Effect of IRC Section 965 Transition Tax on Domestic Corporations, Tax Year 2017

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Congress amended Internal Revenue Code section 965 in the Tax Cuts and Jobs Act (TCJA) on December 22, 2017, as part of the transition of U.S. corporate tax from a worldwide tax system to a quasi-territorial tax system.[1] Previously, the United States taxed U.S. persons, including domestic corporations, on their worldwide income but generally allowed U.S shareholders of foreign corporations to defer U.S. tax on their share of foreign corporations' accumulated earnings and profits (E&P) until these were distributed as dividends to the shareholder. Generally, under the new system, dividends paid from foreign corporations to a domestic corporation that owns at least 10 percent of the vote or value of the stock are now 100 percent deductible, moving U.S. corporate taxation closer to a territorial tax system. However, the subpart F provisions still apply. These rules require that U.S. shareholders who own 10 percent or more of a controlled foreign corporation (CFC) include in their taxable income certain types of income from their CFCs.[2] The types of income that fall under subpart F rules are traditionally subject to low taxation rates and can be easily moved between tax jurisdictions. There is also a new global intangible low taxed income (GILTI) provision, which requires U.S. shareholders to include certain nonsubpart F, CFC income in their gross income. TCJA also introduced other new provisions, including a base erosion and anti-abuse tax (BEAT) and a deduction related to foreign derived intangible income (FDII). As always, taxpayers may claim a foreign tax credit for taxes paid or accrued to other countries to relieve double taxation. The foreign tax credit includes a limitation to prevent taxpayers from crediting foreign taxes paid or accrued in excess of the amount of U.S. tax for the current tax year that would have otherwise been owed on the taxpayer's foreign-source income. This limitation is computed separately with respect to passive income and taxes to limit the ability to use the foreign taxes paid on nonpassive income to offset the U.S. tax owed on passive income, which is typically subject to lower tax rates. TCJA also added two new categories of income, GILTI and foreign branch, for which taxpayers must compute a separate limitation.

Section 965 generally requires a U.S person who owns 10 percent or more of the voting power of a specified foreign corporation (SFC) to include in the person's gross income its pro rata share of such corporation's untaxed accumulated post-1986 E&P as of November 2, 2017, or December 31, 2017 (whichever is greater). A SFC is either a CFC or a foreign corporation, other than a passive foreign investment company (PFIC), that has at least one domestic corporate U.S. shareholder. U.S shareholders included the IRC section 965 inclusion with their gross income for Tax Year 2017 and/or Tax Year 2018, depending on the accounting period of the U.S shareholder and that of their SFCs. Although the number of returns reporting the IRC section 965 inclusion for Tax Year 2018 is expected to be small relative to the number that reported the inclusion for Tax Year 2017, the amount for Tax Year 2018 is expected to be substantial.

Taxpayers are allowed a deduction that results in a 15.5-percent tax on the portion of their section 965 inclusion related to their cash assets and an 8-percent tax on the portion of their section 965 inclusion related to their noncash assets.[3] The taxes deemed paid on the inclusion are eligible for the foreign tax credit, subject to the foreign tax credit limitation, but must first be reduced by a percentage generally corresponding to the section 965 deduction.[4] Gross income included under IRC section 78 (dividend gross-up) is likewise reduced, although the computation of the reduction amount is slightly different.[5]

Taxpayers also include the section 965 inclusion, the section 965 deduction, and the reduced dividend gross-up when computing the foreign tax credit limitation. For some taxpayers, the resulting increase in the foreign tax credit limitation allows them to credit more of the foreign taxes paid or accrued (including carryovers) on income other than the section 965 inclusion.

To compute the total net section 965 tax liability, taxpayers first compute the U.S. tax they would owe with section 965 amounts included, and then subtract the U.S. tax they would owe without these amounts. Taxpayers with an overall loss from other operations in Tax Year 2017 that exceeded taxable income due to section 965 (section 965 inclusion net of section 965 deduction) had no total net section 965 tax liability. Taxpayers with an overall loss in prior years could reduce their section 965 liability with a net operating loss carryforward. Similarly, taxpayers whose foreign tax credit, combined with any other applicable credits, equaled or exceeded the amount of tax that they would otherwise owe on their taxable income due to section 965 did not have a total net section 965 tax liability. Because the losses and excess foreign tax credits absorbed by the inclusion could otherwise have been used to offset tax on other income in 2017 and other years, the total net section 965 tax liability shown here underestimates the tax effect of the inclusion.

Taxpayers can elect to pay their total net section 965 tax liability in eight annual installments without incurring any interest

[1] Formally, "An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018" (P.L 115-97).

[2] A CFC is a foreign corporation in which U.S. shareholders directly, indirectly or constructively own, by vote or value, more than 50 percent of the corporation's stock.

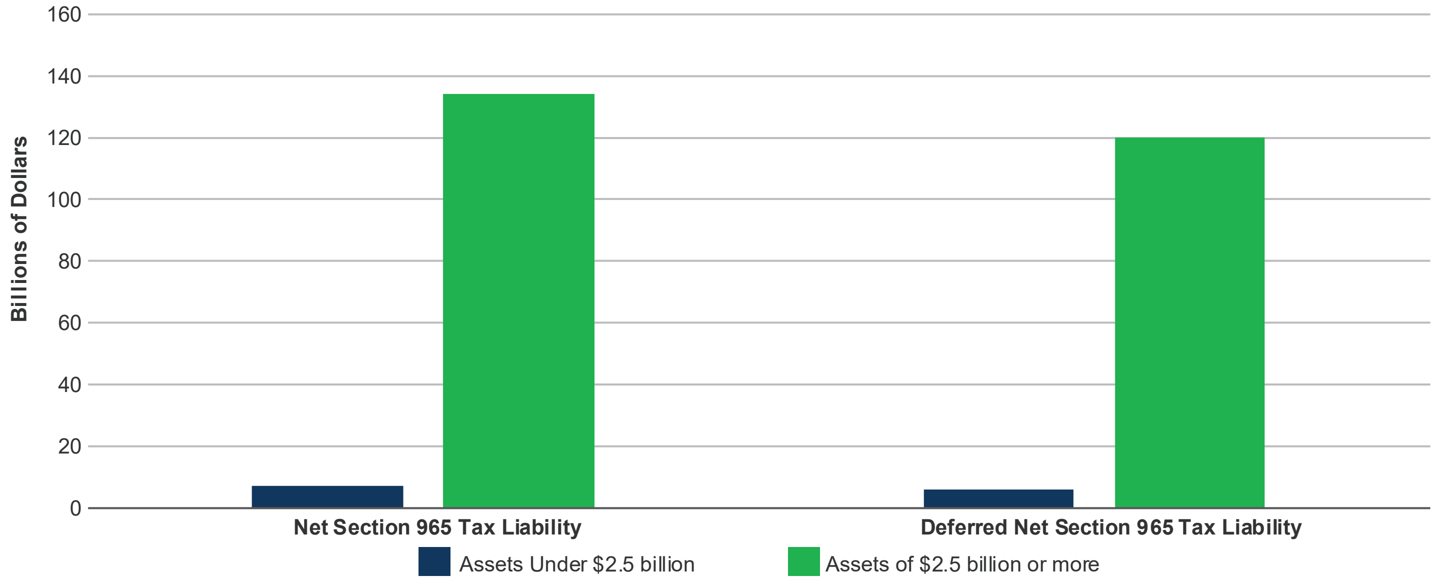
[3] The deduction related to the 15.5-percent tax is applied to the portion of the inclusion attributable to the section 958(a) U.S. shareholder's aggregate foreign cash position. The deduction related to the 8-percent tax is applied to the portion of the inclusion that exceeds the section 958(a) U.S. shareholder's aggregate foreign cash position.

[4] U.S. corporations are permitted an indirect foreign tax credit for certain taxes paid or accrued by the SFC.

[5] The section 965 inclusion is generally "grossed up" by the taxes deemed paid.

Figure 1

Corporations Reporting Net Section 965 Tax Liability, by Size of Total Assets of the U.S. Corporation, Tax Year 2017



SOURCE: IRS, Statistics of Income Division, February 2020

or penalties.[6] If this election is made, eight percent of the total net section 965 tax liability is due in each of the first five years, fifteen percent is due in year six, twenty percent is due in year seven, and the remaining twenty-five percent is due in the final installment. A U.S shareholder who owns an interest in a deferred foreign income corporation through an S corporation can elect to defer the portion of its total net section 965 tax liability attributable to the S corporation until a triggering event, such as the liquidation of the S corporation, occurs (unless the taxpayer enters into a valid transfer agreement).[7]

Since there was insufficient time to revise the corporate tax forms between the passage of the TCJA and the filing due dates for Tax Year 2017 tax returns, the IRS required taxpayers to report their income and income tax without taking into account the provisions under section 965. Separately, taxpayers computed their total net section 965 tax liability and added it to their total tax after credits on their corporate tax returns. They included the total net section 965 tax liability to be paid in future years in their total tax payments. They reported some section 965 amounts, such as the section 965 inclusion and deduction, on a transition tax statement, but due to the difficulty of capturing data from this attachment, only the data included on taxpayers' corporate tax forms are available at this time.[8] Taxpayers are to provide section 965 amounts with respect to Tax Years 2017 and 2018 on Forms 965 and 965-B, which will be filed with their Tax Year 2018 returns. More detailed statistics for Tax Years 2017 and 2018 will be available after the Statistics of Income Division finishes processing the tax return data filed for Tax Year 2018.

Data Highlights

For Tax Year 2017, just over 3,200 corporations reported a total net IRC section 965 tax liability totaling $140.8 billion. Approximately 1,750 corporations elected to pay their tax liability in installments for a total of $126.5 billion in deferred payments. Large corporations accounted for most of the total net section 965 tax liability. There were 528 corporations with total assets over $2.5 billion reporting a total net section 965 tax liability. This represents only 16.5 percent of all corporations that reported a total net section 965 tax liability but represents 95 percent ($133.7 billion) of the total net section 965 tax liability reported in Tax Year 2017 (see Figure 1).

[6] The election is valid until a specified acceleration event, such as the sale of substantially all of the taxpayer's assets, occurs (unless the taxpayer enters into a valid transfer agreement).

[7] A deferred foreign income corporation is a specified foreign corporation with a positive amount of accumulated post-1986 deferred foreign income as of either November 2, 2017, or December 31, 2017.

[8] See https://www.irs.gov/pub/irs-news/Appendix%20-QA3_IRC-965-Transition-Tax-Statement_Fillable.pdf

Table 1 shows net IRC section 965 liability by industry of the U.S. corporation. The manufacturing sector represents almost half of the total net section 965 tax liability ($69 billion). Firms within the chemical manufacturing subsector accounted for 49 percent ($34 billion) of that total. About a third (41) of the 127 corporations in the chemical manufacturing subsector are in pharmaceutical and medicine manufacturing, accounting for 87 percent of the total net section 965 tax liability reported for chemical manufacturing and just over twenty percent of the total for all corporations. The information sector reported $43.5 billion in net section 965 tax liability, almost a third of the total net section 965 tax liability reported by all corporations. Together, corporations classified in pharmaceutical and medicine manufacturing or in information accounted for about half of the total net section 965 tax liability reported in Tax Year 2017.

Data Limitations

The statistics in this data release are estimates based on information reported on applicable corporate tax returns (Forms 1120, 1120-L and 1120 PC) that were included in the 2017 Statistics of Income stratified probability sample of corporate returns.[9] This sample includes returns that posted to the Internal Revenue Service Business Master File from the beginning of July 2017 through the end of June 2019. SOI selected these returns after administrative processing, but prior to any amendments or audit examinations. Since large corporations, which are sampled at 100 percent, reported most of the net section 965 tax liability, the sampling error for the amount of net Section 965 tax liability and the amount to be paid in installments is considered to be very small. Returns for small corporations are selected at much lower rates, however, so estimates of the number of returns reporting net section 965 tax liability should be viewed with caution.

Table 1. Corporations Reporting Net Section 965 Tax Liability, by Selected Sector, Selected Major and Selected Minor Industries of the U.S. Corporation, Tax Year 2017

[All figures are estimates based on a sample—money amounts are in thousands of dollars]

Selected Sector, Selected Major and Selected Minor Industries of U.S. Corporation Filing Return	Number of Returns With Net Section 965 Tax Liability	Net Section 965 Tax Liability	Number of Returns With Deferred Net Section 965 Tax Liability	Deferred Net Section 965 Tax Liability
	(1)	(2)	(3)	(4)
All industries	**3,231**	**140,764,829**	**1,752**	**126,541,949**
Manufacturing	1,063	68,695,273	679	61,649,964
Chemical manufacturing	127	33,966,504	80	31,111,087
Pharmaceutical and medicine manufacturing	41	29,381,359	26	26,991,758
Machinery manufacturing	115	1,242,804	65	992,345
Computer and electronic product manufacturing	168	12,419,907	117	11,046,079
All other manufacturing	653	21,066,059	417	18,500,452
Wholesale and retail trade	**813**	**13,723,221**	**352**	**12,158,303**
Wholesale trade, nondurable goods	147	9,954,356	65	9,002,241
Wholesale trade, all other wholesale trade	589	1,146,684	239	981,241
Retail trade	76	2,622,181	48	2,174,821
Transportation and warehousing	58	396,669	38	341,282
Information	236	43,465,629	111	39,682,012
Finance	202	2,894,384	96	2,413,185
Insurance	72	950,415	26	731,503
All other finance industries	130	1,943,969	70	1,681,683
Management of holding companies (except banks)	181	5,080,788	52	4,544,577
Office of bank holding companies	14	2,590,198	7	2,269,138
Office of other holding companies	167	2,490,590	45	2,275,439
Professional, scientific, and technical services	407	3,211,554	259	2,853,325
All other services [1]	143	2,490,788	91	2,259,649
All other industries	127	806,523	75	639,653

[1] All other services includes Administrative Support, Education Services, Health Care, Arts, Entertainment and Recreation, Accommodation and Food Services and Other Services.

NOTES: Detail may not add to totals because of rounding.

SOURCE: IRS, Statistics of Income Division, February 2020

[9] See also "Description of the Sample and Limitations of the Data" at https://www.irs.gov/statistics/soi-tax-stats-corporation-complete-report