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Expedition Section 965(k): A Journey Through the Extended Statute of Limitations

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The three-year examination window to assess additional tax on 2017 and 2018 timely filed returns, including extensions, generally has passed under §6501(a).¹ To better equip IRS examiners with the tools necessary to identify §965 issues (the “§965 transition tax”), which allows for an extended six-year statute of limitations on assessment under §965(k) (the “§965 extended assessment period”) to make §965 transition tax adjustments, the IRS’s Large Business and International (“LB&I”) division released updated interim guidance in Memorandum LB&I-04-0922-0019 (Sept. 21, 2022) (referred to as the “2022 memo”). The updated interim guidance,

which also incorporates previous guidance on Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and Bipartisan Budget Act of 2015 (BBA) examination issues, serves to ensure IRS agents do not fail to utilize the §965 extended assessment period applicable to the transition tax when appropriate.

This article takes practitioners on an expedition commencing with the background on the §965 transition tax and then delves into the new guidance provided within the 2022 memo.

The 2022 memo updates and supersedes prior interim guidance provided by LB&I in Memorandum LB&I-04-1120-0020 (Nov. 17, 2020). The 2022 memo guidance slightly modifies the prior guidance by briefly discussing how the limitations period in §965 examinations applies to the situation in which an S corporation shareholder makes an election under §965(i) to defer the tax liability until a triggering event. The 2022 memo makes reference to other LB&I memoranda for more specified guidance on the application of the §965 extended assessment period to TEFRA and BBA partnership examinations.

After the reader tours the history behind the §965 transition tax, the reader embarks on a journey into the guidance provided in the 2022 memo by discussing the general application of the §965 extended assessment period to taxpayers that do not fall under the special procedural guidelines as provided in TEFRA and BBA examinations. Next, this article provides practitioners with practical pointers on the application of the §965(k) statute of limitations with respect to the §951 calculation. The tour of the 2022 memo ends with a brief discussion on the application of the §965 extended assessment period to TEFRA and BBA exams via reference to other LB&I memos.

After discussing the contents of the 2022 memo and providing the examples, this article takes readers along on a TEFRA and BBA journey wherein LB&I discusses the specific implication in those cases by delving into two separately issued LB&I interim guidance memoranda from August 20, 2021.

BACKGROUND

U.S. multinational companies are affected by the mandatory §965 transition tax, which treats untaxed

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¹ All section references herein are to the Internal Revenue Code of 1986, as amended (the Code), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

foreign earning and profits of certain foreign corporations as being deemed repatriated generally in either the 2017 or 2018 tax years. Under §965, U.S. shareholders are required to pay a one-time transition tax on the untaxed foreign earnings of specified foreign corporations, as if those earnings had been repatriated to the United States under §965. In general, specified foreign corporations are defined as controlled foreign corporations (CFCs) or a foreign corporation (other than a passive foreign investment company, that is also not a CFC) that has a U.S. shareholder that is a domestic corporation. Section 965 liability is generally applicable to 2017 and/or 2018 tax years, and in some instances the 2019 tax year when involving certain pass-through entities (the “inclusion year”). A taxpayer may elect under §965(h) to pay the transition tax liability in installments over an extended eight-year period.

The §965 transition tax is included in the LB&I’s active compliance campaigns, as the “IRC 965 Campaign” and the “IRC Section 965 Individuals Campaign.” The goal of these two campaigns is to promote compliance with §965 by increasing examinations as well as by providing technical assistance to teams examining §965, with a focus on identifying and addressing taxpayer populations with potential material compliance risk.

LB&I 2022 MEMO

Statute of Limitations

The extended statute of limitations period that is applicable to §965 transition tax adjustments affects taxpayers by extending the period in which the taxpayers’ 2017 or 2018 returns are subject to examination and adjustment on the transition tax liability component of such returns. The IRS issued updated guidance in the 2022 memo to provide additional direction to examiners in applying the §965 extended assessment period to the transition tax component of a return. The memo clarifies that the six-year extended statute is only applicable to the §965 component of the return. According to the memo, issues that may warrant an adjustment, unrelated to §965, are subject to the regular three-year statute of limitations as provided by §6501(a), or extended statute of limitations applicable to substantial omissions provided by §6501(e) (another, separate and distinct, six-year statute of limitations which applies to the entire return).

Of note is that the 2022 memo indicates a subpart F oversight in an §965 calculation may, however, separately trigger application of the assessment period of limitations provided by §6501(e)(1)(C), thus keeping the assessment statute open *for the entire return*

for six years. This position is in line with a recent Chief Counsel Advice memorandum which interpreted §6501(e)(1)(C) as applying to all items on a tax return and not just those items related to omitted Subpart F income.² Although the IRS position is not necessarily a surprise, it is concerning in that a possible immaterial omission in an inclusion calculation could trigger the entire return to an extended assessment period.

Further, the 2022 memo clarifies at what point the §965 extended assessment period begins to run in cases involving nuances implicated in §965. For instance, under the memo, where taxpayers elect under §965(h) to pay the tax liability in installments over an eight-year period, the six-year statute of limitation begins to run from the date the return for the inclusion year was filed, i.e., the year the liability was incurred, and not from the date of the returns for the installment payment years. However, if a separate §965 liability arises during a payment year, a new six-year statute of limitations would run with respect to that year. In the case of an S corporation shareholder making an election under §965(i) to defer liability until a triggering event, the memo provides the statute of limitations runs based on the inclusion year, not the triggering event year.

The 2022 memo also provides general recommendations for examiners when approaching a statute of limitations on assessment deadline, whether it be a three-year or extended six-year period of limitations. As explained in the memo, the decision to let a statute of limitations period expire, rather than soliciting an extension from the taxpayer, must be thoroughly documented, discussed, and approved in writing, and be based on the government’s best interest. The memo does clarify an examination may proceed on a §965 issue for which the six-year limitations period remains open, but where the three-year limitations period for the wider return has expired.

Subpart F Examples

Before this article embarks on the exploration of TEFRA and BBA examinations with §965 transition tax implications, we will provide a couple practical examples involving the extended assessment period involving subpart F calculations

C is a U.S. corporation and as a parent company of a CFC must report its pro rata share of subpart F income. Under §965(a), a CFC generally must increase its share of subpart F income by accumulated E&P. C has 100x of regular subpart F income, as defined under §952, and increased its 2018 Subpart F Income by

² See CCA 202142009.

25x for its §965(a) inclusion. C made an error in calculating its E&P and its correct §965(a) inclusion was 50x E&P. The subpart F component plus §965 tax should have been 150x rather than 125x. Because the 25x understatement is only limited to the §965 limitation, only that portion of the return will have an extended six-year statute of limitations.

Same facts as above, except C understated its 100x of subpart F income, as defined under §952, only reporting 75x. C also included 50x of deferred foreign income pursuant to §965(a). Because the understatement is attributable to subpart F items, as defined under §952, it appears the IRS would argue the §6501(e)(1)(C) statute of limitations applies and the entire return is subject to an extended six-year statute of limitation.

TEFRA and BBA Partnerships

Towards the end of the 2022 memo, the IRS briefly discusses application of the §965 extended assessment period to partnerships and partners subject to the special procedural rules under the TEFRA or BBA regimes.

With respect to examinations involving TEFRA and BBA partnerships, the 2022 memo directs IRS employees to refer to the interim guidance released in August 2021 in Memorandum LB&I-04-0821-0010 (“2021 TEFRA memo”) and Memorandum LB&I-04-0821-0009 (“2021 BBA memo”), each dated August 20, 2021. Employees must follow the detailed steps set forth in those memoranda for all TEFRA and BBA partnership cases in the IRC 965 Campaign or IRC 965 Individuals Campaign, and in other cases where a TEFRA partnership (or investor) or BBA partnership incorrectly calculated its §965 Net Liability, or failed to report §965 inclusion, deduction or tax.

2021 TEFRA MEMO

In the 2021 TEFRA memo, the IRS provides detailed guidance with respect to applying the §965 extended assessment period to examinations involving partnerships governed by TEFRA. The TEFRA procedures govern the examination of partnership items on partnership returns filed for tax years prior to 2018. As the §965 transition tax is generally applicable to the 2017 tax year, the TEFRA procedures are relevant for those partnerships and partners selected for exam for the 2017 tax year.

The statute of limitations for the IRS to assess tax attributable to TEFRA partnership items can be complicated, even without consideration of §965(k). The baseline rule is that the IRS has a minimum of three years from the filing date of the partnership return to

assess tax attributable to TEFRA partnership items (the “partnership-level statute”). However, there are situations after the three-year partnership-level statute has expired when the IRS is still able to assess tax against certain partners. A partner has its own §6501(a) statute of limitations for the IRS to assess income tax against the partner (the “partner-level statute” — generally three years from the filing of the partner’s return). So long as the partner-level statute is open, the IRS can assess tax on that partner’s share of any partnership items even if the partnership-level statute is closed. For example, if a 2017 partnership return was filed on March 15, 2018, and partner A filed its own 2017 income tax return on October 15, 2018, the IRS would generally have had until October 15, 2021, to assess tax attributable to A’s partnership items (notwithstanding the expiration of the partnership-level statute on March 15, 2021).

It seems safe to say that the partnership-level statute for most 2017 tax years expired at some point in 2021. However, the 2021 TEFRA memo highlights that for partners subject to §965, the closing of the partnership-level statute is of little comfort due to the §965 extended assessment period. The 2021 TEFRA memo makes clear that although the §965(k) extended statute of limitations does not extend the partnership-level statute, the §965 extended assessment period does provide a separate six-year statute of limitations for assessing a partner’s §965 net tax liability. A fair reading of the memo suggests that to the extent the partner’s §965 net tax liability, or a portion of such liability, is attributable to a TEFRA partnership item, the IRS has at least six years to assess the partner’s §965 net tax liability even if the partnership-level statute has expired. The 2021 TEFRA memo recognizes there may be situations where the partnership return may be assigned for examination after the partnership-level statute has expired. In those cases, the revenue agent must notate the file that the case is being opened pursuant to the partner’s six-year statute under §965(k) and not the partnership-level statute.

2021 BBA MEMO

In August 2021, LB&I also released specific guidance with respect to applying the §965 extended assessment period in the case of partnerships governed by the BBA regime. The 2021 BBA memo pertinently affects adjustments to the 2018 tax year, as this was the first year subject to the BBA regime (absent an election to apply BBA to the 2017 tax year).

Under BBA, any adjustment to a partnership-related item (a “partnership adjustment”) must be

made at the partnership level.³ The 2021 BBA memo concludes that §965(a) inclusion amounts and §965(c) deduction amounts are partnership-related items of the partnership for the taxable year in which they are required to be reported because these amounts “are required to be shown on the return of the partnership or maintained in its books and records and are relevant in determining the liability of any person under chapter 1 (i.e. the corresponding [§]965(a) inclusions, [§]965(c) deductions, and foreign tax amounts reported by the partners).”

In general, under §6235(a), the period of limitations for the IRS to make a partnership adjustment is three years from the filing date of the partnership return (the “BBA adjustment period”). Section 6235(c) provides special exceptions to this general BBA adjustment period. Relevant to §965, §6235(c)(2) provides an extended six-year statute of limitations to make a partnership adjustment if the partnership omits from income an amount required to be included under §951(a), e.g., a §965(a) inclusion amount. It seems clear, based on the 2021 BBA memo, the IRS would take the position that §6235(c)(2) provides a period of six years for the IRS to adjust the partnership return to reflect an omitted §965(a) inclusion amount.

But is that all the IRS may adjust on the partnership return? Would the IRS argue that the entire partnership taxable year is subject to *any* partnership adjustment based on an omission of a §965 inclusion (similar to the argument the IRS has made with respect to §6501(e)(1)(C))? The 2021 BBA memo does not provide a clear answer to that question. The memo does affirmatively state that “if any adjustments are needed to [a §965(a) inclusion amount] reported by a BBA partnership, the IRS would have six years under [§]6235(c)(2) to make adjustments as opposed to three years.” This statement could be read to suggest the IRS reads §6235(c)(2) as providing a six-year adjustment period for “any adjustments [that] are needed” to a §965(a) inclusion amount, but not for other, unrelated adjustments. This statement also appears to assume that the partnership omitted an inclusion amount that was properly includible in gross income; however, that fact is not clearly stated.

³ §6221.

The 2021 BBA memo also addresses the interaction of §965(k) with partnership adjustments under the BBA. The memo states that §6235 provides a period of limitations on making *adjustments* to partnership-related items, and not a period of limitations on making *assessments*, with the result that “[§]6235 does not affect the time to assess any tax attributable to a [partnership] adjustment.” (emphasis added) Conversely, according to the memo, §965(k) does not affect the period of limitations of making adjustments under §6235 as §965(k) only provides a minimum period to assess the 965 net tax liability. The memo plainly states that “[e]ven if [§]965(k) extended a partner’s period of limitations on assessment for a particular year with respect to a net tax liability under [§] 965, this would not extend the IRS’s ability to make adjustments with respect to the partnership if the [§]6235 period was closed.” Based on these statements in the memo, it appears the IRS believes that both the BBA adjustment period and the partner’s §965 extended assessment period would need to be open in order for the IRS to assess §965 net tax liability attributable to a BBA partnership adjustment (or it may be the case the partner’s regular §6501 statute of limitations is still open).

CONCLUSION

The IRS’s 2022 memo provides insight into examiners’ approach with respect to initiating examinations on tax returns which have §965 transition tax implications. For the most part, application of the extended assessment period under §965(k) is limited to the §965 transition tax component of the return. However, as discussed, a §965 transition tax component may be a part of a larger issue which under the “regular” statute of limitations, pursuant to §6501(e)(1)(C) and §6235(c)(2) (the latter relating to BBA partnerships) is subject to an extended six-year assessment period for the entire return if there is an understatement of tax pertaining to §951. It is key to track those nuances to determine a taxpayer’s exposure to examinations and whether an entire return is subject to examination in an extended six-year assessment period.