Section 965, Related Foreign Tax Credits, and the Use of Statistical Sampling in Support of Taxpayer Compliance

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The Tax Cuts and Jobs Act of ("TCJA") made major changes in U.S. taxation of foreign source income

- Under prior law, with important exceptions, the U.S. generally deferred the taxation of active business income of foreign subsidiaries of U.S. corporations until repatriated to U.S. shareholders.
- To avoid double taxation, previously paid or deemed paid foreign taxes are credited against U.S. tax on foreign source income. This foreign tax credit ("FTC") is subject to limitations to avoid offsetting U.S. tax on U.S. source income. If the foreign tax rate was less than the U.S. rate, then the FTC would not fully offset the U.S. tax.
- Because the U.S. had one of the highest corporate tax rates in the world, much foreign-source income was never brought back to the U.S. and this higher rate encouraged offshore rather than U.S. investment.
- Most other countries do not tax active business income of corporations earned outside their borders. This is often referred to as a territorial tax system.

The TCJA moves the U.S. towards a hybrid (or quasi-) territorial system, reduces the corporate tax rate, and imposes a “toll charge” on deferred earnings

- For post-2017 earnings, the TCJA:
  - Provides a 100% deduction for domestic corporations on foreign dividends paid from specified 10% owned foreign corporations – no FTC is allowed with respect to a qualified dividend
  - Subjects certain low-taxed active foreign business income to current U.S. tax under the GILTI
  - Reduces the federal corporate tax rate from 35% to 21%
- For pre-2018 accumulated earnings, new section 965 imposes a one-time “toll charge” and allows an FTC against this tax
  - The toll charge may be paid over 8 annual installments. For a calendar-year corporation with a 6-month extension returns are due by October 15
  - Proposed section 965 regs. were published August 1, 2018 and comments are due October 1 leaving little time for taxpayers to fully comply
  - It is likely that many tax returns will be amended and examined by the IRS

Section 965 basics

- Section 965 imposes a 15.5-percent rate of tax on accumulated post-1986 foreign earnings held in the form of cash or cash equivalents, and 8-percent rate of tax on all other earnings
- Accumulated earnings or deficits must be separately reported by each foreign corporation, and the toll charge is computed and reported by the U.S. shareholder on an aggregate basis
- Similarly, the U.S. shareholder must collect and analyze information from each foreign corporation where it has an ownership interest, obtain foreign income tax returns and proof of payment, and translate as necessary for the past 31 years
- The statute of limitations remains open for 6 years rather than the typical 3 years

Collecting and analyzing information on creditable foreign taxes will be administratively burdensome

- Large U.S. based multinational corporations ("MNCs") tend to have hundreds or thousands of CFCs and other foreign investments, each with multiple foreign tax returns and tax payments per year
- While the IRS may examine a taxpayer's documentation of foreign corporation taxes supporting FTCs claimed, many MNCs have not previously collected such documentation for earnings thought to be permanently deferred and foreign taxes for which credits were unlikely to be claimed
- With mandatory repatriation and the toll charge this information has now become relevant
- U.S. corporations with less than a majority shareholder interest may have particular difficulty in accessing a foreign corporation's records

Use of statistical sampling for determining potentially creditable foreign taxes

- While not a substitute for maintaining records, statistical sampling may reduce administrative burdens
- Rev. Proc. 2011-42 provides a sampling methodology
  - Generally allows taxpayers to use the same statistical sampling methodologies as the IRS (see IRM 4.47.3.3).
  - Provides a safe harbor – if taxpayers follow this methodology, the IRS will accept the sample as statistically valid
  - Limits information requested in examinations – the IRS generally will limit its review to the taxpayer’s sample and not select its own sample
  - Upon examination, the IRS may challenge the sufficiency of documentation and may disagree with the taxpayer’s interpretation of sample items, in which case the IRS will use the taxpayer’s sample to project a disallowance

Rev. Proc. 2011-42 methodologies are generally similar to SOI's, but with key differences

- The full population should be identified in advance and the sample results may be projected only to the population from which it has been selected
- Adequate support must be provided for each sampled item
- Four estimators are evaluated (mean, difference, combined ratio, and combined regression) and the estimator with the best statistical properties, generally the estimator with the lowest standard error, is selected
- If the sampling error exceeds 10% of the projected amount at a 95% (one-sided) level of confidence, the projected amount will be adjusted for sampling error to the least favorable limit; i.e., in the direction least favorable to the taxpayer for a taxpayer sample, or least favorable to the IRS for an IRS sample
- This sampling error adjustment provides an incentive to use a sample design and sample size adequate to assure reasonable precision