

Managing Indefinite Deferral of Transition Tax Under Code Sec. 965(i)

By *Brian Jenn*

As part of the Tax Cuts and Jobs Act of 2017, the U.S. international tax system shifted from a system in which U.S. shareholder taxation of most foreign corporation earnings was deferred until repatriation of those earnings to a system in which U.S. shareholders within the meaning of Code Sec. 951(b) (“U.S. shareholders”) are subject to current taxation of such foreign corporation earnings as Global Intangible Low-Taxed Income (“GILTI”) under Code Sec. 951A. In connection with this transition, Congress enacted Code Sec. 965, which as a general rule provides for the treatment as Subpart F income of the accumulated post-1986 deferred foreign income in the last taxable year of a deferred foreign income corporation (“DFIC”) which begins before January 1, 2018.

Although any U.S. shareholder was allowed to elect under Code Sec. 965(h) to pay the net tax liability under Code Sec. 965 with respect in installments over eight years, Code Sec. 965(i) offered shareholder of S corporations a uniquely favorable deal: indefinite deferral of Code Sec. 965 transition tax liability. In particular, under Code Sec. 965(i), a shareholder of an S corporation that is a U.S. shareholder of a DFIC may elect to defer payment of the shareholder’s net tax liability under Code Sec. 965 until the taxable year of a triggering event defined in Code Sec. 965(i)(2). As defined in the statute, a triggering event includes: (1) the S corporation ceasing to be an S corporation; (2) a liquidation or sale of substantially all the assets of the S corporation, a cessation of business by such S corporation, such S corporation ceasing to exist, or any similar circumstance;¹ and (3) a transfer of stock in such S corporation (including by reason of death). The statute treats a partial transfer of S corporation stock as triggering only the Code Sec. 965 liability associated with the transferred stock and allows continued deferral of Code Sec. 965 liability if the transferee agrees to assume liability for the deferred Code Sec. 965 tax associated with the transferred stock.²

While the Code does include different forms of tax deferral, the indefinite deferral of net tax liability allowed under Code Sec. 965(i)—with the possibility of a triggering event at any point in the distant future causing the liability to come due—holds a somewhat unique position in the Code. Additionally, Code Sec.



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965(i) provides unique rules regarding the assessment of Code Sec. 965(i) deferred tax liability, as well as an extension of the statute of limitations for collections. These features of a Code Sec. 965(i) election raise interesting questions regarding when and how the Internal Revenue Service (“IRS”) could assert a tax liability with respect to which a taxpayer made a Code Sec. 965(i) election. This Note will explore those questions at a high level.

Statutory Framework for Assessment and Collection of Deferred Tax Liability Under Code Sec. 965(i)

As a general matter, Code Sec. 6201(a) directs the IRS to assess all taxes due under the Code, including taxes determined by the taxpayer or by the IRS as to which tax returns are made.³ The IRS must assess such tax within three years after the relevant return is filed⁴ and must begin collection proceedings within 10 years after the assessment of the tax.⁵ Code Sec. 965(k) additionally extends the time period for assessment of tax under Code Sec. 965 to the date that is six years after the return for the tax year to which the assessment relates.

Code Sec. 965 creates a somewhat unique creature in the Code—a floating tax liability that is determined based on facts of a past year and may be assessed at any point in the future upon the occurrence of a future event.

Special rules govern the assessment of Code Sec. 965 tax liability deferred under Code Sec. 965(i). In particular, Code Sec. 965(i)(1) provides that Code Sec. 965(i) deferred tax liability “shall be assessed on the return of tax as an addition to tax in the shareholder’s taxable year which includes such triggering event.” That is, in the case of a Code Sec. 965(i) election, the assessment of tax under Code Sec. 965 happens in the year of the triggering event, rather than the assessment occurring in the transition tax year and the payment of assessed tax merely being deferred (as is the case where a taxpayer elects under Code Sec. 965(h) to pay the transition tax in eight installments).

Interestingly, the mandate of Code Sec. 965(i)(1) that tax liability “shall be assessed” does not seem to have an analogue among other Code sections for determining tax liability, which generally depends on the IRS making an assessment of that tax liability under Code Sec. 6201. In the case of Code Sec. 965(i), the assessment of tax on the tax return for the triggering event year arguably happens by operation of the statute rather than by reason of an affirmative act by the IRS under Code Sec. 6201. Alternatively, Code Sec. 965(i) could be read in conjunction with Code Sec. 6501 as an instruction to the IRS to make the assessment of Code Sec. 965(i) deferred tax liability on the return for the year of the triggering event.

Given that Code Sec. 965(i) fixes the assessment in the year of the triggering event, it appears that the normal three-year assessment period in Code Sec. 6501 applies from the due date for the return for the year of the triggering event. Even if the assessment happens by operation of Code Sec. 965(i) rather than under Code Sec. 6501, any act by the IRS to perfect the assessment—as described in Code Sec. 6204—would seem to need to occur within the period prescribed under Code Sec. 6501. In general, the special six-year period of limitations under Code Sec. 965(k) generally should not be relevant for the assessment of Code Sec. 965(i) deferred tax liability, since the extension of the assessment under Code Sec. 965(k) keys off of the transition tax year tax return and not the triggering event year tax return.

It should also be noted that Code Sec. 965(i)(6) extends the normal statute of limitations on collection for Code Sec. 965(i) deferred tax liability. In particular, Code Sec. 965(i)(6) provides that any limitation on the time period for collection of a Code Sec. 965(i) deferred tax liability shall not be treated as beginning before the date of the triggering event with respect to such liability. Accordingly, the statute of limitations for collection of Code Sec. 965(i) deferred tax liability is generally 10 years from the date of the triggering event. It is unclear, however, what Code Sec. 965(i)(6) adds to the statutory scheme, since the assessment of Code Sec. 965(i) deferred tax liability happens in the year of the triggering event and Code Sec. 6502(a) provides a collection statute that runs for 10 years from the date of the assessment.

Managing Code Sec. 965(i) Deferred Tax Liability in Practice

Taxpayers that have made an election under Code Sec. 965(i) need to monitor for (and to the extent possible,

avoid) potential triggering events and consider how long the IRS has to assert a tax liability.

Assuming an S corporation shareholder made a valid Code Sec. 965(i) election, no tax will be assessed under Code Sec. 965 until the year of a triggering event. The amount of tax that is assessed on the occurrence of a triggering event is determined based on information that was reported on the tax return for the transition tax year. Fortunately, because the assessment does not occur until the triggering event year, no interest applies on the deferred tax amount for periods between the transition tax year and the year of the triggering event.

Because the assessment of transition tax does not occur until the triggering event year where a Code Sec. 965(i) election is made, the IRS presumably may propose adjustments to the assessed amount for up to three years from the date of the return for the year of the triggering event. Similarly, if the IRS determines that a triggering event occurred but was not reported as such by the taxpayer, the IRS would have three years from the due date for the return for the year of the purported triggering event to propose an adjustment.⁶ In that case, if the assessment is upheld, the applicability of underpayment penalties should be considered.

Although the IRS theoretically could assert that a taxpayer's Code Sec. 965(i) election was invalid, such that the Code Sec. 965 tax liability should have been included in the transition tax year, the IRS would have

been required under Code Sec. 965(k) to make an assessment within the six-year period following the return for the transition tax year. For most taxpayers, that statute of limitations for assessment has already passed.

In the event there is a triggering event with respect to a Code Sec. 965(i) deferred tax liability, Code Sec. 965(i)(4) offers a small bit of additional relief. That provision allows for the deferred Code Sec. 965(i) tax liability that is assessed as a result of the triggering event to be paid in installments over eight years, as taxpayers who made elections under Code Sec. 965(h) were permitted to do.

Conclusion

Code Sec. 965 creates a somewhat unique creature in the Code—a floating tax liability that is determined based on facts of a past year and may be assessed at any point in the future upon the occurrence of a future event. Perhaps, with the passage of sufficient time, Congress will consider whether it may make more sense to simply forgive the deferred liability rather than carry it into the distant future (although with inflation, the real value of the deferred liability will decline over time). In the meantime, taxpayers will need to continue to monitor for potential triggering events (under an unnecessarily broad regulatory definition) and be sure to satisfy annual reporting requirements under Code Sec. 965.

ENDNOTES

¹ Reg. §1.965-7(c)(3)(ii)(B) modifies the “substantially all” statutory prong of the triggering event definition in a way that does not obviously follow from the statute or the authority delegated under Code Sec. 965(o). In particular, the regulation includes an “exchange” or “other disposition” of substantially all of the assets of the S corporation as a triggering event, with the Treasury Department and the preamble pointedly declining to clearly scope

out nonrecognition exchange transactions like contributions under Code Sec. 351 or 368(a)(1)(F) reorganizations.

² Code Secs. 965(i)(2)(B) and (C).

³ The IRS may make a supplemental assessment under Code Sec. 6204 when it determines that any assessment is “imperfect or incomplete in any material respect.”

⁴ Code Sec. 6501(a).

⁵ Code Sec. 6502(a).

⁶ Although it could be argued that because the assessment of the transition tax liability occurs by operation of Code Sec. 965(i)(1), there is no need for the IRS to perfect the assessment within the three-year period in order to collect the deferred Code Sec. 965(i) liability, it is unclear how the IRS could collect an amount for which no assessment (self-assessment or otherwise) is formally made.

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