

Repatriation Tax Audits: Managing IRS Enforcement Actions and Strategies for Tax Professionals

Calculating Section 965 Inclusions, IRS Regulations, Cash vs. Non-Cash or Non-Liquid Assets, Foreign Tax Credits

WEDNESDAY, NOVEMBER 4, 2020

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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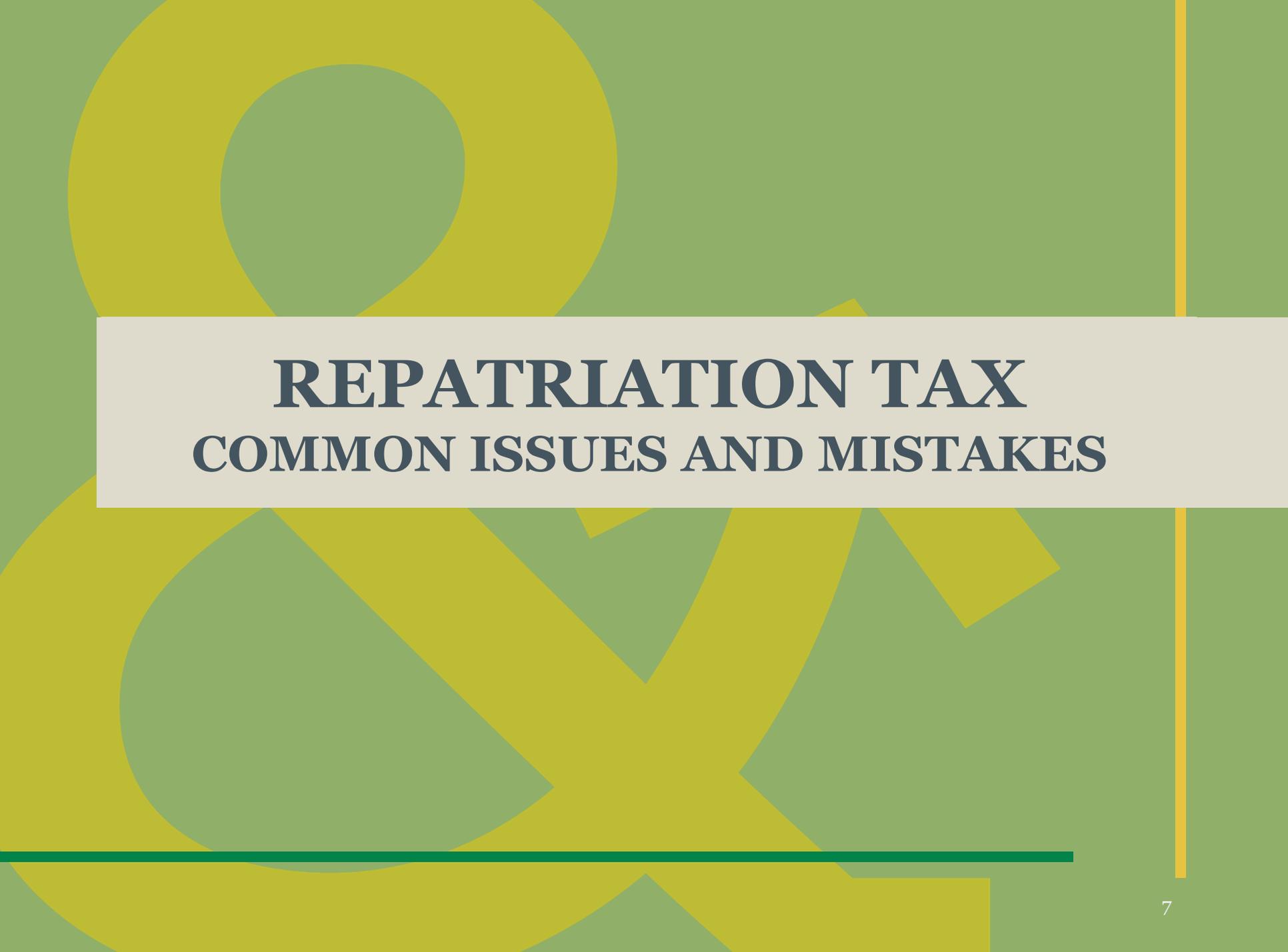
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REPATRIATION TAX AUDIT



REPATRIATION TAX

COMMON ISSUES AND MISTAKES

Background

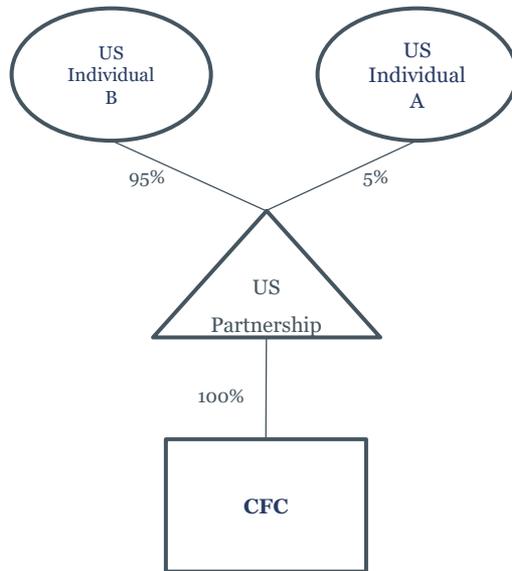
- **Repatriation Tax (Sec. 965) was enacted by Tax Cut and Job Act in late 2017**
 - November 2, 2017 House introduced the Tax Cuts and Jobs Act - House bill
 - December 22, 2017 TCJA is signed into law by President Trump and Sec. 965 enacted.
 - December 29, 2017 IRS released Notice 2018-07 (address issues of E&P calculation, cash position)
 - January 19, 2018 IRS released Notice 2018-13 (alternative method calculating E&P, cash position, attribution rules)
 - February 23, 2018 IRS released Rev. Proc. 2018-17 (prevents changes to the accounting period of CFC to reduce or delay transition tax, 52-53 week period CFCs)
 - March 13, 2018 IRS provided transition tax Q&A Q1~12 (address Sec. 965 reporting)
 - April 2, 2018 IRS released Notice 2018-26 (prevent the Sec. 965 avoidance, guidance of Sec. 965 reporting and payment)
 - April 13, 2018 IRS provided transition tax Q&A Q13~14 (estimated tax application)
 - June 4, 2018 IRS provided transition tax Q&A Q15~17 (late payment relief)
 - August 1, 2018 Treasury issued proposed Sec. 965 regulations.
 - October 1, 2018 IRS Notice 2018-78 basis election can be made 90 days after final regulations.
 - January 15, 2019 Treasury issued final Sec. 965 regulations.
 - June 27, 2019 IRS provided repatriation tax Q&A for both 2017 and 2018 (payment obligations, triggering event and transfer agreement).

Background and General Issues

- Sec. 965 was enacted by Tax Cut and Job Act in late 2017 (introduced on November 2 and enacted December 22, 2017).
- A very high level summary of Sec. 965:
 - Certain US taxpayers are required to include in Subpart F income their share of specified foreign corporations' (SFC) accumulated foreign earnings and profits for the last year of the SFC's accounting year that began before January 1, 2018.
 - For the US taxpayers that own interests of multiple SFCs, the deferred foreign earnings and deficits should be aggregated with all the SFCs. The deferred foreign earnings are the greater of the accumulated foreign income of a SFC determined as of November 2, 2017 or as of December 31, 2017. However, the deficits of a SFC's foreign earnings should be determined as of November 2, 2017.
 - It is a mandatory one-time tax on SFCs' deferred foreign earnings. The tax rate is lower than the regular US tax - i.e., the repatriation tax rate is between 8%~15.5% depending on SFC's aggregate foreign cash position (for US corporate taxpayers).
 - Cash position means cash and cash equivalent assets (e.g., FMV of actively traded property, CD, government securities, short-term obligations) plus net account receivables (if any).
 - S-corporation shareholders can elect deferral of the repatriations tax payment indefinitely until a triggering event. Corporations, individuals, trusts and estates can elect 8-year annual installment payments for the net repatriation tax liability.

Common Mistakes and Potential Issues

- **Repatriation tax is not limited to US Shareholders** (as defined under Sec. 951(b))
 - US persons (that are not US Shareholder of a SFC) who are partners or shareholders of US flow-through entities (that are US shareholder of the SFC) could still be subject to repatriation tax.

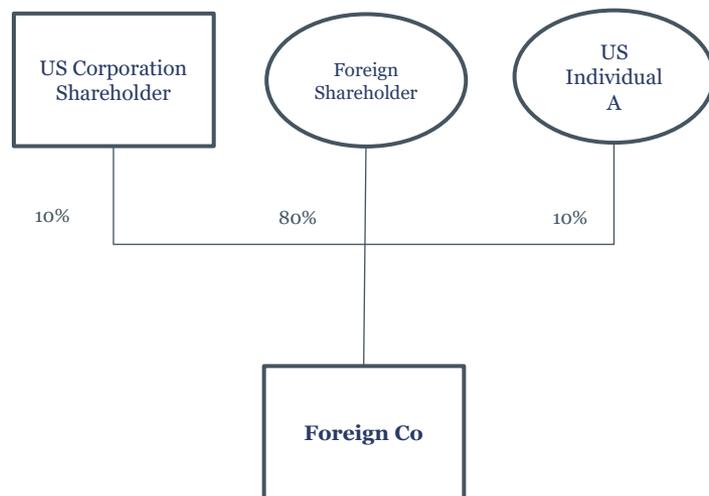


- US Individual A received a K-1 from US Partnership, which listed the Sec. 965(a) and 965(c) amounts. US Individual A reports the net Sec. 965(a) amount as other income. US Individual A had to separately calculate the repatriation tax liability by comparing the tax difference between “with and without deemed repatriation earnings”. (See Appendix I for repatriation tax reporting guidance).
- US Partnership K-1 may not include all the information necessary for partners to calculate the repatriation tax (such as cash positions, foreign tax credits). In this case, the US partners should request additional information from the partnership.

- **There are no de Minimis rules or safe harbor rules for repatriation tax**

Common Mistakes and Potential Issues - cont'd

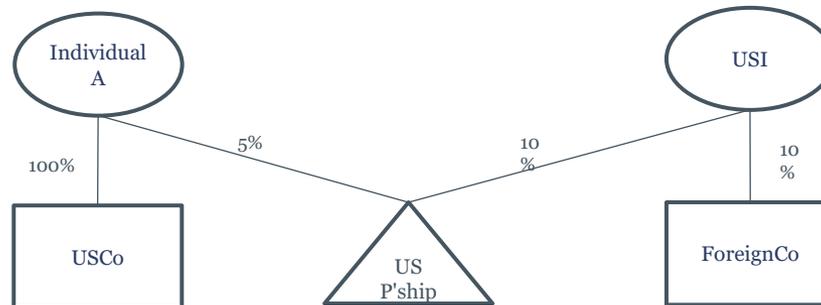
- **SFC is not limited to controlled foreign corporations (CFC)**
 - Certain non-CFC could also give rise to repatriation tax (IRC 965(e)(1)(B))



- In this case, Foreign Co is not a CFC. However, Foreign Co has a 10% US corporation shareholder. Therefore, Foreign Co should be treated as a SFC. US Individual A must include 10% of the deferred earnings of Foreign Co and be subject to repatriation tax.

Common Mistakes and Potential Issues - cont'd

- **Downward attribution rules apply for purposes of repatriation tax**



- Under Sec. 958(b) and Sec. 318(a)(3)(A), a US Partnership is treated as owning 100% of USCo and 10% of ForeignCo.
- Further, the 10% of ForeignCo should be treated as owned by USCo, which would cause ForeignCo to be a SFC (as it has a 10% US corporate shareholder). As a result, USI is subject to repatriation tax rules with respect to ForeignCo.
- **The issue is how would USI know what Individual A owns?**

Common Mistakes and Potential Issues – cont'd

- **Common elections under Sec. 965**
 - Sec. 965(i) election – S corporation shareholders elect to defer repatriation tax indefinitely until a triggering event. The election must be made by the shareholder of an S corporation rather than the S corporation.
 - Sec. 965(h) election – US taxpayers elect to pay the repatriation tax under 8-year annual installments. The election must be made by US taxpayers rather than flow-through entities.
 - Sec. 965(n) election – US taxpayers elect not to apply net operating loss (NOL) deduction against the deemed repatriation income. Also see the interaction with CARES Act NOL carryback provisions (Rev Proc. 2020-24).
 - According to the statute, the above elections should be made on the timely filed income tax returns (including extensions, if any). If the elections were not made on the originally filed returns, they may not be made on the amended tax returns. Also see IRS Q&A about Reporting Related to Sec. 965 on 2017 Tax Returns (#12).
- **Common triggering events of accelerating the deferred repatriation tax liability**
 - S corporation shareholders exit or the ownership changes
 - US taxpayer terminated his/her US residency
 - US taxpayer, directly or indirectly, sold the SFC stock
 - Reorganization
 - Failed to make installment payments
 - In some cases, the deferred repatriation tax liability could be transferred (or assumed by another party) without being accelerated
- **Reporting of certain common elections under Sec. 965 (see next pages)**

IRC 965 Transition Tax Statement (Portable Document Format with a filename of '965 Tax')

Taypaper Name: _____

SSN/FEIN: _____

Item

Amount

Total amount required to be included in income by reason of section 965(a).

Line 1 \$ _____

Aggregate foreign cash position, if applicable.

Line 2 \$ _____

Total deduction under section 965(c).

Line 3 \$ _____

Total deemed paid foreign taxes associated with the total amount required to be included in income by reason of section 965(a).

Line 4a \$ _____

Total deemed paid foreign taxes disallowed pursuant to IRC 965(g)(1).

Line 4b \$ _____

Total net tax liability under section 965 (as determined under section 965(h)(6), without regard to whether such paragraph is applicable), if applicable, which will be assessed.

Line 5 \$ _____

Amount of the net tax liability under section 965 to be paid in installments under section 965(h), if applicable.

Line 6 \$ _____

Listing of applicable elections under section 965 or the election provided for in Notice 2018-13 that the taxpayer has made, if applicable.

<u>Provision Under Which Election is Made</u>	<u>Title</u>	<u>Attached (Y or N)</u>
Section 965(h)(1)	Election to Pay Net Tax Liability Under Section 965 in Installments under Section 965(h)(1).	
Section 965(i)(1)	S Corporation Shareholder Election to Defer Payment of Net Tax Liability Under Section 965 Under Section 965(i)(1)	
Section 965(m)(1)(B)	Statement for Real Estate Investment Trusts Electing Deferred Inclusions Under Section 951(a)(1) By Reason of Section 965 Under Section 965(m)(1)(B)	
Section 965(n)	Election Not to Apply Net Operating Loss Deduction under section 965(n)	
Notice 2018-13, Section 3.02	Election Under Section 3.02 of Notice 2018-13 to Use Alternative Method to Compute Post-1986 Earnings and Profits	

Under penalties of perjury, I declare that I have examined this statement, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.



Signature of Taxpayer and/or Officer

Common Reporting Mistakes

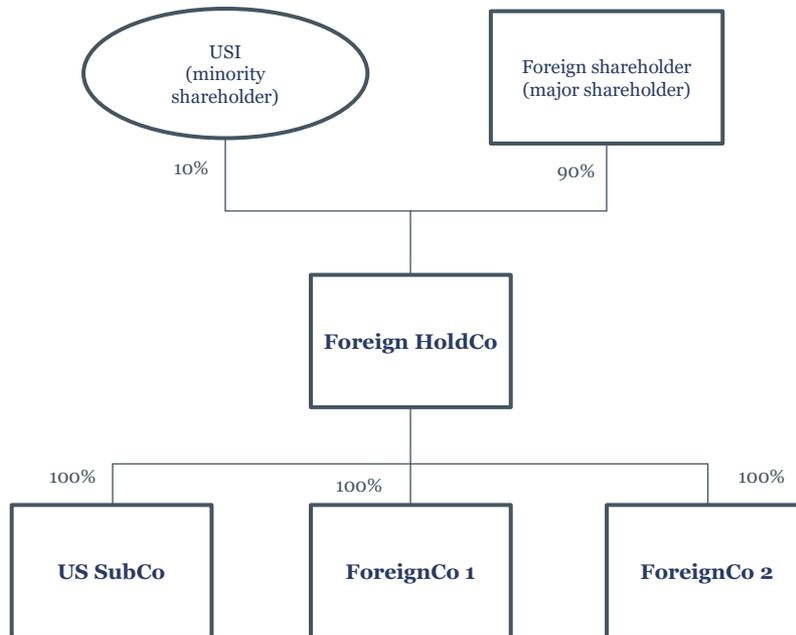
- **Form 965 series were published for 2018 tax year reporting**
 - In addition to reporting any 2018 repatriation tax, US taxpayers who were subject to 2017 repatriation tax must report the 2017 repatriation tax calculation again on the 2018 year Form 965 and related schedules.
 - 2018 Form 965 should be consistent with 2017 Sec. 965 statement.
- **Additional reporting requirements post-2018 to disclose the net Sec. 965 tax liabilities.**

Such as:

 - Form 965-A: Individual Report of Net 965 Tax Liability
 - Form 965-B: Corporate and REIT Report of Net 965 Tax Liability

Other Potential Issues Related to Repatriation Tax

- **An M&A example**



Assuming USI (US individual) has invested 10% in a foreign group 10 years ago, as depicted on the left. All the entities have December accounting year end. USI is considering a sale of the 10% investment of Foreign HoldCo in 2020. Both ForeignCo 1 and Foreign Co 2 have deferred foreign earnings at the end of 2017.

- ForeignCo 1 and ForeignCo 2 should be treated as SFC due to the downward attribution rules (i.e., constructively owned by US SubCo). USI should be required to include 10% of the deferred earnings of ForeignCo 1 and ForeignCo 2.
- Upon sale of the 10% ownership of Foreign HoldCo, should the stock basis of Foreign HoldCo be adjusted by the deemed repatriation earnings of ForeignCo 1 and ForeignCo 2?

Appendix I

Reporting Repatriation Tax

- Form 1040 - Individual income tax returns
- Form 1120s – S corporation income tax returns
- Form 1041 – Estate and Trust income tax returns
- Form 1065 – Partnership income tax returns
- Form 1120 – US Corporation income tax returns

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Section 965

IRS Enforcement

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IRS Sets Its Sights on 965

- The IRS has announced three campaigns that will bring audit scrutiny to Section 965 liabilities of companies and individuals.
- In this section we will cover:
 - IRS enforcement priorities in this area,
 - What to do to prepare for audit and beyond,
 - Section 965 anti-abuse rules,
 - Challenges to Section 965 guidance.

IRS Section 965 Campaign

- On November 4, 2019, the IRS announced a Section 965 compliance campaign to provide technical assistance to Exam teams, with a focus on identifying and addressing taxpayer populations with potential material compliance risk
- 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:
 - 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;
 - definitional issues such as determining what constitutes cash and cash equivalents; and
 - the anti-abuse rules in Treas. Reg. section 1.965-4 relating to reducing the section 965 inclusion

IRS Section 965 Campaign (cont.)

- Focus on large Section 965 inclusion taxpayers
 - Use filters to identify other potential high-risk filers – for example, those who filed Forms 5471 with positive earnings and profits
- Include conducting examinations and providing technical assistance to IRS teams on Section 965 compliance examinations
 - Focus on identifying taxpayer populations with potential material compliance risk
- Start with 2017 returns; likely expand to 2018 returns for those selected
- Exam will review other international provisions of the TCJA, especially for 2018, and examine those issues where appropriate
- Based on its interaction with CAP taxpayers, IRS expects litigation on substantive Section 965 issues
- Review notifications issued beginning January 1, 2020

TCJA Compliance Campaign

- On May 1, 2020, LB&I announced a campaign focused on the changes in taxpayer behavior under TCJA, which will undoubtedly include examination of Section 965.
- “LB&I has initiated the TCJA Campaign to closely monitor issues on a select pool of returns and share information learned throughout LB&I and the IRS. LB&I is also considering the impact of the Coronavirus Aid, Relief and Economic Security (CARES) Act on these returns as well as any others examined. The goal of this campaign is to identify transactions, restructuring and technical issues and better understand taxpayer behavior under the new law.”
- Campaign will include outreach, soft letters, and examinations.

Individual Taxpayers' Section 965 Liability

- In July of this year, the IRS added a campaign focused on individual taxpayer compliance with Section 965.
- “Pursuant to the changes to IRC §965 under the Tax Cuts and Jobs Act, 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 for the last taxable year of the SFC beginning before January 1, 2018, and 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).”
- Campaign will include soft letters and examinations.

What to Expect and How to Prepare

- Despite the challenges that were present when Section 965 liabilities were initially calculated, taxpayers must be ready to answer IRS questions that may be raised in audit.
- Expect careful review of calculations.
- You will be asked to provide backup for your: Total amount required to be included in income by reason of section 965(a), aggregate foreign cash position, total deduction under 965(c), total deemed paid foreign taxes associated with the total amount required to be included in income by reason of section 965(a), total deemed paid foreign taxes disallowed pursuant to section 965(g)(11).
- You will also need to provide detailed information and backup regarding distributions and your Section 78 gross-up.

What to Expect and How to Prepare

- Ask yourself:
 - Do you have this information readily available?
 - Is it segregated from other information, especially privileged information?
 - Do your calculations match 5471 reporting?
 - Review your calculations to ensure accuracy.
 - E&P
 - FTC
 - Were your calculations done internally? Consider engaging third party to do careful review, possibly under *Kovel* agreement.

What to Expect and How to Prepare

- Ensure that you have adequate documentation to explain what was included vs. excluded, and what is cash and cash equivalent vs. other.
 - Do you have a clear record of categorization? Is that categorization consistent?
 - What documentation do you have of why those decisions were made? Could you articulate why you drew the lines you did if asked tomorrow?
 - Best is always contemporaneous documentation, but given the lack of guidance and compressed timeline
 - Are you relying on advice of tax advisor or counsel?
 - If penalties are asserted, you may need to rely on reasonable cause defense.
- *Remember the 6 year statute of limitations and check that you have a document retention policy that will prevent automatic destruction of documents that might be relevant to your calculations.

Preparing to Defend on Anti-Abuse Issues

- Anti-avoidance rules require transactions, changes in method, or entity classifications that change a “965 element” be disregarded for purposes of calculating 965 liability.
- In audit, you will be asked to list:
 - E&P corrections and whether an amended return was filed to correct US tax calculations,
 - List of changes to method of accounting or annual accounting periods,
 - All cash reducing transactions,
 - All E&P reducing transactions,
 - Pro Rata share transactions,
 - Changes in methods of accounting, and
 - Changes in entity classification.

Preparing to Defend on Anti-Abuse Issues

- Some transactions are deemed “per se” avoidance transactions, and will be disregarded whether or not they were undertaken to avoid liability or not.
- Other transactions create a presumption of avoidance, but taxpayers may rebut that presumption. Whether or not a transaction was undertaken to reduce 965 liability, is a facts-and-circumstances inquiry. A taxpayer with this transaction, must attach a statement to their return stating that they have rebutted the presumption.

Preparing to Defend on Anti-Abuse Issues

- Have you conducted a thorough review of all transactions, and analyzed their effect on your 965 calculation?
- If you have “per se” transactions, did you disregard them for purposes of your 965 calculation?
- If you filed a statement of rebuttable presumption, prepare to explain those transactions, especially their business purpose.
- Have an advisor conduct a review of those transactions.
- Collect documentation of these transactions that will assist you in contextualizing them for the IRS.
- For presumption transactions, it is **YOUR BURDEN OF PROOF**. If you cannot meet that burden, the transaction, or change in method will be disregarded.

Challenges to the Section 965 Guidance

- “Overpayment rule” already challenged
- Challenges have already been mounted to Section 965 Regulations, and more may be coming.
 - Remember that there are three types of challenges to regulations:
 - “Procedure” Challenges
 - Agency did not comply with formal requirements of APA rulemaking
 - “Process” Challenges
 - Agency did not exercise “reasoned decision making”
 - “Outcome” challenges
 - Regulation cannot stand where it is manifestly contrary to the statute