aggregate described in item (1), above, determined as of the close of the tax year of each specified foreign corporation that precedes the tax year referred to in item (a), above (Code Sec. 965(c)(3)(A), as amended by the 2017 Tax Cuts Act).

COMMENT

In other words, the aggregate foreign cash position is the greater of the aggregate cash position as of the last day of the last tax year beginning before January 1, 2018, and the average aggregate cash position as of the last day of each of the last two years ending before the date of introduction (November 2, 2017).

The cash position of any specified foreign corporation is the sum of:

1) cash held by the foreign corporation;
2) the net accounts receivable of the foreign corporation (the excess (if any) of the corporation's accounts receivable over its accounts payable, determined under Code Sec. 461), plus
3) the fair market value of the following assets held by the corporation:
    a) Actively traded personal property for which there is an established financial market.
    b) Commercial paper, certificates of deposit, the securities of the Federal government and of any State or foreign government.
    c) Any foreign currency.
    d) Any obligation with a term of less than one year.
    e) Any asset that the Secretary identifies as being economically equivalent to the assets described above (Code Sec. 965(c)(3)(B) and (C), as amended by the 2017 Tax Cuts Act).

To avoid double counting, cash assets described in items (2), (3)(a) and (3)(d), above, are not taken into account in determining the aggregate foreign cash position to the extent that the U.S. shareholder demonstrates to the satisfaction of the Secretary that the amount is taken into account by the shareholder with respect to another specified foreign corporation (Code Sec. 965(c)(2)(D), as added by the 2017 Tax Cuts Act).

COMMENT

Thus, cash holdings of a specified foreign corporation in the form of publicly traded stock may be excluded to the extent that a U.S. shareholder can demonstrate that the value of the stock was taken into account as cash or cash equivalent by another specified foreign corporation of the U.S. shareholder.

Cash positions of certain noncorporate entities. A noncorporate entity is treated as a specified foreign corporation of a U.S. shareholder for purposes of determining the shareholder's aggregate foreign cash position if (i) any interest in the entity is held by a specified foreign corporation of the U.S. shareholder (determined after application of this rule), and (ii) the entity would be a specified foreign corporation of the shareholder if the entity were a foreign corporation (Code Sec. 965(c)(2)(E), as added by the 2017 Tax Cuts Act).

COMMENT

As stated in the Conference Committee Report, the cash position of a U.S. shareholder does not generally include the cash attributable to a direct ownership interest in a partnership, but cash positions of certain noncorporate foreign entities owned by a specified foreign corporation are taken into account if such entities would be specified foreign corporations if the entity were a foreign corporation. For example, if a U.S. shareholder owns a five-percent interest in a partnership, the balance of which is held by specified foreign corporations of the U.S. shareholder, the partnership is treated as a specified foreign corporation with respect to the U.S. shareholder, and the cash or cash equivalents held by the partnership are includible in the aggregate cash position of the U.S. shareholder on a look-through basis. It is expected that the Secretary will provide guidance for taking into account only the specified foreign corporation's share of the partnership's cash position, and not the five-percent interest directly owned by the U.S. shareholder (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

Anti-abuse rule. The Secretary is authorized to disregard transactions that are determined to have the principal purpose of reducing the aggregate foreign cash position (Code Sec. 965(c)(2)(F), as added by the 2017 Tax Cuts Act).

Disallowance of foreign tax credit and deduction for taxes. No foreign tax credit or deduction is allowed for a portion (referred to as an applicable percentage) of any foreign income taxes paid or accrued (or deemed paid or accrued) with respect to any mandatory inclusion amount for which a deduction is allowed under the above rules (Code Sec. 965(g)(1) and (3), as added by the 2017 Tax Cuts Act).

The disallowed portion of the foreign tax credit is 55.7 percent of foreign taxes paid attributable to the portion of the inclusion amount attributable to the U.S. sahreholder's aggregate foreign cash position, plus 77.1 percent of foreign taxes paid attributable to the remaining portion of the mandatory inclusion amount (Code Sec. 965(g)(2), as added by the 2017 Tax Cuts Act).

COMMENT

Other foreign tax credits used by a taxpayer against tax liability resulting from the deemed inclusion apply in full.

COMMENT

As a result of this foreign tax credit disallowance rule, the foreign tax credit is limited to the taxable portion of the mandatory inclusion amount.

A special rule coordinates the disallowance of foreign tax credits, described above, with the Code Sec. 78 requirement that a domestic corporate shareholder is deemed to receive a dividend in an amount equal to foreign taxes it is deemed to have paid and for which it claimed a credit. Under the coordination rule, the foreign taxes treated as paid or accrued by a domestic corporation as a result of the mandatory inclusion are limited to those taxes in proportion to the taxable portion of the mandatory inclusion. The gross-up amount equals the total foreign income taxes multiplied by a fraction, the numerator of which is the taxable portion of the increased subpart F income inclusion under the transition rule and the denominator of which is the total increase in subpart F income under the transition rule (Code Sec. 965(g)(4), as added by the 2017 Tax Cuts Act).

Installment payments. A U.S. shareholder of a deferred foreign income corporation may elect to pay the net tax liability resulting from the mandatory inclusion of deferred foreign income in eight installments. If installment payment is elected, the payments for each of the first five years equals eight percent of the net tax liability. The amount of the sixth installment is 15 percent of the net tax liability, increasing to 20 percent for the seventh installment and 25 percent for the eighth installment (Code Sec. 965(h)(1), as added by the 2017 Tax Cuts Act).

The first installment must be paid on the due date (determined without regard to extensions) of the tax return for the last tax year that begins before January 1, 2018 (the tax year of the mandatory inclusion). Succeeding installments must be paid annually no later than the due dates (without extensions) for the income tax return of each succeeding tax year (Code Sec. 965(h)(2), as added by the 2017 Tax Cuts Act).

COMMENT

Thus, a U.S. shareholder can elect to pay the transition tax arising from the mandatory inclusion over a period of eight years.

Making the election. An election to pay the net tax liability from the mandatory inclusion in installments must be made by the due date of the tax return for the last tax year that begins before January 1, 2018 (the tax year in which the pre-effective-date undistributed earnings are included in income under the transition rule). The Treasury Secretary has authority to prescribe the manner of making the election (Code Sec. 965(h)(5), as added by the 2017 Tax Cuts Act).

Net tax liability. The net tax liability that may be paid in installments is the excess of (i) the U.S. shareholder's net income tax for the tax year in which an amount is included in income under the mandatory inclusion rules, over (ii) the taxpayer's net income tax for that year determined without regard to the mandatory inclusion and any income or deduction properly attributable to a dividend received by the U.S. shareholder from any deferred foreign income corporation. The net income tax is the regular tax liability reduced by the general business credit (Code Sec. 965(h)(6), as added by the 2017 Tax Cuts Act).

Acceleration rule. If (1) there is an addition to tax for failure to pay timely any required installment of the transition tax, (2) there is a liquidation or sale of substantially all of the U.S. shareholder's assets (including in a bankruptcy case), (3) the U.S. shareholder ceases business, or (4) another similar circumstance arises, the unpaid portion of all remaining installments is due on the date of the event (or, in a bankruptcy proceeding or similar case, the day before the petition is filed). This acceleration rule does not apply to the sale of substantially all the assets of the U.S. shareholder to a buyer if the buyer enters into an agreement with the Secretary under which the buyer is liable for the remaining installments due in the same manner as if the buyer were the U.S. shareholder (Code Sec. 965(h)(3), as added by the 2017 Tax Cuts Act).

Proration of deficiency to installments. If an election is made to pay the net tax liability from the mandatory inclusion in installments and a deficiency is later determined with respect to that net tax liability, the additional tax due is prorated among the installment payments. The portions of the deficiency prorated to an installment that was due before the deficiency was assessed must be paid upon notice and demand. The portion prorated to any remaining installment is payable with the timely payment of that installment payment. However, these rules do not apply if the deficiency is attributable to negligence, intentional disregard of rules or regulations, or fraud with intent to evade tax (Code Sec. 965(h)(4), as added by the 2017 Tax Cuts Act).

COMMENT

If the deficiency is attributable to negligence, intentional disregard of rules or regulations, or fraud with intent to evade tax, the entire deficiency is payable upon notice and demand.

COMMENT

The timely payment of an installment does not incur interest. If a deficiency is determined that is attributable to an understatement of the net tax liability due under the transition rule, the deficiency is payable with underpayment interest for the period beginning on the date on which the net tax liability would have been due, without regard to an election to pay in installments, and ending with the payment of the deficiency. Furthermore, any amount of deficiency prorated to a remaining installment also bears interest on the deficiency, but not on the original installment amount (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

Special rules for S corporations. A special rule permits deferral of the transition net tax liability for shareholders of a U.S. shareholder that is an S corporation. Under this rule, any shareholder of the S corporation may elect to defer the payment of his portion of the net tax liability resulting from the mandatory inclusion until the shareholder's tax year in which a triggering event occurs. The deferred transition tax is assessed as an addition to tax on the shareholder's return for the tax year of the triggering event (Code Sec. 965(i)(1), as added by the 2017 Tax Cuts Act).

For purposes of this rule, the shareholder's net tax liability is the net tax liability that would be determined under the transition rule if the only subpart F income taken into account by the shareholder under the mandatory inclusion were allocations from the S corporation (Code Sec. 965(i)(3), as added by the 2017 Tax Cuts Act).

The S corporation shareholder must make the election to defer the transition tax not later than the due date for the shareholder's return for the tax year that includes the close of the S corporation's last tax year that begins before January 1, 2018, in which the mandatory inclusion is made. The election is made in the manner provided by the Secretary (Code Sec. 965(i)(8), as added by the 2017 Tax Cuts Act).

Triggering events. The following three types of events may trigger an end to deferral of the net tax liability of an S corporation shareholder:

1) The corporation ceases to be an S corporation (determined as of the first day of the first tax year that the corporation is not an S corporation).
2) A liquidation, a sale of substantially all of the S corporation's assets (including in a bankruptcy or similar case), a termination of the S corporation, a cessation of its business, or a similar event.
3) A transfer of shares of stock in the S corporation by the electing taxpayer, whether by sale, death or otherwise, unless the transferee of the stock agrees with the Secretary to be liable for net tax liability in the same manner as the transferor (Code Sec. 965(i)(2), as added by the 2017 Tax Cuts Act).

Partial transfers of the S corporation stock trigger the end of deferral only with respect to the portion of tax properly allocable to the portion of stock sold.

Election to pay deferred liability in installments. After a triggering event occurs, an S corporation shareholder that has elected to defer the net tax liability may elect to pay the net tax liability in eight installments, subject to rules similar to those generally applicable absent deferral. However, if the triggering event is a liquidation, sale of substantially all corporate assets, termination of the S corporation or end of its business, or similar event, the installment payment election can be made only with the consent of the Secretary. The installment election must be made by the due date of the return for the tax year in which the triggering event occurs, and the first installment payment is required by that due date, determined without regard to extensions of time to file (Code Sec. 965(i)(4), as added by the 2017 Tax Cuts Act).

Joint and several liability; extension of limitation on collection. If a shareholder of an S corporation has elected deferral and a triggering event occurs, the S corporation and the electing shareholder are jointly and severally liable for any net tax liability and related interest or penalties (Code Sec. 965(i)(5), as added by the 2017 Tax Cuts Act). The period within which the IRS may collect a deferred liability does not begin before the date of the triggering event (Code Sec. 965(i)(6), as added by the 2017 Tax Cuts Act).

Annual reporting of net tax liability. If an election to defer payment of the net tax liability is in effect for an S corporation shareholder, the shareholder must report the amount of the deferred net tax liability on its return for the tax year for which the election is made and on each subsequent tax year return until the deferred amount has been fully assessed on the returns. Failure to include that information with each income tax return during the period that the election is in effect will result in a penalty equal to five-percent of the amount that should have been reported. For this purpose, a deferred net tax liability is the amount of the net tax liability the payment of which has been deferred under these rules and which has not been assessed on a return of tax for any prior tax year (Code Sec. 965(i)(7), as added by the 2017 Tax Cuts Act).

Reporting by S corporations. An S corporation that is a U.S. shareholder of a specified foreign corporation is required to report on its income tax return the amount includible in gross income under the mandatory inclusion rules, as well as the amount of deduction from mandatory inclusion that would be allowable under the transition rule. In addition, the corporation must furnish a copy of that information to its shareholders. The information provided to shareholders also must include a statement of the shareholder's pro rata share of these amounts (Code Sec. 965(j), as added by the 2017 Tax Cuts Act).

Limitations on assessment extended. Under an exception to the otherwise generally applicable limitations period for assessment of tax, the period for the assessment of the transition net tax liability arising from the mandatory inclusion does not expire prior to six years from the date on which the tax return initially reflecting the mandatory inclusion was filed (Code Sec. 965(k), as added by the 2017 Tax Cuts Act).

Recapture for expatriated entities. A special recapture rule applies if a U.S. shareholder is allowed a deduction from mandatory inclusion under the transition rule and first becomes an expatriated entity at any time during the 10-year period beginning on December 22, 2017, with respect to a surrogate foreign corporation that first becomes a surrogate foreign corporation during that period (i.e., post-enactment). In this case, the tax imposed by Chapter 1 of the Code is increased for the first tax year in which the taxpayer becomes an expatriated entity by an amount equal to 35 percent of the amount of the allowed deduction from mandatory inclusion. In addition, no tax credits are allowed against the additional tax due as a result of the recapture rule (Code Sec. 965(l)(1), as added by the 2017 Tax Cuts Act).

COMMENT

Although the amount due is computed by reference to the year in which the deemed subpart F income was originally reported, the additional tax arises and is assessed for the tax year in which the U.S. shareholder becomes an expatriated entity.

For purposes of this rule, an expatriated entity is a domestic corporation or partnership acquired in an inversion transaction and the surrogate foreign corporation is the foreign corporation acquiring the expatriated entity in the inversion transaction (Code Sec. 7874(a)(2)). However, an entity is not treated as an expatriated entity, and is not within the scope of this recapture rule, if the surrogate foreign corporation is treated as a domestic corporation under Code Sec. 7874(b) because former shareholders or partners of the acquired entity hold 80 percent or more (by vote or value) of the stock of the surrogate foreign corporation after the transaction (Code Sec. 965(l)(2) and (3), as added by the 2017 Tax Cuts Act).

Special rules for U.S. shareholders that are REITs. Special rules are provided if a U.S. shareholder is a REIT in order to reduce the burden of compliance with the transition rule by REITs. First, if a real estate investment trust (REIT) is a U.S. shareholder in one or more deferred foreign income corporations, any amount required to be included as mandatory subpart F inclusion is not taken into account as gross income of the REIT for purposes of determining the qualified REIT's income in applying the Code Sec. 856(c)(2) and (3) income tests to any tax year for which the amount is taken into account under the subpart F inclusion (Code Sec. 965(m)(1)(A), as added by the 2017 Tax Cuts Act).

In addition, although a REIT generally must take into account the mandatory inclusion in determining its taxable income under Code Sec. 857(b), the REIT is allowed to make an election to defer the mandatory inclusion and take it into income over the period of eight years as follows:

1) Eight percent of the amount in the case of each of the tax years in the five-tax year period beginning with the tax year in which the amount would otherwise be included.
2) 15 percent of the amount in the case of the first tax year following that period.
3) 20 percent of the amount in the case of the second tax year following that period.
4) 25 percent of the amount in the case of the third tax year following that period (Code Sec. 965(m)(1)(B), as added by the 2017 Tax Cuts Act).

COMMENT

A REIT is required to distribute at least 90 percent of the REIT income (other than net capital gain) annually under Code Sec. 857. A required inclusion under the transition rule may trigger a requirement that the REIT distribute an amount equal to 90 percent of that inclusion despite the fact that it did not receive distribution from the deferred foreign income corporation. To avoid the requirement that any distribution requirement be satisfied in one year, an election to defer the mandatory inclusion is permitted.

The election for deferred inclusion must be made not later than the due date for the first tax year in the five-tax year period in the manner provided by the Secretary (Code Sec. 965(m)(2)(A), as added by the 2017 Tax Cuts Act).

Special rules apply if the deferral election is in effect. Thus, in each of those years, the REIT may claim a partial deduction from mandatory inclusion under Code Sec. 965(c)(1) in the applicable percentages in proportion to the amount included in each of the eight years. The REIT also cannot elect to use the installment payment for any tax year from the eight-year period, discussed above (Code Sec. 965(m)(2)(B)(i), as added by the 2017 Tax Cuts Act).

In addition, if there is a liquidation or sale of substantially all the assets of the REIT (including in a bankruptcy or similar case), a cessation of business by the REIT, or any similar circumstance, any portion of the required inclusion not yet taken into income is accelerated and required to be included as gross income as of the day before the event and the unpaid portion of any tax liability with respect to such inclusion will be due on the date of the event (or in the case of a bankruptcy or similar case, the day before the petition is filed) (Code Sec. 965(m)(2)(B)(ii), as added by the 2017 Tax Cuts Act).

Election not to apply the NOL deduction. A U.S. shareholder of a deferred foreign income corporation can make an election for the last tax year beginning before January 1, 2018 (the tax year of the mandatory subpart F inclusion) not to take into account the mandatory inclusion and certain other amounts (described below) in determining (i) the net operating loss (NOL) deduction under Code Sec. 172 for that tax year, or (ii) the amount of taxable income for that tax year which may be reduced by NOL carryovers or carrybacks to that tax year (Code Sec. 965(n)(1), as added by the 2017 Tax Cuts Act).

The amount not taken into account includes the mandatory inclusion and, in the case of a domestic corporation that chooses to have the benefits of subpart A of part III of subchapter N for the tax year, the taxes deemed to be paid by the corporation under the deemed-paid credit rules of Code Sec. 960(a) and (b) for the tax year with respect to the mandatory inclusion that are treated as dividends under Code Sec. 78 (Code Sec. 965(n)(2), as added by the 2017 Tax Cuts Act).

The election is made not later than the due date (including extensions) for filing the return for the tax year in the manner prescribed by the Secretary (Code Sec. 965(n)(3), as added by the 2017 Tax Cuts Act).

Regulations. The Secretary is authorized to issue regulations or other guidance as may be necessary or appropriate to carry out the mandatory inclusion provisions or to prevent the avoidance of the purposes of these rules, including through a reduction in earnings and profits through changes in entity classification, changes in accounting methods, or otherwise (Code Sec. 965(o), as added by the 2017 Tax Cuts Act).

COMMENT

According to the Conference Committee Report, in order to avoid double-counting and double non-counting of earnings, the Secretary may provide guidance to adjust the amount of post-1986 earnings and profits of a specified foreign corporation to ensure that a single item of a specified foreign corporation is taken into account only once in determining the income of a U.S. shareholder subject to mandatory inclusion. Such an adjustment may be necessary, for example, when there is a deductible payment (e.g., interest or royalties) from one specified foreign corporation to another specified foreign corporation between measurement dates.

In addition, taxpayers may engage in tax strategies designed to reduce the amount of post-1986 earnings and profits in order to decrease the amount of the mandatory

inclusion. Such tax strategies may include a change in entity classification, accounting method, and tax year, or intragroup transactions such as distributions or liquidations. It is expected that the Secretary will prescribe rules to adjust the amount of post-1986 earnings and profits in such cases in order to prevent the avoidance of the purposes of the transition rule (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

Effective date. No specific effective date is provided. The amendment is, therefore, considered effective on December 22, 2017, the date of enactment.