

Audits May Increase For US Shareholders Of Foreign Cos.

By **David Fischer and Teresa Abney** (June 21, 2019, 1:45 PM EDT)

Although taxpayers have already calculated and reported their Section 965 deemed repatriation tax, Section 965 will have a continuing impact. First, taxpayers are well advised to review their approach to estimated taxes. The IRS refuses to issue refunds of overpaid income taxes to taxpayers who elected to pay Section 965 taxes in annual installments, effectively penalizing taxpayers who conservatively overpay estimated taxes. Second, the IRS plans extensive enforcement efforts. A recent U.S. Treasury Inspector General for Tax Administration report highlights these issues, including recommendations for the IRS concerning the IRS enforcement plan.



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Overview: The Deemed Repatriation Tax

Section 965 of the Internal Revenue Code, as enacted by the Tax Cuts and Jobs Act of 2017, required U.S. shareholders of “specified foreign corporations,” or SFCs, to pay a one-time tax on the SFC’s untaxed foreign earnings as if those earnings had been repatriated to the United States in the SFC’s last tax year beginning before Jan. 1, 2018.[1]



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Section 965 required taxpayers to include in gross income their share of the SFC’s undistributed and previously untaxed post-1986 foreign earnings and profits.[2] Foreign earnings attributable to cash and cash equivalents are taxed at a 15.5% rate; foreign earnings attributable to all other assets are taxed at an 8% rate.[3]

Congress recognized that the imposition of current tax on potentially 31 years of accumulated foreign earnings could result in extremely large tax bills — at the time of enactment, it was estimated that some companies would have Section 965 tax liabilities in the billions. To soften the blow, Congress permitted taxpayers to elect to pay the one-time tax in interest-free installments over 8 years: 8% of the tax in years 1 through 5, 15% of the tax in year 6, 20% in year 7 and 25% in year 8.[4] Unpaid remaining installments are accelerated and due if an installment payment is missed, the taxpayer liquidates or sells substantially all of its assets or the business ceases operation.[5]

No Refunds While Deemed Repatriation Tax Unpaid, IRS Says

By making the tax payable in installments, and providing that the installments increase over the eight year period, it is clear that Congress intended taxpayers to be able to plan for the potentially large

Section 965 repatriation tax. Unfortunately, such cash flow planning may be frustrated by the IRS' position that it cannot issue refunds to companies who have elected to pay the repatriation tax in installments. The IRS claims in such circumstances there is no "overpayment" of taxes under Section 6402 because, in the case of taxes payable in installments, Section 6403 requires the IRS to apply an overpayment of an installment against future unpaid installments.[6]

In May 2019, TIGTA released a report evaluating the IRS' implementation of the Section 965 repatriation tax.[7] TIGTA concluded that the IRS did not clearly inform taxpayers of its position that it could not refund overpayments and did not timely advise taxpayers how to calculate their Section 965 repatriation tax liability.[8] At least 115 taxpayers made \$2.8 billion in payments towards the Section 965 repatriation tax liability that they would not have made if they had been fully informed.[9] TIGTA did not contest whether the IRS was able to refund the tax but recommended that the IRS should inform the taxpayers that their excess remittances were applied to the deferred Section 965 tax liability.[10] The IRS agreed with TIGTA's recommendation and stated that during the 2018 filing season it issued manual notices to taxpayers whose refunds were applied toward their Section 965 tax liabilities.[11]

Taxpayers have urged Congress to clarify that overpayments are not applied to future Section 965 installment payments. In late 2018, a bill was introduced in the U.S. House of Representatives that expressly states that overpayments shall not be credited against a taxpayer's future Section 965 installment payments.[12] However, it remains unclear if this bill will ultimately be enacted.

In addition to a legislative fix, a judicial challenge to the IRS' position seems likely and may be successful. First, the IRS' position thwarts the clear intention of Congress. Congress did not intend taxpayers to pay more than the scheduled installment payment towards their repatriation tax liability. Second, the IRS' position, in addition to thwarting the intent of the statute, is arguably technically incorrect. Arguably, Section 6403 does not apply because the tax is not yet due or because estimated payments are not an overpayment toward the Section 965 tax.[13]

Many taxpayers are conservative when estimating their tax liability — opting to overpay their taxes to avoid underpayment penalties. Until there is judicial or legislative relief, taxpayers will have to balance the risk of underpayment penalties with the risk that they will not receive a refund of their overpayments.

Big Revenue Expectations for Section 965 Creates High Audit Risk

The deemed repatriation tax was intended to be one of the most significant revenue raisers of the Tax Cuts and Jobs Act. At the time of enactment, the Joint Committee of Taxation estimated that Section 965 would raise \$338.8 billion of tax revenue during fiscal years 2018 through 2027.[14] More than \$78 billion was expected to be raised in 2018 alone.[15]

The Section 965 revenue actually collected is much lower than expected. TIGTA reported that as of Nov. 8, 2018, taxpayers reported only \$30.2 billion in Section 965 tax and paid only \$11.2 billion (deferring \$22.7 billion).[16] Both TIGTA and the IRS believe these figures may be understated. The IRS said the numbers will likely change significantly because the IRS had not yet processed all the returns filed with extensions in October 2018.[17]

The lower than expected Section 965 revenue will likely trigger enhanced compliance efforts by the IRS. Even before these figures were known, the IRS had already identified Section 965 as an issue-focused compliance campaign and had assigned its most experienced tax examiners to manually process the

Section 965 returns.[18] The TIGTA report urged the IRS to do even more. TIGTA stated that “[i]t is essential that the IRS develop a service-wide compliance strategy to ensure compliance with Section 965 of the Act.”[19] TIGTA recommended that the comprehensive plan include:

- A strategy to identify taxpayers that did not properly comply with Section 965;
- An assessment of the benefit of issuing notices to those taxpayers that may be subject to Section 965 filing requirements;
- Procedures to monitor taxpayers that elected to defer the tax;
- Validation of Section 965 data reported by the taxpayer; and
- Steps to ensure that taxpayers did not violate anti-abuse rules.

TIGTA also suggested that the IRS use Form 5471, Information Return of U.S. Person With Respect to Certain Foreign Corporations, to identify taxpayers who should have reported the Section 965 tax but did not. TIGTA noted that taxpayers who filed Form 5471 may also be subject to the Section 965 tax.[20] Based on the number of returns filed with Forms 5471, TIGTA estimates that more than 51,000 filers may be subject to the Section 965 tax — significantly more than the approximately 31,000 filers who reported the Section 965 tax. [21]

What Does This Mean for Taxpayers?

First, taxpayers who elected the installment method should confirm that the IRS properly applied any overpayments to its deferred Section 965 tax liability. Such taxpayers should also take steps, if possible, to minimize potential overpayments of their income tax liabilities in future years. Taxpayers who are willing to challenge the IRS’ position should consider filing administrative refund claims with the IRS seeking a refund of their overpayments with interest. Given the IRS’ stated position, the IRS will likely deny the claim and the taxpayer would have to file in court, which admittedly could take a few years to resolve. However, if the court ultimately found that the IRS should have refunded the money with interest, that alone might make the litigation worthwhile, as no interest is due on Section 965 repatriation tax installment payments.

Second, taxpayers who filed Forms 5471 but did not report Section 965 repatriation tax should be prepared to explain to the IRS why they are not subject to the Section 965 tax.

Third, taxpayers who reported Section 965 tax and are otherwise under an IRS audit should expect inquiries about the Section 965 tax, and many who reported Section 965 tax should expect an audit of their Section 965 tax. An audit of the Section 965 repatriation tax could be extensive — potentially forcing companies to go through 31 years of earnings and profits and foreign taxes paid or accrued. Companies selected for audit should work with the IRS to minimize the burden, including the use of sampling.

The Section 965 audits will likely focus on two key issues related to the taxpayer’s calculation of the tax due: (1) the post-1986 accumulated earnings and profits, and (2) the amount of foreign earnings attributable to cash and cash equivalents.

The E&P amount directly determines the amount of the tax due. There are many complicated issues

involving the netting of positive and negative balances for different SFCs. The IRS is likely to inquire, even in easy cases, about the amount of E&P, adjustments that have been made, E&P carryforward balances, exchange rates used and SFC dividends. Taxpayers should not assume that just because they have reported E&P on Form 5471 year after year without audit that those amounts will be accepted by the IRS for purposes of Section 965.

Foreign earnings attributable to cash and cash equivalents are taxed at a rate almost twice the rate applicable to other earnings. The IRS is likely to examine which foreign earnings are attributable to cash and cash equivalents, and it will particularly focus on companies that elected to use a date to calculate earnings and cash position other than Nov. 2, 2017, or Dec. 31, 2017.[22]

Simply put, taxpayers should not assume that they are done with the one-time Section 965 tax — not only do installment payments continue for eight years, but issues about refunds and the calculation of the Section 965 repatriation tax will be ongoing for the next several years.

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[1] 26 U.S.C. § 965. A “specified foreign corporation” is a “controlled foreign corporation” (CFC) or any foreign corporation in which a U.S. person owns 10 percent or more of the voting power of all classes of voting stock or 10 percent of the total value of shares of all stock of a foreign corporation. 26 U.S.C. §965(e);26 U.S.C. § 951(b); 26 C.F.R. §1.965-1(f)(47).

[2] 26 U.S.C. §965(a).

[3] 26 U.S.C. §965(c).

[4] 26 U.S.C. §965(h)(1).

[5] 26 U.S.C. §965(h)(3). A buyer of substantially all the assets may avoid acceleration of future installments by entering into an agreement with the IRS that it is liable for all future installment payments.

[6] IRS PMTA 2018-016, Overpayments and I.R.C. §965(h) (August 2, 2018).

[7] Treasury Inspector General for Tax Administration, Implementation of the Tax Cuts and Jobs Act Deemed Repatriation Tax Presented Significant Challenges (May 22, 2019), available at <https://www.treasury.gov/tigta/auditreports/2019reports/201934033fr.pdf>.

[8] Id. at 5-6.

[9] Id. at 12.

[10] Id. at 12.

[11] Id. at 12.

[12] H.R. 88, 115th Cong. (2018), available at <https://www.congress.gov/bill/115th-congress/house-bill/88/text>.

[13] *Jones v. Liberty Glass Co.*, 332 U.S. 524, 531 (1947) (“Hence we read the word ‘overpayment’ in its usual sense, as meaning any payment in excess of that which is properly due.”).

[14] Joint Comm. on Taxation, JCX-67-17, Estimated Budget Effects Of The Conference Agreement For H.R. 1, The “Tax Cuts And Jobs Act” at 6, available at <https://www.jct.gov/publications.html?func=startdown&id=5053>.

[15] Id.

[16] Implementation of the Tax Cuts and Jobs Act Deemed Repatriation Tax Presented Significant Challenges at 15-16.

[17] Id.

[18] IRS Announces the Identification and Selection of Five Large Business and International Compliance Campaigns (July 2, 2018), <https://www.irs.gov/businesses/irs-announces-the-identification-and-selection-of-five-large-business-and-international-compliance-campaigns>; Implementation of the Tax Cuts and Jobs Act Deemed Repatriation Tax Presented Significant Challenges at 16.

[19] Implementation of the Tax Cuts and Jobs Act Deemed Repatriation Tax Presented Significant Challenges at 22.

[20] Id. at 20.

[21] Id. at 20, 15-16.

[22] See Treas. Reg. §1.965-7(f).