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Tax Notes

Are You Prepared for an IRC Section 965 Repatriation Audit?

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As part of the growing IRS compliance review campaign, there is now a direct focus on high-net-worth individuals, especially those who have formed private foundations and also those with international business activities. In addition, the IRS has announced they will be examining individuals and corporations that were required to pay a transition tax related to foreign earnings that were deferred from U.S. taxation. This tax became law as part of the Tax Cuts and Jobs Act (TCJA) passed at the end of 2017.

Although most U.S. individuals and companies have complied with the requirements, much guidance was released well after the initial attempts to comply. Accordingly, companies should reexamine their calculations and compliance and be prepared if the IRS comes knocking on the door.

Background

Pursuant to Internal Revenue Code §965, U.S. shareholders, including individuals, that directly or indirectly own at least 10% of the stock of a specified foreign corporation (SFC) are required to include in gross income their share of the SFC's accumulated post-1986 deferred foreign income as of the end of 2017 (generally referred to as their accumulated earnings and profits). The tax is included in the last taxable year of the SFC beginning before January 1, 2018, and the taxpayer must report this amount on their returns for the taxable year in which or with which their SFC's taxable year ends (generally, 2017 and/or 2018).

Effective tax rates differed between E&P related to cash assets vs. non-cash. Corporations, but not individuals, were able to use foreign tax credits to reduce their income inclusion.

Prior to the implementation of §965, U.S. tax on earnings of foreign corporations could generally be deferred until the foreign corporation paid a dividend. §965 essentially created a deemed dividend at the end of 2017, and was part of the transition to the new international tax system that allows free repatriation of foreign earnings, but also makes deferral more difficult.

The IRS recently announced it will address noncompliance through soft letters and examinations. In a recent communication, Douglas O'Donnell, Commissioner of the IRS's Large Business and International Division, stated the following:

- "We believe that there's a high likelihood of noncompliance in this space …"
- "The new code section is complex, and the taxpayers may have difficulty obtaining the information they need to compute shareholder liability, which may lead to errors."
- "In addition to audits, the division expects to send thousands of taxpayers letters this fall suggesting that they take a second look at what they've reported to the IRS and consider filing an amended return."

Implications

The §965 campaign aligns with the IRS's heightened focus on TCJA compliance. IRS representatives have indicated that the IRS will be looking closely at taxpayers' earnings and profits calculations, the classification of assets as cash versus non-cash, and how taxpayers determined their foreign tax credits, among other issues. Exam personnel will also look at how §965 intersects with other TCJA provisions, such as BEAT, GILTI and FDII. This is particularly significant given the extended six-year statute of limitations on assessments that applies to §965 liabilities.

Contact Us

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