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The IRS has begun to communicate with individual taxpayers as part of a formal campaign to review calculations of the IRS §965 transition tax paid on the untaxed foreign earnings of certain foreign corporations.

If you have any questions about the Section 965 transition tax, contact our tax team at 410-862-4220 or fill out our online form.

The Transition Tax Campaign and Small Business — Soft Letters for a Hard-Luck Provision

By Peter Palsen

Background

In early 2020, the IRS announced a formal campaign to examine individuals' transition tax calculations—spearheaded by the IRS Director, Withholding and International Individual Compliance. The individual campaign is an offshoot of a broader 2019 campaign to review transition tax calculations as well as certain planning conducted mostly by large companies. The IRS has over 50 campaigns in place to allocate resources to examine issues that are common among many taxpayers.

Recently, as part of this campaign, the IRS has begun to send what it calls "soft letters" to some taxpayers who owned foreign corporations in 2017, and who could thus be expected to be subject to the transition tax. While a soft letter does not require a specific reply, an opportunity is provided to amend a prior return (referencing the letter). By encouraging self-compliance, the IRS can dedicate its limited resources to other taxpayers.

Impact of the Transition Tax on Small Businesses

The new IRC §965 transition tax was one of only a handful of provisions of the TCJA to take effect on 2017 tax returns. Since the TCJA was signed into law on December 22, 2017, with little legislative guidance, small business taxpayers and their limited pool of international-savvy advisors were forced to quickly address the complex and math-heavy rules.

To put the transition tax effort in context, the revenue target was $338 billion and Treasury regulations noted that the rules could impact up to 100,000 taxpayers—tens of thousands of which would be small businesses.

The Treasury Department and the IRS made a noble effort to issue guidance through the tax filing season, including a running Q&A, a series of notices, templates contained in Publication 5292—and a helpful, yet lengthy set of proposed regulations issued in August 2018.

The changes made by the TCJA were viewed as so complex that the U.S. Securities and Exchange Commission provided public companies with additional time to complete their mandatory financial reporting, citing an example involving the need to determine the transition tax liability. Another indication of the complexity of the calculations is that new IRC §965(k) provides the IRS with an extension of the statute of limitations for an additional three years to assess the tax liability.

Despite clear and numerous indicators of distress, small businesses received no specific relief. In fact, they received an unwelcome surprise in 2018 when the IRS created a mandatory Form 965 that required taxpayers impacted by the transition tax in 2017 to show all of their math on their 2018 tax return—forcing many taxpayers to rebuild the details from high-level determinations spanning up to 30 years of earnings.

Ultimately, the burdensome impact on small business was brought to light in several legal actions against the government, including most notably the case of expatriate and small businessman, Monte Silver.

Silver v. IRS: A Small Business Fights Back

Silver is a dual citizen of the U.S. and Israel. He resides in Israel and owns an Israeli corporation through which he conducts his legal business. Early in 2019, Silver filed suit on behalf of himself and his corporation (which has one employee—Silver) to seek relief that could be applied broadly to the tens of thousands of impacted small businesses (including an estimated 20,000 or more owned by U.S. citizens living abroad). The cost of filing the initial action was crowdfunded—a classic small business move!

The U.S. government pushed back on the filing by asserting that Silver and his law firm were not small businesses. Although Silver reminded the government that you can't get any smaller than one employee, the reply was that the determination of "small business" for purposes of transition tax obligations was based on the Small Business Administration criteria—which requires U.S.-based activity. Silver's legal action is ongoing.

With respect to small businesses that do have U.S. activity, the Treasury has generally suggested they are neither sufficiently sophisticated nor resourced to have the extent of foreign corporate activity to warrant broad small business relief. This conclusion that small businesses would not be broadly impacted by the transition tax is surprising given the high estimate of impacted taxpayers and the allocation of sparse IRS resources to launch a campaign to examine compliance of individual business owners.

A "Do-Over" for Small Business Owners

The IRS's announcement of its individual campaign indicated that the IRS would address potential noncompliance through soft letters and examinations. Those letters are now being received by individual taxpayers, reminding them of their obligations under new IRC §965 (including associated disclosure requirements including Form 965). The IRS has been using soft letters in other compliance campaigns for several years. According to statements made by IRS representatives in the past, a typical soft letter is not an examination and there is no formal obligation of a taxpayer to respond.

Following a decade of budget cuts that has trimmed IRS enforcement staff by approximately 25%, the IRS currently has around 75,000 total employees. Reviewing up to 100,000 potentially impacted taxpayers will be a challenge—even with an extra three years. In that light, it makes sense for them to encourage taxpayers to self-review their calculations—and possibly, those who amend their returns and reference the soft letter ID number can avoid further intrusions.

Whether you received the letter or not, you may benefit by reviewing the calculation in order to be prepared in the event of an examination. Furthermore, as previously noted, there are incentives available to minimize the tax cost. And finally, income included under new IRC §965 is generally available to be distributed without a further tax cost (even if you elected to pay over time), or it can be used to reduce future capital gains on the sale of the foreign corporation.

Takeaway

Ideally, as the IRS pursues its campaign, it should take into consideration the challenges that many small business owners faced to timely and accurately comply with the transition tax. Perhaps Monte Silver has effectively succeeded in making the case that large numbers of small businesses were harshly impacted by the transition tax. Whether as a result of a soft heart or resource constraints, the IRS is now giving taxpayers a do-over that many should welcome.