

**Highlights:**

- The Net Section 965 Inclusion Amount (defined below) must be included in a corporate taxpayer's federal taxable income or an individual taxpayer's federal adjusted gross income. For many corporate taxpayers, this amount could be offset in whole or in part as nonbusiness income, non-Missouri Dividends, or as part of the Missouri Dividends Deduction.
- Most taxpayers electing to pay the Transition Tax over multiple installments must include the full amount of the Transition Tax in calculating their federal income tax deduction in the first year the taxpayer becomes liable for the Transition Tax.
- Taxpayers must include any federally-required Transition Tax Statement when filing their original or amended Missouri return for tax years 2016 or 2017.

***The New Federal Transition Tax May Affect Taxpayers' Missouri Income Tax Computation***

On December 22, 2017, President Trump signed PL 115-97, popularly known as the Tax Cuts and Jobs Act ("TCJA"). Included in the TCJA is the requirement, generally speaking, that taxpayers must pay a Transition Tax on certain past earnings of their specified foreign corporations (SFCs).<sup>1</sup> The Transition Tax is first computed by taking the U.S. taxpayer's portion of these past foreign earnings – the "Repatriation Amount" – and including it in the taxpayer's federal Subpart F Income pursuant to IRC §§ 965(a) and 951. The Repatriation Amount is reduced by certain foreign losses during the same period under IRC § 965(b) (the "965(b) Reduction"), and a deduction is also allowed under IRC § 965(c) that depends on the SFCs' cash position compared to other assets (the "965(c) Deduction"). Throughout this guidance, the Repatriation Amount less the 965(b) Reduction and 965(c) Deduction is referred to as the "Net Section 965 Inclusion Amount." Taxpayers may be provided with a foreign tax credit associated with the

Repatriation Amount, and Section 965 may also impact a taxpayer's "Section 78 Gross-Up."<sup>2</sup>

For many taxpayers, the TCJA allows the taxpayer to elect to pay its federal income tax liability resulting from the Transition Tax provision in eight installment payments.<sup>3</sup> The TCJA's Transition Tax provision may apply to taxpayers in tax years 2016, 2017, or 2018.<sup>4</sup>

***Guidance for Missouri Corporate Income Taxpayers***

The IRS has released guidance requiring many federal corporate income taxpayers to complete a Transition Tax Statement, and to refrain from entering the Repatriation Amount and 965(c) Deduction on federal Form 1120.<sup>5</sup> Instead, the IRS instructs these taxpayers to calculate the tax liability attributable to the Transition Tax (the "net tax liability") and enter it on federal Form 1120, Page 3, Schedule J, Part 1, Line 11.<sup>6</sup> The IRS further instructs such taxpayers who elect to pay the Transition Tax in installments to enter the net tax liability to be paid in installments on federal Form 1120, Page 3, Schedule J, Part II, Line 19d.<sup>7</sup>

<sup>1</sup> "Specified Foreign Corporation" is defined in IRC § 965(e), and includes, among other things, controlled foreign corporations.

<sup>2</sup> See IRC §§ 78, 965(g).

<sup>3</sup> IRC § 965(h).

<sup>4</sup> See "Questions and Answers About Reporting Related to Section 965 on 2017 Tax Returns," IRS, available at <https://www.irs.gov/newsroom/questions-and-answers-about-reporting-related-to-section-965-on-2017-tax-returns> (last reviewed or updated

October 2, 2018) (hereinafter cited as "IRS Q&A"). The IRS has provided an example of a situation in which the Transition Tax would apply to tax year 2016. See Publication 5292 at pgs. 2-3, 5, IRS (April 6, 2018), available at <https://www.irs.gov/pub/irs-pdf/p5292.pdf>.

<sup>5</sup> IRS Q&A.

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

Under the TCJA, the Repatriation Amount is included in the taxpayer's share of Subpart F Income, and therefore is included in the taxpayer's federal taxable income. Notwithstanding the above-described IRS guidance, Missouri corporate income taxpayers must include the Net Section 965 Inclusion Amount in federal taxable income on MO-1120, Line 1. Missouri corporate income taxpayers must also include the Section 78 Gross-Up Amount associated with the Transition Tax provision in MO-1120, Line 1. Missouri corporate income taxpayers must attach or electronically include any federally-required Transition Tax Statement when filing the Missouri corporate income tax return.

Because it is Subpart F Income, the Repatriation Amount is treated as a dividend for Missouri purposes.<sup>8</sup> For corporate taxpayers apportioning using Method One, Three Factor Apportionment, if the Net Section 965 Inclusion Amount constitutes the taxpayer's business income, an apportioned share of this amount may be subtracted through the Missouri Dividends Deduction on MO-1120, Line 10.<sup>9</sup> To the extent the Net Section 965 Inclusion Amount is nonbusiness income, the amount should be included on Forms MO-NBI and MO-MS, Part 1, Lines 9 or 12. It is imperative that taxpayers reporting nonbusiness income include on MO-NBI a sufficiently detailed description of their business, the nonbusiness income, and explanation of why the income is reported as nonbusiness income. Identifying that the income was part of the Net Section 965 Inclusion Amount is not itself a sufficient explanation as to why it is being treated as nonbusiness income. Failure to do so will result in the Department's Taxation Division disallowing the reported nonbusiness income amount. The Net Section 965 Inclusion Amount does not constitute property or payroll for purposes of computing the apportionment factor using Three Factor Apportionment. To the extent it is not allocated, the Net Section 965 Inclusion Amount should be included in the sales factor for Three Factor Apportionment purposes if it qualifies as a sale pursuant

to 12 CSR 10-2.045(19), 12 CSR 10-2.075(42), and/or 12 CSR 10-2.075(64)(c).

Any treatment of this amount as a sale may be disallowed in order to fairly apportion income.<sup>10</sup> Missouri's enactment of the Multistate Tax Compact authorizes the Department to use a reasonable alternative apportionment method, as to any part of a taxpayer's business activity, in order to arrive at equitable allocation and apportionment.<sup>11</sup>

For corporate taxpayers using Method Two or Two A, an apportioned share of the Net Section 965 Inclusion Amount should be included in the Missouri Dividends Deduction, MO-1120, Line 10, to the extent it is attributable to sources within Missouri. To the extent that this amount constitutes dividends from a non-Missouri payor, it should be entered on MO-MS, Part 2, Line 12. To the extent this amount does not fall within either of these categories, it should not be included on MO-1120, Line 10 or MO-MS, Part 2, Line 12. The Net Section 965 Inclusion Amount generally does not constitute sales or business transacted for purposes of calculating the numerator or the denominator of the Method Two or Two A apportionment factors.<sup>12</sup>

The Section 78 Gross-Up Amount associated with the Transition Tax provision is also a deemed dividend for Missouri purposes.<sup>13</sup> The same guidance regarding the Net Section 965 Inclusion Amount in the preceding two paragraphs applies to the Section 78 Gross-Up Amount associated with the Transition Tax.

The Transition Tax leads to an increase in federal income tax liability. In calculating the federal income tax deduction, the full net tax liability (the tax liability attributable to the Transition Tax) must be used, even if the taxpayer has elected to pay the net tax liability in installments. In light of the IRS guidance referenced above, the taxpayer must enter the full amount of federal Form 1120, Schedule J, Line 11 onto MO-1120, Part 3, Line 1.<sup>14</sup> Because the taxpayer does not separately include the foreign tax credit attributable to the Transition Tax on

<sup>8</sup> See *Dow Chem. Co. v. Dir. of Revenue*, 787 S.W.2d 276, 286 (Mo. 1990).

<sup>9</sup> See *id.* at 286, n. 16.

<sup>10</sup> See 12 CSR 10-2.075(43).

<sup>11</sup> See RSMo. § 32.200, Art. IV, Section 18.

<sup>12</sup> Cf. RSMo. §§ 143.451.2(2)(b); 143.451.2(3)(b).

<sup>13</sup> See *Dow Chem. Co. v. Dir. of Revenue*, 787 S.W.2d 276, 286 (Mo. 1990).

<sup>14</sup> See RSMo. § 143.171.

federal Form 1120, it must calculate its foreign tax credit attributable to the Transition Tax and enter it on MO-1120, Part 3, Line 2.<sup>15</sup> The taxpayer **must not** include on any of MO-1120, Part 3, Lines 1 through 3 the amount of future Transition Tax installments included on federal Form 1120, Page 3, Schedule J, Line 19d.

Special Guidance for Consolidated Taxpayers Filing Separately in Missouri (“Consolidated Federal and Separate Missouri Return”):

Taxpayers filing a consolidated federal return and separate Missouri corporate income tax returns should follow the guidance in the paragraphs above with the following modifications.

The separate company that is a member of an affiliated group for federal return purposes must determine its Net Section 965 Inclusion Amount as if it filed a separate federal corporate income tax return for the same tax year. For example, if the separate company held no ownership percentage of its affiliated group’s SFCs, it would have no Net 965 Inclusion Amount for Missouri purposes. Conversely, if only one corporation within the affiliated group held all of the affiliated group’s ownership interest in SFCs, that corporation would include the full Net Section 965 Inclusion Amount in its federal taxable income for Missouri purposes.

When calculating the separate company’s federal income tax deduction, the separate company federal taxable income, including the Net Section 965 Inclusion Amount determined to be included in its federal taxable income under the paragraph above, should be entered on MO-1120, Part 3, Line 4. To determine the amount of all positive separate company federal taxable incomes to include on MO-1120, Part 3, Line 5, a pro forma federal Form 1120 must be prepared for each separate company with positive federal taxable income due to the Net Section 965 Inclusion Amount determined in accordance with the paragraph above. Separate companies with pro forma positive federal taxable income only by reason of

the Net Section 965 Inclusion Amount must also be included in calculating MO-1120, Part 3, Line 5.

Special Guidance for Real Estate Investment Trust Corporations (“REITs”):

Missouri corporate income taxpayers that are Real Estate Investment Trusts (REITs) should follow the general guidance for corporations given above, with the following modifications.

Under IRC § 965(m), special rules apply to REITs subject to the Transition Tax provision. A REIT is permitted to elect that portions of its Net Section 965 Inclusion Amount be included in its gross income, and therefore taxable income on the federal level, over a series of years.<sup>16</sup> REITs making this election and subject to Missouri Corporate Income Tax should compute their federal taxable income on MO-1120, Line 1 by including only the portion of the Net Section 965 Inclusion Amount that was included at the federal level. In calculating the federal income tax deduction, REITs should include their tax liability attributable to that year’s Net Section 965 Inclusion Amount in addition to their ordinary federal income tax liability on MO-1120, Part 3, Line 1.

*Guidance for Missouri Individual Income Taxpayers*

Individual income taxpayers may be subject to the Transition Tax provision to the extent that they are U.S. shareholders of SFCs.<sup>17</sup> The IRS has released guidance requiring such individual income taxpayers to complete a Transition Tax Statement.<sup>18</sup> The IRS instructs individual income taxpayers to include their Net Section 965 Inclusion<sup>19</sup> in “Other Income” on federal Form 1040, Line 21.<sup>20</sup> Therefore, this amount will already be included when an individual reports his or her federal adjusted gross income on Form MO-1040, Line 1. Individual income taxpayers must attach or electronically include

<sup>15</sup> See *id.*

<sup>16</sup> IRC § 965(m)(1)(B).

<sup>17</sup> See IRC §§ 965(a) & 965(e);

<sup>18</sup> See IRS Q&A.

<sup>19</sup> The Net Section 965 Inclusion amount should include “distributive shares and pro rata shares of section 965(a) inclusion amounts of domestic partnerships, S corporations, and

other passthrough entities” and subtract “distributive shares and pro rata shares of deductions under Section 965(c) of domestic partnerships, S corporations, and other passthrough entities.” See IRS Q&A.

<sup>20</sup> See *id.*

any federally-required Transition Tax Statement when completing their Missouri individual income tax return.

For purposes of the federal income tax deduction, individuals should include in their federal income tax liability the full amount of their net tax liability incurred in that tax year, even if they have elected to pay their net tax liability over multiple installments. The taxpayer may not carry forward or backward an amount of net tax liability even if the limit on the taxpayer's federal income tax deduction has been reached. For individual income taxpayers who elect to pay their net tax liability in installments, IRS Guidance requires that taxpayers reduce the amount of tax on federal Form 1040, Line 44 by the amount deferred under IRC § 965(i) (relating to S corporations).<sup>21</sup> Missouri individual income taxpayers filing amended 2017 Missouri returns should add the amount deferred under IRC § 965(i) back in to their federal income tax liability on MO-1040, Line 11. For 2016 Missouri amended return filers, the deferred amount should be added to MO-1040, Line 10. Individuals receiving a foreign tax credit attributable IRC § 965 should be sure to include that foreign tax credit amount when calculating their federal income tax deduction.

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<sup>21</sup> See *id.*