LATHAM&WATKINS

Client Alert Commentary

Latham & Watkins Tax Controversy Practice

July 13, 2018 | Number 2347

IRS Launches New Compliance Campaigns on Repatriation of Foreign Earnings and Virtual Currency

LB&I has announced compliance initiatives regarding the Section 965 Transition Tax, Repatriation via Foreign Triangular Reorganizations, and Virtual Currency transactions.

Key Points:

- The IRS continues its efforts to educate taxpayers regarding Section 965[1] and the one-time transition tax on untaxed foreign earnings while also increasing scrutiny of cross-border triangular reorganizations.
- The IRS is doubling down on its position that virtual currency should be treated as property for federal income tax purposes and warns that there are no plans to implement a voluntary disclosure program for unreported gains.

Last year, the Large Business & International Division (LB&I) of the IRS replaced its tiered issue program with a series of compliance initiatives referred to as "compliance campaigns." The campaigns are intended to improve tax compliance with respect to certain "hot" tax issues, and coincide with LB&I's transition to issue-based examinations. Over the past 18 months, LB&I has introduced 40 such campaigns, with the most recent five announced on July 2, 2018. The newly announced campaigns consist of (1) the Section 965 Transition Tax, (2) Repatriation via Foreign Triangular Reorganizations, (3) Virtual Currency, (4) S Corporation Distributions, and (5) Restoration of Sequestered AMT Credit Carryforward. The campaigns will target taxpayers through several treatment streams, from soft letters (pre-audit notices to taxpayers identifying potential campaign issues and encouraging compliance) to issue-based examinations. This *Client Alert* discusses the first three of these recently announced compliance campaigns.

Repatriation of Foreign Earnings

The IRS has announced two campaigns that concern repatriation of foreign earnings: (1) the Section 965 Transition Tax, and (2) Repatriation via Foreign Triangular Reorganizations. These campaigns stem from the December 2017 enactment of the Tax Cuts and Jobs Act (TCJA), which fundamentally changed the treatment of Subpart F income. Under amended Section 965, US shareholders generally pay a one-time transition tax on the untaxed foreign earnings of certain foreign corporations as if those earnings had been repatriated. As discussed in a recent Latham & Watkins White Paper, calculation of the transition tax liability is complex, but fundamentally based on two numbers, post-1986 earnings and the amount of cash or cash equivalents held by a foreign corporation. Taxpayers may elect to pay the transition tax in installments over an eight-year period.

The IRS's inclusion of the new transition tax as a compliance campaign is one of several recent actions taken to alert and educate potentially impacted taxpayers as they transition to a partial participation dividends-received deduction tax regime:

IRS GUIDANCE ON SECTION 965 TRANSITION TAX	
Notice 2018-7	Describes regulations that Treasury and the IRS intend to issue addressing the application of Section 965
Notice 2018-13	Provides additional guidance on future regulations, including that the gain reduction rule described in Notice 2018-7 also applies to distributions received from a deferred foreign income corporation (DFIC) through a chain of ownership described in Section 958(a)
Notice 2018-26	Describes additional regulations covering a number of topics including anti-avoidance rules, procedural requirements for making certain elections, and reporting and payment
Publication 5292	Describes how to calculate and report the transition tax
Section 965 FAQ	Includes questions and answers regarding reporting and payment of the transition tax

The Section 965 transition tax campaign follows this chain of outreach in an effort to raise awareness concerning filing and payment obligations. Notably, however, the one-time repatriation provision under the American Jobs Creation Act of 2004 generated controversies and indeed litigation.[2] Although that provision was based on a different statutory infrastructure, it is reasonable to assume that the TCJA version of Section 965 will generate some level of controversy, given the amounts at stake and so many factual variables in the marketplace.

While the Section 965 transition tax campaign appears to stem from the IRS's education and guidance efforts, the related campaign on foreign triangular reorganizations takes a different tone. The stated goal of the campaign on repatriation via foreign triangular reorganizations is to "identify and challenge these transactions by educating and assisting examination teams in audits of these repatriations."

The IRS has considered cross-border triangular reorganizations — also referred to as Killer B transactions — as being used to facilitate repatriation of untaxed foreign earnings without incurring US federal income tax. Variations on the transaction involving different structures have been subjected to a string of published guidance starting in 2006 and continuing through Notice 2016-73 which sought to curtail the practice by describing future modifications to the regulations under Section 367.[3] The recently announced compliance campaign appears to continue this trend of the government taking aim at triangular reorganizations. While other compliance campaigns announce the intention of sending out soft letters and raising taxpayer awareness, the triangular reorganization campaign appears directed at exam teams.

Virtual Currency

In 2014, the IRS published Notice 2014-21, announcing that it considers transactions with convertible virtual currency (sometimes referred to as digital currency or cryptocurrency) to be taxable just as any other transaction in property would be. The Notice is the only substantive guidance issued by IRS with respect to virtual currency and makes clear that the IRS does not consider virtual currency to be legal tender. The scope of the Notice is limited to convertible virtual currency, such as Bitcoin (*i.e.,* virtual currency that has an equivalent value in real currency, or acts as a substitute for real currency). The Notice does not address the tax treatment of Initial Coin Offerings (ICOs) or other forms of virtual currency that do not have a current equivalent value in real currency.

The Notice describes several significant tax principles for convertible virtual currency:

- **Gain/Loss:** The fair market value of virtual currency received as payment for goods or services must be included when calculating gross income. Fair market value is measured in US dollars as of the date that the virtual currency was received, and gain or loss is recognized upon the sale or exchange of virtual currency (regardless of whether it was exchanged for cash, property, or other virtual currency).

- **Character:** The character of any gain or loss will depend upon whether the virtual currency was a capital asset in the hands of the taxpayer (*i.e.*, stocks, bonds, or other investment property).

- **Mining Realization Event:** A taxpayer who "mines" virtual currency (*i.e.*, electronically validates virtual currency transactions and maintains the public transaction ledger — see the Latham & Watkins primer on cryptocurrency), realizes gross income when he or she successfully mines virtual currency. As such, the taxpayer must include the fair market value of the virtual currency as of the date of receipt.

- **Self-Employment Tax:** If a taxpayer's mining activities constitute a trade or business, and the activities are not undertaken by the taxpayer as an employee, the net earnings resulting from those activities constitute self-employment income and are subject to the 15.3% self-employment tax.

- **Withholding and Reporting:** Payments made using virtual currency are subject to backup withholding and information reporting to the same extent as any other payment made in property. Wages paid in virtual currency are subject to federal income tax withholding, Federal Insurance Contributions Act tax (FICA), and Federal Unemployment Tax Act tax (FUTA) and must be reported on Form W-2.

Two years after issuing the Notice, the Treasury Inspector General for Tax Administration (TIGTA) issued a report that was highly critical of the IRS's efforts with respect to virtual currency tax enforcement and compliance. Among its findings, TIGTA concluded that there had been little evidence of coordination within the IRS to identify and address taxpayer noncompliance issues and no compliance initiatives had been developed. Since issuing the report, TIGTA has highlighted the lack of an IRS virtual currency compliance initiative in each of its semiannual reports to Congress. This is the backdrop against which the IRS announced its recent virtual currency compliance campaign.

The campaign seeks to educate taxpayers about the tax principles above, and encourage the correction of prior returns to report virtual currency transactions. The announcement thus affirms the IRS's position that virtual currency is not legal tender and should be taxed as property. Notably, despite the IRS's insistence that taxpayers amend prior returns, the announcement further states that the IRS is not

currently planning a specific voluntary disclosure program to facilitate such reporting. Accordingly, it is unclear how effective the compliance campaign will be in substantially reducing the apparent gap between reported and unreported virtual currency transactions.

The IRS's 2014 guidance leaves many of the most difficult questions concerning the taxation of virtual currency unanswered. Nevertheless, taxpayers with misreported or previously unreported income from virtual currency transactions should seriously consider proactively coming into compliance now to avoid the risk of more aggressive enforcement activity that is likely in the near future.

Final Thoughts

Taxpayers will benefit from the transparency these compliance campaign announcements achieve. For example, taxpayers engaged in a transaction described in a compliance campaign should not be surprised to receive from the IRS a soft letter or additional inquiries from an examination team concerning the taxpayer's reported position. Accordingly, taxpayers should take steps to ensure campaign-related issues are well-documented, including an assessment of documents potentially subject to privilege.

Finally, while the compliance campaign initiative has drawn some lines in the sand — such as not initiating a virtual currency voluntary disclosure program — the IRS will likely have new leadership this year. Consequently, any announced initiative may be subject to change.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Nicholas J. DeNovio
nicholas.denovio@lw.com
+1.202.637.1034
Washington, D.C.

Andrew C. Strelka
andrew.strelka@lw.com
+1.202.637.1006
Washington, D.C.

Miriam L. Fisher
miriam.fisher@lw.com
+1.202.637.2178
Washington, D.C.

Shannon Fiedler
shannon.fiedler@lw.com
+1.617.880.4634
Boston

Brian C. McManus
brian.mcmanus@lw.com
+1.617.948.6016
Boston

Jason B. Grover
jason.grover@lw.com
+1.202.637.1037
Washington, D.C.

Jean A. Pawlow
jean.pawlow@lw.com
+1.202.637.3331
Washington, D.C.
Silicon Valley

Stephen N. Shashy
stephen.shashy@lw.com
+1.202.637.1005
Washington, D.C.

You Might Also Be Interested In

US Tax Reform Resource Center

We've Got Washington Covered

New Guidance Issued for Transition Tax on Deferred Foreign Earnings

Endnotes

1 All references to "Section" are to the Internal Revenue Code of 1986, as amended.

2 *See, e.g., Analog Devices, Inc. v. Commissioner*, 147 T.C. No. 15 (Nov. 22, 2016) (accounts receivable payable by a CFC to a related party under a closing agreement did not reduce the amount allowed as a temporary dividends-received deduction under former Section 965).

3 Notice 2016-73 announced future modifications to the Section 367 regulations regarding the treatment of property used to acquire parent stock or securities in some triangular reorganizations involving foreign corporations and to modify the amount of an income inclusion required in some inbound nonrecognition transactions. The IRS has previously issued no fewer than four similar notices announcing its intent to issue regulations to further circumscribe the use of triangular reorganizations, resulting in a procession of changes to Treas. Reg. §§ 1.367(b)-1 through 1.367(b)-13 as well as the regulations under Section 7874. *See, e.g.*:

Notice 2014-32, 2014-20 I.R.B. 1006 (05/12/2014): https://www.irs.gov/pub/irs-irbs/irb14-20.pdf

Notice 2009-78, 2009-40 I.R.B. 452 (10/05/2009): https://www.irs.gov/pub/irs-utl/irb09-40.pdf

Notice 2007-48, 2007-25 I.R.B. 1428 (06/18/2007): https://www.irs.gov/pub/irs-irbs/irb07-25.pdf

Notice 2006-85, 2006-41 I.R.B. 677 (10/10/2006): https://www.irs.gov/pub/irs-irbs/irb06-41.pdf.

Further, on July 11, 2018, Treasury and the IRS issued final regulations that include special definitions and rules with respect to triangular reorganizations. *See* Treas. Reg. § 1.367(b)-4(g) (as amended by T.D. 9834). These regulations, which pertain to corporate inversions and related transactions, will be the subject of a forthcoming Latham *Client Alert*.