

Get Ready For IRS Repatriation Enforcement

By **David Fischer and Teresa Abney** (August 17, 2020, 6:06 PM EDT)

Beginning this fall, taxpayers should expect to see IRS enforcement efforts with respect to their Section 965 repatriation tax liabilities. The IRS has announced that it will soon start sending soft letters to taxpayers and placing other taxpayers in its audit pipeline. After some background on the repatriation tax, we discuss five things taxpayers should know about the upcoming Section 965 enforcement efforts.

In general, Section 965 required U.S. shareholders owning 10% or more of the vote or value of a specified foreign corporation to pay a one-time toll charge, or repatriation tax, on offshore profits accumulated since 1986.

Under the repatriation tax, these earnings were deemed to have been repatriated to the U.S., and were taxed at a rate of 15.5% to the extent of cash holdings or other liquid assets or 8% to the extent reinvested. Credits for foreign taxes were permitted, to reduce double taxation, subject to limitations. Specified foreign corporations include essentially all foreign corporations with a corporate shareholder and controlled foreign corporations owned by individuals.

Section 965 applied to the last taxable year of the specified foreign corporation that began before Jan. 1, 2018, and the amount included in income under Section 965 was includable in the U.S. shareholder's income in the tax year in which such specific foreign corporation's year ended.

Here are five things to know about Section 965 and IRS enforcement efforts:

1. Section 965 has not generated as much revenue as predicted.

When it passed the Tax Cuts and Jobs Act, Congress expected the repatriation tax to be one of the most significant revenue raisers of the act. At the time of enactment, the Joint Committee on Taxation estimated that Section 965 would raise \$338.8 billion of tax revenue during fiscal years 2018 through 2027.[1] It expected to raise \$78 billion in 2018 alone.[2]

Although the final statistics are not yet available, initial reports indicate that Section 965 may raise significantly less revenue than expected. The first report, published by the Treasury Inspector General



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for Tax Administration in May 2019, stated that, as of Nov. 8, 2018, taxpayers reported only \$30.2 billion in Section 965 tax, reporting \$22.7 billion deferred, and paid only \$11.2 billion.[3] At the time, it was known that the numbers could change significantly because the IRS had not yet processed all the returns filed with extensions in October 2018.[4]

The current statistics, based on a sampling of returns filed through June 2019 for tax years ending in 2017, are that corporations reported \$140 billion in Section 965 tax, with \$126 billion deferred.[5] Thus, it appears that the taxes collected in fiscal 2018 remain only a fraction of the \$78 billion estimated at the time of enactment. The data for the 2018 tax year, with taxes collected in 2019, is not yet available.

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 issued-focused compliance campaign and had assigned its most experienced tax examiners to manually process the Section 965 returns.[6]

2. Some taxpayers will receive soft letters.

The IRS says that it will send thousands of soft letters to taxpayers. Soft letters are an enforcement tool the IRS uses when it wants to reach many taxpayers. Soft letters are meant to put taxpayers on notice of issues.

IRS officials say they will send soft letters to taxpayers the IRS suspects may need to comply more fully with the repatriation tax. The IRS says it sends letters to taxpayers who may have misunderstood their reporting requirements or failed to obtain the necessary information relevant to their tax liabilities.

The IRS uses soft letters to encourage voluntary self-correction. A soft letter is not an examination. However, taxpayers who ignore soft letters risk the possibility of the IRS beginning an audit.

The Treasury Inspector General for Tax Administration report on Section 965 suggested that many taxpayers who are required to file Form 5471 could also have Section 965 reporting requirements, and many will have repatriation tax liability.[7] The IRS considered sending letters to those taxpayers prior to the 2018 filing season, to remind them of the Section 965 responsibilities, but decided not to because this group both did not include all taxpayers subject to Section 965, and included taxpayers who might not be subject to Section 965.[8]

We would not be surprised, however, to see many of these taxpayers receive soft letters asking about Section 965, and many audits of taxpayers who filed Form 5471 but did not report Section 965 liabilities.

3. Audits are set to begin this fall.

The IRS expects to begin auditing hundreds of taxpayers with respect to the Section 965 tax. The IRS announced that it will start placing Section 965 audits in its audit pipeline in October. Some of those audits will seek to identify taxpayers who did not report Section 965 liabilities but perhaps should have.

Based on IRS agency announcements and IRS official statements, taxpayers should expect the audits of taxpayers who reported Section 965 liabilities to focus on computational issues and definitional issues. In particular, the IRS will likely focus on taxpayers' earnings and profits calculations, classification of assets as cash versus noncash, and how taxpayers determined foreign tax credits, referred to as Section 965 elements.

Each of the Section 965 elements has a direct and significant effect on the amount of repatriation tax due. The U.S. Department of the Treasury regulations under Section 965 provide the IRS broad anti-abuse authority to disregard transactions undertaken with a principal purpose of changing a Section 965 element.

Taxpayers who engaged in transactions impacting a Section 965 element after Nov. 2, 2017, could be subject to examination and adjustment, even if the transactions were planned without consideration of Section 965. The IRS is likely to be interested in dividends or other distributions, liquidations or incorporations including checking or unchecking the box, cash transfers among related entities, and changes in methods of accounting.

It has been two years since taxpayers have computed their Section 965 tax liabilities. Taxpayers should take the opportunity to review their computations with fresh eyes. When reviewing their computations, taxpayers should ask themselves if they have an explanation and documentation for every decision made during the computation and if the IRS would find their documentation sufficient.

Earnings and profits may be a particularly difficult item. Section 965 requires inclusion in income of cumulative deferred foreign income after 1986. Deferred foreign income includes earnings and profits, except to the extent those earnings and profits were attributable to a U.S. trade or business or would be treated as previously taxed income if distributed.

Although taxpayers report accumulated earnings and profits, and adjustments to earnings and profits, on Form 5471 each year, substantiating earnings and profits from 1986 through 2017 could be a tall order. It remains unclear whether the IRS will accept Forms 5471 as substantiation of earnings and profits. Taxpayers who reported earnings and profits for Section 965 purposes differently than on Forms 5471 will have a significant burden.

As indicated above, taxpayers who engaged in cash-related transactions impacting their Section 965 calculation should anticipate examination of those transactions. Taxpayers should also consider whether they have taken any subsequent actions inconsistent with their classification of assets as cash or noncash. If they have, they should consult their tax advisers.

In anticipation of these audits, taxpayers should also consider potential defenses to accuracy-related penalties. Many taxpayers have had significant Section 965 tax liabilities; the sheer size of these liabilities means that even a minor adjustment could trigger the substantial understatement accuracy-related penalty.

To prepare for a reasonable cause defense, taxpayers should ensure they have documentation supporting their computations and classifications and what legal authority they relied on in making those computations and classifications. Likewise, if taxpayers relied on the advice of tax advisers, they should consider how they will handle any IRS requests for such advice and how to ensure they do not have any unintended privilege waivers.

Taxpayers should also remember that the IRS has longer than normal to audit their Section 965 tax liability. Usually the IRS has only three years to complete its examination and assess a tax liability. However, under Section 965(k), the IRS has six years to assess a Section 965 tax liability. Thus, just because a taxpayer's transition tax is not audited this fall does not mean the IRS will not audit it in the future. Taxpayers should retain their Section 965 documentation for the six-year period, at a minimum,

plus any agreed extensions.

4. Transition tax audits may not be limited to just the transition tax.

Transition tax audits may not be limited to just the transition tax. The IRS says that if it selects a return for a transition tax audit, it will risk-assess the return for other material issues. The IRS will focus on issues related to TCJA planning. Taxpayers whose returns are selected for audit should be prepared for the audit to expand to include TCJA provisions (e.g., base erosion and anti-abuse tax, global intangible low-taxed income, foreign-derived intangible income).

5. The IRS continues to refuse to issue refunds to taxpayers who have elected to pay the transition tax via installment payments.

We may begin to see lawsuits challenging the IRS' no-refund policy for taxpayers who elected to pay the Section 965 transition tax via installment payments.

When Congress enacted the Section 965 transition tax, it was estimated that some companies would have transition tax liabilities in the billions. To soften the blow, Congress allowed taxpayers to elect to pay the tax in installments over an eight-year period.[9] Unfortunately, such cash flow planning has been frustrated by the IRS' position that it cannot issue refunds to companies electing the installment payment option. 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.[10]

The IRS has expanded this position to the net operating losses allowed by the Coronavirus Aid, Relief, and Economic Security Act. As part of the CARES Act, Congress amended the Internal Revenue Code to allow taxpayers to carryback net operating losses arising in a taxable year beginning after Dec. 31, 2017, and before Jan. 1, 2021, to each of the five taxable years preceding the taxable year in which the loss arises. However, the IRS has said that taxpayers who made the election to pay the Section 965 transition tax will receive a refund only if their entire Section 965 transition tax liability is paid in full.[11] Arguably, such a position defies congressional intent to put cash back in the hands of businesses. Taxpayers should monitor legal developments to see if the IRS' position is challenged.

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[1] Internal Revenue Code Section 965; 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>.

[2] Id.

[3] TIGTA Report 2019-34-033 (May 22, 2019), Implementation of the Tax Cuts and Jobs Act Deemed Repatriation Tax Presented Significant Challenges at 15-16.

[4] Id.

[5] Table 1: Net Section 965 Liability By Industry, SOI Tax Stats, <https://www.irs.gov/statistics/soi-tax-stats-section-965-transition-tax>, discussed at Effect of IRC Section 965 Transition Tax on Domestic Corporations, Tax Year 2017, <https://www.irs.gov/pub/irs-soi/soi-a-co965-id2002.pdf>.

[6] 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.

[7] TIGTA Report 2019-34-033 (May 22, 2019), Implementation of the Tax Cuts and Jobs Act Deemed Repatriation Tax Presented Significant Challenges at 20-21. The TIGTA report estimates that over 51,000 taxpayers may be subject to Section 965, based on taxpayers which filed Forms 5471 and earnings and profits analysis. In adopting the regulations under Section 965, however, Treasury stated that "roughly 20,000" multinational corporations are expected to have been subject to Section 965. T.D. 9846, 84 F.R. 1848, 1873.

[8] Id.

[9] Section 965(h)(1).

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

[11] IRS Frequently asked questions about carrybacks of NOLs for taxpayers that have had Section 965 inclusions, <https://www.irs.gov/newsroom/frequently-asked-questions-about-carrybacks-of-nols-for-taxpayers-who-have-had-section-965-inclusions> (last visited August 14, 2020).