

CLIENT ALERT

IRS Expected to Issue Section 965 Audit Notifications Soon

Jan.08.2020

Taxpayers may soon start receiving audit notifications with respect to the Section 965 transition tax. The IRS previously announced its intention to issue tax return review notifications beginning January 1, 2020. These audits will be pursuant to the Section 965 compliance campaign that the IRS announced in November 2019. Accordingly, taxpayers who had reported the transition tax should be prepared for an audit of their calculation as well as other items on their returns.

Background

In general, section 965 requires U.S. shareholders, as defined under Code section 951(b), to pay a one-time toll charge, or transition tax, on offshore profits accumulated since 1986. Under the transition tax, these earnings are deemed to have been repatriated to the United States, and are taxed at a rate of 15.5 percent for cash holdings or other liquid assets, or 8 percent for reinvested income.

Section 965 applies to the last taxable year of the relevant specific foreign corporation that begins before January 1, 2018, and the amount included in income under section 965 is includible in the U.S. shareholder's income in the tax year in which or within which such a specific foreign corporation's year ends. Although under section 965(h) affected companies were given the option of paying the tax interest-free over eight years, the vast majority of section 965 liabilities are expected to arise on corporate tax returns for 2017 and 2018.

When it enacted section 965, Congress expected the transition tax to raise more than \$338.8 billion of revenue. So far the section 965 revenue actually collected is much lower than expected. In May 2019, we stated that this revenue gap would likely lead to enhanced compliance efforts by the IRS (see article [here](#)). In November 2019, the IRS announced on its website a campaign to promote compliance with section 965 (see IRS announcement [here](#)).

Focus of Campaign

The new campaign provides few details on what specifically will be the focus of the IRS in section 965 exams. It is anticipated that this campaign will focus on (1) computational issues, such as the calculation of the accumulated earnings and profits of the foreign corporations and the amount of the estimated tax paid and the foreign tax credits claimed by U.S. taxpayers; (2) definitional issues such as determining what constitutes cash and cash equivalents; and (3) the anti-abuse rules in Treas. Reg. section 1.965-4 relating to reducing the section 965 inclusion.

The campaign will focus on large section 965 inclusion taxpayers and will use filters to identify other potential high-risk filers – for example, those who filed Forms 5471 with positive earnings and profits.

The campaign will include conducting examinations as well as providing technical assistance to IRS teams on examining returns for section 965 compliance, with a focus on identifying taxpayer populations with potential material compliance risk. The

campaign will start with 2017 returns; however, taxpayers chosen for audit likely will have their 2018 returns examined as well. It is anticipated that returns selected as part of the 965 campaign will also be examined for other material issues, especially issues related to TCJA planning.

Other Material Issues to be Examined

For returns selected for review under the campaign, the IRS will ask examiners to look at other international provisions of the TCJA, especially for 2018, and examine those issues where appropriate.

Current and Expected Litigation

The section 965 regulations are currently being challenged in the U.S. District Court for the District of Columbia as procedurally invalid under the Administrative Procedure Act; the Paperwork Reduction Act, which requires that agencies offer factual support for their certification that a regulation minimizes small businesses' compliance burdens; and the Regulatory Flexibility Act, which requires federal agencies to perform and publicly release an analysis of a regulation's effects on small businesses and the appropriateness of simplified compliance requirements or exemptions. On December 24, 2019, the district court denied the government's motion to dismiss this litigation for lack of standing and subject matter jurisdiction. *See Monte Silver and Monte Silver Ltd. v. IRS*, No. 19-cv-00247 (D.D.C.).

The IRS has indicated that, based on its interaction with Compliance Assurance Process taxpayers, it expects litigation on substantive 965 issues.

Next Steps

Taxpayers had to file their tax returns for 2017 without the benefit of final regulations under section 965, which were issued in January 2019. Because more information about the IRS's positions is now available, taxpayers should consider amending their previously filed returns where appropriate to eliminate potential audit issues. Taxpayers should also begin thoroughly preparing, pre-audit for the section 965 issues that the IRS will likely focus on during audit.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

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